

Existing and needed infrastructure in Mexico and the experience of North American participants

To understand the process of participating in the Mexico mortgage market, it is helpful to understand the basic components of an efficient market, to be cognizant of the mortgage market history of Mexico and to learn from the experience of other market participants. The Mexico mortgage market has evolved over the years and, while it is not totally seamless, it is making great strides towards becoming an efficient and fully developed mortgage marketplace.

There is a certain level of infrastructure that is required for a mortgage market to function no matter where it is domiciled. These items are varied with some being more critical than others. For example, there is a need to have some or all of the following third-party service providers such as servicers, title insurance companies, appraisers and credit reporting agencies. In addition, underwriting standards, laws permitting foreclosure, eviction and perfection of security interests and appropriate regulations and regulators are required. Technology designed for the relevant mortgage products and distribution channels must be present and for mortgage bankers, a functioning secondary market should be present. For a foreign banker, there must also be appropriate foreign investment laws, currency hedge instruments and authority for currency repatriation.

The existing market infrastructure is best understood through a review of the history of Mexico mortgage lending. The history can be divided into two time periods; first, the time prior to the signing of the North America Free Trade Agreement ("NAFTA") and second, the post-NAFTA period. Each period has had a significant impact on the current mortgage market.

Prior to NAFTA, the Mexico banking system was relatively closed. With the exception of Citibank, there were no U.S. banks and no other foreign banks of any substance. Mexican law did not contemplate nonbank financial institutions and, therefore, there were no companies that would be recognized as mortgage banks. Mexico had gone through several cycles of nationalizing and then privatizing banks and, in fact, the banks had been privatized for only a couple of years at the time NAFTA became law.

In addition to the prohibitions against foreign banks, there were also significant foreign investment laws that limited the ability of foreigners to participate in the real estate market. Generally, these laws prohibited 100% foreign ownership in certain real estate and limited foreign investment in many related industries. Foreign capital entered Mexico in the form of complicated joint venture arrangements and other nonefficient means.

During the pre-NAFTA period, there were only limited sources of mortgage funding with banks providing mortgage financing only to the extent there was room on their balance sheets for that kind of asset. Pension funds provided a

source of limited mortgage financing and governmental entities such as INFONAVIT and FOVI provided some mortgage financing primarily to the lower income segments of the market. The remainder of the financing was done through "self-help" methods. The market as a whole was historically underserved and did not address in any kind of broad sense the needs of all of the market participants.

In general, the pre-NAFTA period did not provide an environment for a well functioning mortgage market to develop. Indeed, the system almost militated against mortgages being widely available. With NAFTA came the impetus to push into the previously unexplored frontier.

Subject to certain limitations, NAFTA cleared the way for foreign banks to begin participating in the banking sector of the Mexican economy. At the same time, NAFTA contained provisions designed to eliminate the historic cycles of nationalization and privatization of banks. NAFTA was designed to encourage foreign lenders to enter the market and thus, it also permitted foreign nonbank financial institutions to also enter the market through a vehicle known as a "SOFOL." This has had the effect of bringing many North American and European financial intermediaries into Mexico.

In addition to the systemic banking changes, reforms to the foreign investment laws and real property ownership laws were enacted that over time will phase in significant enticements for foreign investment in Mexico. Basically, over the next several years, all significant impediments to incoming foreign capital will be eliminated or ameliorated.

While NAFTA encouraged the development of a mortgage banking industry, the effects of the 1994 peso devaluation cannot be overlooked. The decision in December 1994 to allow the peso to devalue slowed much of the progress that had been made in creating a functioning mortgage market. The effects of the devaluation were reflected in mortgage interest rates that in some instances exceed 100% and in an almost catastrophic breakdown in the banking system. Over a two-year period, almost \$65 billion of bank assets were acquired by FOBAPROA.

The 1994 crisis also brought with it a change in the political environment. The once completely dominant PRI party began to see its power diffused and the development of additional political parties. For the first time since the revolution, the ruling party does not control both houses of the Congress. The sharing of political power is a new concept in Mexico and has resulted in a slowing of the passage of reforms needed to resolve the banking crisis and to permit the development of a more efficient mortgage market.

With this history as a background, it is easy to understand the current state of the market's infrastructure. Initially, one is struck with the limited number of financial intermediaries in Mexico. While in the United States there are in excess of 25,000 financial intermediaries, in Mexico there are less than 30. Even with the limited number of market participants, there is very little product uniformity and there are very limited uniform underwriting standards.

The Mexico mortgage market is also characterized by a limited number of third-party service providers. There are less than three true mortgage servicers in the country, one government authorized title insurance company called Title Insurance de Mexico, and a limited number of credit reporting agencies. The technology being used in origination and servicing is relatively new, but is product specific and market specific and has been developed in Mexico for Mexican mortgages.

There currently exists no secondary market in Mexico. Part of this is related to the lack of law which clearly defines how mortgages are to be securitized. In addition, the Mexican economy and the nature of existing mortgages makes securitization extremely difficult. That notwithstanding, there is currently a multi-class mortgage security awaiting pricing. The issuer will be one of the largest banks in Mexico and the collateral will be selected from its performing portfolio. Other mortgage originators, like FOVI, which have created a uniform instrument and have ameliorated the delinquency risk seem to be likely candidates for issuing mortgage backed securities in the near future.

The building of infrastructure in the environment described above has been interesting, challenging and, in many instances, fruitful. Pre 1994, WSM Services de Mexico, S.A. de C.V. had one business plan and after the devaluation another plan developed. Prior to the monetary difficulty, WSM was actively soliciting its builder clients in the U.S. who were looking to Mexico as a new market for their product and, at the same time, was negotiating with a group of Mexico banks to buy the loans to be originated in connection with the purchase of the homes. The Mexico banks were enticed because they would be getting uniform products from world class builders and borrowers. WSM was to originate the loans, sell them to the banks and then service for the banks. After the devaluation hit, builders got skittish and lenders, who were also hit with new accounting rules, lost their capital and ability to fund. Consequently the plan changed.

WSM made the decision to enter the servicing and loan administration business. At the height of the problems in the system, WSM became the first entity to offer the data processing for existing loans. The process included redesigning the systems several times as the government announced various loan restructuring plans. WSM participated with the designer of the software, Pedro Gongora, in changing the software to allow for the recasting of debt, the implementation of a new currency unit and the forgiveness of debt for prior payments. The process was a true initiation by fire. At one time, over 30 technical people were involved in the changing of the systems to accommodate government changes on the 25,000 loans being administered. The whole process involved closely working with regulators from three separate government regulatory bodies. WSM, however, learned Mexican mortgages in a way that positioned them to take advantage of other opportunities to create other parts of the required infrastructure.

WSM implemented a strategy for developing a nationwide collection company and, in conjunction with its partner, now offers collection and telemarketing services on all kinds of receivables using the state of the art technology. Again, the process involved selling holders of receivables on the

need to outsource a function to a third party. Collections was a process that was understood and WSM has been able to provide a much needed service to a wide array of users. Again, one of the keys to success was the use of technology developed in Mexico, in Spanish, for the local product.

With the vast amount of distressed assets in the market-place owned by both the government as well as private entities, the need for companies that could provide due diligence services is great. WSM made a determination that it could provide additional infrastructure to the system. It designed software for the various distressed products that allows it to capture data, stratify assets and provide valuations of various portfolios. Along with a team trained in conducting due diligence, the software has been used to evaluate loan portfolios and aid in the valuation process.

WSM has also created an investment banking and merchant banking division to aid in the process of creating certainty and liquidity in the marketplace. This group aids investors and sellers alike in matching resources with assets. In addition, WSM provides consulting services and resources to entities looking to enter the Mexico market.

History has shown that one must be agile and entrepreneurial in approaching the mortgage business in Mexico. One must be willing to adapt to constant change. Certainly, the key is found in the ability to modify experiences gained in more mature mortgage markets to the specifics of this market. Those who are willing will find many opportunities to be engaged in many parts of the business.

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