

MEXICO

Special Report

Subnational Financing: Regulatory Changes & Benefits for the Market

Analysts

Isaura Guzman Leal
isaura.guzman@fitchmexico.com

Alfredo Gomez Garza
alfredo.gomez@fitchmexico.com

Humberto Panti Garza
humberto.panti@fitchmexico.com

Marcela Andrade Martinez
marcela.andrade@fitchmexico.com

t. +52 (81) 8335 7179
+52 (55) 5202 7302
f. +52 (81) 8378 4406

Relevant Considerations

- Due to major regulatory changes introduced since 2000, the 32 federal entities in Mexico, 69 municipal governments, 6 decentralized enterprises and one public university currently have two issuer ratings
- The finances of the states and principal municipalities in Mexico are now more open to the financial community and society in general
- The market can differentiate among the risks posed by rated entities, and rated municipalities have greater access to a wider range of financing, which favors a more efficient placement of available funds with borrowers
- The debt securities market has become a new option for subnationals, diversifying its sources of financing
- The subnational financing market is deeper and more specialized
- It is thought that the number of rated municipalities will continue to grow over time, especially in medium-sized entities
- Also, a moderate growth on decentralized water entities ratings is expected

■ Regulatory Changes

In April 2000, major changes were made to the legal-financial scheme for the contracting of subnational debt. For subnational debt contracted from this date onwards ("New Debt"), there is a new regulatory framework which contains three important fundamental changes:

1st The elimination of the mandate scheme, and all previous schemes, whereby in cases of default the Federal Treasury Department (*Secretaría de Hacienda y Crédito Público*: SHCP) paid creditors on behalf of the subnational, and deducted the corresponding amount from the federal revenue sharing that the subnational would otherwise have received. The Treasury Department thus ceased to be the "signer of guarantees" in the contracting of "New Debt," and the use of management and source of payment trusts (Special Purpose Vehicles to service debt, SPVs) became a common way of backing subnational borrowing.

2nd Treasury Department rules which modified the capitalization requirements applicable to development banks and commercial banks, regarding loans to subnationals. These requirements –updated recently in December 2005– are based upon the use and maintenance of two credit risk ratings by the borrower; also, the registration of the financings at the Unit of Fiscal Federalism with State Government (UCEF) of SHCP is required. Municipalities and decentralized enterprises are given the option of seeking guarantees from the state or municipal government, in which case the rating of the government offering the guarantee applies.

3rd The general provisions applying to the methodology used by the National Banking and Securities Commission (CNBV) for rating the loan portfolios of credit institutions, wherein it is stated that from December 2004 both development banks and commercial banks shall set aside preventive reserves against loans made to subnationals, based upon the issuer rating and/or the specific debt rating.

The main purposes of the above changes are as follows:

- To avoid the unlimited drawing on federal revenue sharing and possible over-borrowing situations, by assigning a given amount or proportion of said revenue stream for each loan.
- To promote the use of SPVs as backing for loans, without the intervention of the Treasury Department in the event of default.
- To discourage possible extraordinary support and financial bailouts by the federal government, such as happened prior to the national crisis of 1995.
- To differentiate among the credit risks posed by subnationals. This did not happen under the previous scheme, as the banks considered loans to subnationals as "federal risk."

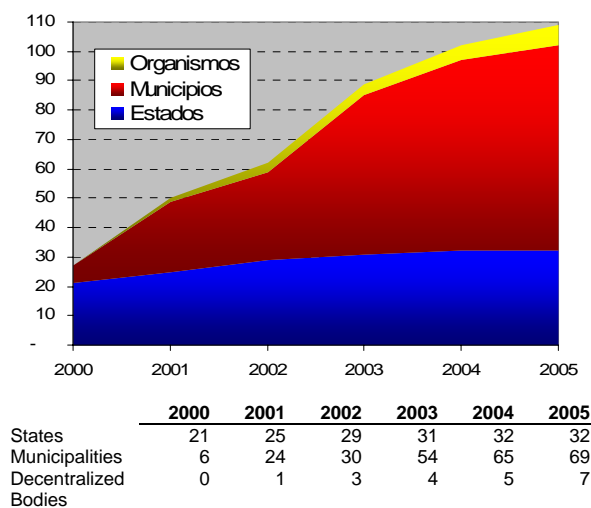
- To diversify alternative borrowing sources, paving the way for subnationals to access the debt securities market. In this respect, the use of SPVs has been the key to backing debt issues.
- To promote the use of structured mechanisms to back bank loans made to subnationals.

■ Issuer Ratings

In 1998, two years before the use of issuer ratings for subnational authorities was regulated, the State of Sonora was assigned an issuer rating by *FitchRatings*, and thus became the first Mexican subnational government to have its public debt rated. *FitchRatings* was therefore the first rating agency to participate in the state and municipal government sector in Mexico.

As a result of these changes in the subnational financing environment, the number of subnationals with two issuer ratings has increased significantly in recent years.

Exhibit 1
Performance of Rated Mexican Subnationals



As may be seen from Exhibit 1: a) at the end of 2005 all states had two issuer ratings, and eleven of them had three ratings; b) there has been a significant increase in the number of municipalities with ratings; while only six had current ratings in December 2000, there are now 69 municipalities who have chosen to have their credit quality rated, despite having the option of calling on their State to stand surety; c) only a small number (7) of decentralized state and/or municipal utilities have chosen to seek two ratings, mainly because a considerable number of them have

a weak financial position. This group is composed by 6 water and sewerage utilities and one public university.

A gradual growth in the number of ratings in water and sewerage utilities sector is expected, coming from those authorities who have improved their charges and have obtained more efficient cost structures.

Of the 108 subnationals having at least two issuer ratings (please refer to Appendix 1 at the reverse of the document), Fitch has rated 85, and of the total number of this type of current ratings (227), FitchRatings has assigned 37.4%.

The issuer ratings assigned to date by Fitch are assessments of the willingness and capacity of an entity to comply fully and punctually with its financial obligations, without considering any specific guarantees or subordination; they are therefore unsecured issuer ratings. It should be noted that the ratings refer to a domestic scale, placing the subnationals in the Mexican context, and are not therefore comparable on an international level. As mentioned above, subnationals may not borrow in foreign currency, nor may they borrow from foreign-domiciled institutions.

Based on unsecured issuer or issuer risk ratings, Fitch has rated specific subnational bond issues and bank loans, which may receive a higher rating than the unsecured issuer rating thanks to legal/financial strengths which provide greater security for banks or investors.

To date, all debt issues and bank loans that have been rated use a trust fund as repayment source: the government irrevocably assigns a fixed portion of a revenue stream to the trust fund through a legal mechanism by which a third party (the trustee) is charged with managing the funds, making repayments on debt, establishing reserves, and returning any surplus funds to the subnational.

The funds typically used to date by governments to back such structures are the future streams from federal revenue sharing; however, some states have assigned payroll tax revenues, one decentralized municipal water authority used water rates, and some municipalities are studying the possibility of using the property tax. Similarly, some state trust funds have issued debt against future revenues from highway tolls.

In addition to the issuer ratings, as of December 31, 2005 there are 76 current structured finance ratings, 33% of which are market issues and 67% bank loans. FitchRatings is involved in 72% and 90%, respectively, of these ratings.

■ Benefits for the Subnational Financing Market

The new regulatory framework for subnational bank loans and the introduction of issuer ratings has paved the way for:

1. Encouraging transparency at state and municipal level, by significantly improving the quality and timeliness of the financial information provided by the rated authorities. The finances of the states and principal municipalities in Mexico are now more open to the financial community than in the past; the vast majority of the states and over half the rated municipalities have external audits.

2. Differentiating among the credit risks posed by rated subnationals, and comparing them with non-rated bodies. Currently at least 90% of Mexican subnational debt belongs to bodies with two issuer ratings, which favors a more efficient placement of available funds with borrowers.

3. The opening of the debt securities market as a further financing option for Mexican subnationals from December 2001 onwards, so diversifying their sources of borrowing. The mandate scheme, like all previous schemes, hindered the placement of debt issues, by not including the repayment characteristics required by the debt securities market. In contrast, the use of SPVs without the intervention of the Treasury Department has been key to the placement of 29 issues to date which together total Ps\$15,622MM (approximately US\$1,420MM).

4. Significant growth (25.7%) in the subnational financing market over the last five years.

5. A greater diversification in sources of borrowing, hitherto mainly concentrated in development banks.

6. A greater degree of specialization in the market, reflected in greater involvement by commercial and investment banks, the appearance of structure agents, and greater interest in operating in this segment among suppliers of partial and full guarantees.

■ Outlook

FitchRatings believes, the subnational financing market performance will be positive over the next years. The number of rated municipalities is expected to continue increasing with time, especially in the case of medium-sized municipalities. Access to the debt securities market has hitherto only been available to the states and a small number of municipalities located in the major metropolitan areas; however, debt issue ratings could increase if pooled structures are implemented to allow the authorities, especially the municipalities, to access the debt securities market in better terms and conditions.

Similarly, a moderate increase is expected in water authority ratings: while investment and funding requirements are high in this sector, only a few authorities can boast a sound financial position. In addition to the decentralized water authorities, it is foreseen that some public state universities and hospitals may seek issuer ratings in the future.

The situation depends, among other factors, on the ongoing macroeconomic stability that the country has enjoyed in recent years, which Fitch foresees will prevail in the future.

Appendix 1 Subnational entities with 2 Current Ratings (at December 31st, 2005)

STATES (32) †					
Aguascalientes	AA(mex)	Guerrero	BBB+(mex)	Quintana Roo	A-(mex)pcp
Baja California	*	Hidalgo	A(mex)	San Luis Potosi	BBB+(mex)
Baja California Sur	A-(mex)	Jalisco	A+(mex)	Sinaloa	A(mex)
Campeche	A(mex)pcp	Mexico	BB(mex)pcp	Sonora	A(mex)
Coahuila	AA+(mex)	Michoacan	A+(mex)	Tabasco	AA-(mex)
Colima	A(mex)	Morelos	A(mex)	Tamaulipas	*
Chiapas	*	Nayarit	*	Tlaxcala	*
Chihuahua	A+(mex)pcp	Nuevo Leon	A(mex)	Veracruz	A+(mex)pcn
Distrito Federal	AAA(mex)	Oaxaca	A-(mex)	Yucatan	*
Durango	A-	Puebla	A+(mex)pcp	Zacatecas	*
Guanajuato	*	Queretaro	AA-(mex)		

MUNICIPALITIES (69) ‡					
Acapulco, Gro	A+(mex)	Huixquilucan, EM	BB+(mex)	Sn Nicolas de los Garza, NL	AA-(mex)
Aguascalientes, Ags	*	Irapuato, Gto	A+(mex)pcp	Sn Pedro Gza Garcia, NL	AA(mex)
Ahome (Los Mochis), Sin	A-(mex)	Ixtlahuaca, EM	BBB(mex)	Santa Catarina, NL	A+(mex)
Apodaca, NL	A+(mex)	Leon, Gto	*	Solidaridad (P.Carmen), QR	A-(mex) pcp
Atizapan de Zaragoza, EM	A+(mex)	Lerma, EM	BB+(mex)	Tampico, Tamps	A(mex)
Atlixco, Pue	A-(mex)	Los Cabos, BCS	A+(mex)	Tecamac, EM	BBB+(mex)
Cajeme (Obregon), Son	A+(mex)	Manzanillo, Col	A(mex)	Tepatitlan de Morelos, Jal	BBB(mex)
Celaya, Gto	A+(mex)	Mazatlan, Sin	BBB(mex)	Tepic, Nay	BBB(mex)
Centro (Villahermosa), Tab	BBB+(mex)	Merida, Yuc	*	Texcoco, EM	BBB(mex)
Juarez, Chih	AA(mex)	Metepec, EM	A+(mex)	Tijuana, BC	AA-(mex)pcp
Chicoloapan, EM	BBB-(mex)	Monterrey, NL	*	Tlajomulco, Jal	A(mex)
Coatzacoalcos, Ver	A(mex)	Morelia, Mich	A+(mex)pcp	Tlalnepantla de Baz, EM	*
Colima, Col	*	Naucalpan, EM	A-(mex)	Tlaquepaque, Jal	A+(mex)
Cuautitlan Izcalli, EM	BBB(mex)	Navojoa, Son	BBB(mex)	Toluca, EM	*
Cuernavaca, Mor	AA-(mex)	Oaxaca, Oax	*	Tonalá, Jal	*
Culiacan, Sin	BBB+(mex)	Puebla, Pue	AA-(mex)	Torreón, Coah	AA(mex)
Durango, Dgo	*	Puerto Penasco, Son	BBB(mex)	Tuxtla Gutierrez, Chis	A(mex)
Ecatepec, EM	BBB(mex)	Puerto Vallarta, Jal	AA-(mex)	Uruapan, Mich	BBB+(mex)pcp
General Escobedo, NL	A+(mex)	Queretaro, Qro	*	Veracruz, Ver	A+(mex)pcp
Gómez Palacio, Dgo	A+(mex)	Saltillo, Coah	AA-(mex)	Zamora, Mich	A-(mex)
Guadalajara, Jal	AA-(mex)	Sn Andres Cholula, Pue	BBB+(mex)	Zapopan, Jal	*
Guadalupe, NL	A(mex)	Sn Luis Potosi, SLP	AA-(mex)	Zapotlan el Grande, Jal	BBB-(mex)pcn
Hermosillo, Son	A-(mex)pcp	Sn Luis Río Colorado, Son	BBB(mex)	Zitacuaro, Mich	*

DECENTRALIZED ENTERPRISES (7) §					
AGUAH (Hermosillo, Son)	BBB(mex)	SAPAL (Leon, Gto)	AA-(mex)	UANL (NL, University)	A(mex)
CEA (Queretaro, Qro)	BBB(mex)pcp	SIAPA (Jalisco)	*		
OPDM (Tlalnepantla, EM)	*	SIMAS (Torreón, Coah)	A+(mex)		

Notes: pcp = positive credit outlook; pcn = negative credit outlook; ◆ rating watch; ▲ rating watch positive; ▼ rating watch negative; * Not rated by FitchRatings; † 11 States have 3 ratings: Chihuahua, Distrito Federal, Durango, Guerrero, Mexico, Michoacan, Nuevo Leon, Puebla, Queretaro, Sinaloa y Veracruz.; ‡ Additionally 14 municipalities have just 1 rating: Chihuahua, Chih [AA(mex)]; Cordoba, Ver [A(mex)]; Nogales, Son [BBB(mex)▲]; Pachuca, Hgo [A-(mex)]; Playas de Rosarito, BC [A-(mex)pcp]; Reynosa, Tamps [A(mex)]; San Juan del Rio, Qro [A(mex)]; Temixco, Mor [BBB-(mex)]; Tultitlan, EM [BBB-(mex)]; Xalapa, Ver [A(mex)]; Chalco, EM [*]; Coacalco, EM [*]; y Guasave, Sin [*]; Mexicali, BC [*]; § Water Authorities with just 1 rating: CESPT (Tijuana) [A+(mex)]; SADM (Monterrey) [AA-(mex)]; CAPA (Quintana Roo) [BBB-(mex)]; CESPM (Mexicali) [A(mex)]; JUMAPAM (Mazatlan) [BBB-(mex)]; SIDEAPA (Durango) [*].