

Mexico looks to Denmark on mortgage-backed securities

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In recent years Mexico has produced a growing number of mortgage-backed securities transactions similar to MBS transactions in the United States. In many of the Mexican transactions, mortgage lenders, mainly limited-purpose financial companies organised in Mexico as *Sociedades Financieras de Objeto Limitado* or SOFOLs,² have transferred portions of their mortgage loan portfolios to special-purpose vehicles or entities (SPVs) that have issued securities backed by such loans. Some of this activity has occurred in the growing Mexican market for the securities called *certificados bursátiles*. This growth was made possible by a sharp increase in the volume of Mexican pension funds since the Mexican pension system began to be transformed about 10 years ago. Despite this activity, increasing attention is being given to a new model for the development of the MBS market in Mexico. The new system would draw on the system in use in Denmark for over 150 years, in which mortgage loans are securitised more directly than under the US model and in which SPVs would be avoided or greatly simplified.

TRADITIONAL SPV RATIONALE FOR MBS STRUCTURES

SPVs have been utilised in the US market mainly because they enable mortgage lenders to transfer loans off their balance sheets, freeing up capital for new loans. They also serve to assure MBS investors that the mortgage loans backing the MBS instruments meet standard criteria. They must be separated from the rest of the mortgage lender's portfolio, which may not necessarily meet the same high standards as those that back the MBS instruments. In order to achieve investor objectives in this regard, the transfers of loans to the SPVs must be accomplished in a way that will ensure that investors do not run the risk of the originating mortgage lender's bankruptcy. The SPV must therefore be bankruptcy-remote and the transfer of the loans must be a "true sale". Unfortunately, this approach involves substantial costs - including the costs of creating the SPV, obtaining assurances as to a true sale and bankruptcy-remoteness, investment bankers' fees, etc. - which add to financing costs and indirectly to the costs assumed by the mortgage borrowers and reflected in the interest rates borne by them.

There are also concerns that this traditional approach to MBS securitisation is not sufficiently transparent to investors, who do not necessarily receive complete information about the nature and quality of the mortgage loans that underly the MBS offerings. The SPV process has also been criticised for doing little to ensure the safety and soundness of mortgage lenders, which continue to bear interest rate risk on the portions of their portfolios that have not been securitised. Mexican finance authorities will want to prevent the SOFOLs from falling into the kind of financial crisis that afflicted the Mexican banking system in 1994-95, when most Mexican banks effectively became insolvent and were eventually acquired by foreign banks.

ATTRactions OF THE DANISH SYSTEM

As a recent study for the Bank for International Settlements³ has illustrated, the Danish mortgage finance system avoids many of the problems associated with the MBS system developed in the US. Among other things, Danish mortgage lenders incur less interest rate/market risk and prepayment risk than do their counterparts in the US and Mexico. This is because Danish lenders finance their lending more directly through the Danish MBS market than lenders in other countries. A Danish lender typically skips the SPV step and, rather than fund its loans through borrowings, funds them through the issuance of its securities directly in the market. This is encouraged by the Danish Government's promotion of the "balance principle", which provides that each lender's mortgage loans should be directly balanced by market funding, to avoid a mismatch between the rates paid for funding and the rates charged to borrowers.⁴

Thus mortgage lenders such as Nykredit issue securities on the basis of periodic MBS series - every 12 months for non-callable bullet bonds and every 36 months for most other types of bonds - and funds raised through the MBS offerings are used to fund the mortgage loans. It appears that each MBS series represents a limited-recourse obligation of the issuer, backed by specified mortgage loans, which does not give rise to a claim against other assets of the issuer, unless expressly so provided.⁵ Adherence to the balance principle has helped Danish banks to avoid insolvencies and financial crises better than

institutions in most other countries. The periodic series approach to issuing bonds results in much larger MBS pools than in either Mexico or the US. This, together with the transparency of the system and standardisation of mortgage and bond terms, seems to substantially reduce investor risk. Denmark appears to have developed reliable mortgage registry systems and legal assurances of rapid mortgage foreclosure processes, which have also helped to avoid defaults on Danish MBS offerings.⁶ It is also important to note the legal restrictions on mortgage lenders which prevent them from lending more than specified percentages of the market value of the properties involved. This has further helped to safeguard Danish lenders against the effects of financial crises.

CAN DENMARK BE A MODEL FOR MEXICO?

One might question whether a 150-year-old system in use in a developed country of five million people can be readily adapted for use in a developing country with over 20 times the population. One answer to this concern is the argument that a developing country like Mexico needs a simple system like Denmark's - developed in a civil law system more like that of Mexico than the common-law tradition of the US - that has relatively low transaction costs and has been well tested over a long period with virtually no bank failures. In contrast, the US system has high transaction costs, low transparency, a higher rate of lender failure and housing finance agencies that are widely criticised.

Another concern is whether the adoption of the Danish model will require extensive new legislation to be adopted by the Mexican Congress. This is an important issue because many of President Fox's recent legislative initiatives have been bottled up in Congress, which his party does not control. We believe that adoption of key elements of the Danish model would require little, if any, new Mexican legislation. It will, however, require the establishment of certain new entities and business practices for the mortgage lending industry and a commitment by the Mexican authorities to support the new approach. For example, regulatory approval would have to be obtained for a new mortgage lending entity⁷, each offering would have to obtain CNBV approval, and the Banco de México might need to establish a repo facility to enable the new bonds to be adequately liquid and tradable.

The process might be accelerated if some of the leading SOFOLs were to jointly form an entity similar to Totalkredit, a Danish consortium lender whose constituent institutions (mostly local and regional banks) act as originators of new loans, by interviewing and evaluating prospective borrowers using uniform scoring criteria and preparing the

loan documentation but leaving the booking and funding of the loan to Totalkredit under a partial guarantee from the originating institutions.⁸ The local and regional banks' expertise with properties and loan customers make it possible for Totalkredit (which was recently acquired by Nykredit) to operate with a relatively small amount of staff.

If this "master lender" approach is to be adopted, in which the lender issues its own MBS instruments in separate periodic series, it would have to be modified to reflect limitations under Mexican law. In Mexico, because a SOFOL cannot issue "limited recourse" obligations⁹, each period's loans might need to be made, and the corresponding annual series of bonds to be issued by, a separate legal entity. The Mexican equivalent of Totalkredit might, instead of lending and securitising for its own account, function as the trustee for separate trusts which would act as the mortgage lenders and MBS issuers. In effect, it would be creating SPVs but, unlike the typical SPVs in the US, these would make loans as well as securitise them, thus avoiding the true-sale step. The need for such activities for economies of scale would be one of the arguments in favour of using a consortium trustee/issuer trust approach, in which loans originated by a number of existing SOFOLs would actually be booked and securitised by the new trusts. The trustee would also provide a range of centralised and standardised services including accounting, credit-scoring, documentation and securitisation services.¹⁰

In Denmark the bond offering process does not involve prospectuses but rather brief "bond-terms" documents, containing merely a summary of the basic payment terms for the bonds. This minimum disclosure of the nature of each offering seems to have been sufficient for investors. This is largely because the process is widely known and of long standing, the MBS products have very similar contractual terms and many investor protections are statutory.¹¹ The MBS prospectuses in Mexico might have to be more extensive, particularly with the initial offerings of the new type of securities. For investors to be adequately assured, the initial offerings may also have to feature enhancements such as insurance of the mortgage loans and/or the bonds, provided by private insurers in the US and Mexico, multilateral agencies and/or government entities such as the Federal mortgage institution (*the Sociedad Hipotecaria Federal or SHF*).

In order for the periodic MBS series process to work, each period's consortium issuer trust would probably conduct a shelf registration (*listado previo*) of such series with the National Banking and Securities Commission (*the Comisión Nacional Bancaria y de Valores or CNBV*), in order for the MBS offerings to be done in stages during the period. Gradually, as funding becomes necessary for the

mortgage loans that are originated, portions of the MBS instruments would be placed in the market. From a regulatory viewpoint, the principal focus of the supervisory task might shift gradually from the existing SOFOLs to the new issuer trusts, because the traditional SOFOLs that chose to participate in the consortium process would eventually have fewer loans on their books. Their principal exposure would be on the partial guarantees they issued on the loans they originated but which were actually booked by the consortium issuer trusts.

CONCLUSION

While the Danish model appears to be a relatively simple system to emulate, actual adoption of this approach in the short term would require a sustained effort by existing SOFOLs as well as by the SHF, the CNBV, the Ministry of Finance and Public Credit and Indeval, the central securities depository. However, momentum is developing due to the efforts of George Soros' Open Society Institute, which the "Partnership for Prosperity", organised by the Fox and Bush administrations, has enlisted to assist in accelerating the development of

a modern mortgage finance system in Mexico. The institution is encouraging the parties to consider the advantages of the Danish model. It is expected that significant progress will be reported in this connection in the near future.

Notes:

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² SOFOLs are established under the Credit Institutions Law of Mexico with the

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authorisation of the Ministry of Finance and Public Credit, for the purpose of granting loans of a specific type or to a specific sector (mortgage loans, car loans, etc.) and may obtain resources from the placement of securities or borrowing from institutional lenders but not from taking deposits from the public. Foreign investment in SOFOLs is currently limited to no more than 49% of their voting capital.

³ Allen Frankel et al., *The Danish mortgage market*, BIS Quarterly Review, March 2004, p. 95.

⁴ Another way of describing the balance principle is that funds raised by the issue of bonds may in principle be used solely for lending against mortgages on real property. Authorised mortgage lenders in Denmark are the only institutions entitled to issue mortgage-backed bonds in Denmark. English translations of some of the relevant laws and executive orders can be found on the website of the Danish Financial Supervisory Authority (Finanstilsynet), www.finanstilsynet.dk.

⁵ See Art. 22 et seq. of the Danish Mortgage-Credit Loans and Mortgage-Credit Bonds, etc. Act (Act No. 454 of 10 June 2003), an English translation of which can be found at <http://www.finanstilsynet.dk/sw7817.asp>.

⁶ Further information on the Danish mortgage finance system can be found at the website of the Danish Mortgage Bankers' Association, www.realkreditraadet.com, including information about reports thereon by Moody's and by the consultant firm Mercer Oliver Wyman. It should be noted

that an important feature of Danish mortgage bonds is that they can be acquired by the mortgage borrowers to whose mortgage loans they relate, which enables homeowners to refinance their mortgage loans more directly and easily than in the US system.

⁷ This might have to include a ruling by the Federal Competition Commission that the entity did not raise antitrust concerns.

⁸ The sufficiency of such guarantees for MBS investors would depend on the creditworthiness of the respective originating SOFOLs.

⁹ Article 2964 of the Civil Code for the Federal District and the corresponding provisions of the Civil Codes for the States of the Mexican Republic.

¹⁰ The integrity and sophistication of any such trustee might require it to develop systems such as those that have been developed by VP (VærdiPapircentralen AS) in Denmark, an institution which acts as a central processor for the Danish mortgage finance system.

¹¹ Samples of bond-terms documents issued by Nykredit can be found at <http://www.nykredit.dk/templates/standardpage.sp?pageid=2208345359313&menuitemid=26>.

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