pfi market intelligence

LATIN AMERICAN PROJECT FINANCE

EDITED BY NICOLE GELINAS

THOMSON™

SECTION 02 CHAPTER 11

TAX-REVENUE SECURITISATIONS: A NEW BORROWING OPTION FOR PUBLIC-SECTOR ISSUERS IN MEXICO

By José Antonio Chavez, partner, and Luis Castro, associate, Chadbourne & Parke, Mexico City office

As the current credit crisis demonstrates, developing countries can have difficulty obtaining low-cost, long-term loans during times of financial strain. Securitisation of future-flow receivables, tax revenues in particular, can help investment-grade public- and private sector entities in these countries obtain credit ratings higher than those of their governments and raise funds in capital markets. Mexico is a good example of a nation that has effectively deployed this strategy for its sub-national public-sector issuers, perhaps allowing a source of critical infrastructure financing to remain open in these difficult times for global capital markets.

General background

Over the past decade, financial crises have occurred in a number of emerging markets, including the Mexican peso crisis of 1994, dealing severe blows to investor confidence. Developing countries have needed to find innovative ways of securing foreign finance. Securitisation of future revenue flows, of course, has been one such way. It allows issuers from developing countries to lengthen the maturities of their debt, improve risk management and balance sheet performance, and tap a broader class of investors – for example, insurance companies facing limitations on buying sub-investment-grade debt. Moreover, by establishing credit histories for borrowers, these deals enhance borrowers' future ability to access capital markets and reduce their borrowing costs.

Future-flow securitisation deals work as follows: based on their assessment of performance, product, and sovereign risks, the rating agencies rank future-flow receivable transactions from most secure to least secure. But it is possible to securitise even the least secure future-flow receivables: several Argentine provinces in late 1998, for example, securitised tax revenues to be received via federal tax sharing. Of course, the lower in the hierarchy they are, the more future-flow receivables transactions require safeguards to improve their credit ratings. Before the biggest such firms had lost their AAA ratings, insurance companies had played a growing role in structured-finance transactions by providing complete financing guarantees, as MBIA had done in 2001 for a securitisation launched by Pemex, Mexico's state-owned oil and gas company. Even as this insurance-wrap market has largely lost its ability to do deals, due to their losses stemming from the credit crisis, it's not clear that entities like the Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group, which have provided insurance against political risks in future-flow deals in the past, will do so again in the near future, in light of the credit crisis.

The history of rated future-flow asset-backed securities, though, is encouraging. There have been no debt defaults on rated future-flow asset-backed securities issued by developing country entities despite repeated liquidity and solvency crises. The asset class withstood the test of the Mexican peso crisis in 1994–95, the Asian liquidity crisis in 1997–98, and the Russian and Ecuadorian debt defaults in 1998 and 1999 respectively. An interesting example is the receivable deal of PTCL, Pakistan's phone company, which continued to perform even in the face of selective default on sovereign debt. Despite this track record, future-flow asset-backed debt has not yet been severely tested because it still represents a very small percentage of total debt. The current credit crisis has soured many investors on any kind of securitisation, as deal flow shows, and it is too early too tell if future-flow asset backed securities deals will be able to overcome the global crisis.

An equally important incentive for governments to promote this asset class lies in the positive externalities associated with it. Future-flow deals involve a much closer scrutiny of the legal and institutional environment – the existence as well as the implementation of laws relating to property rights and bankruptcy procedures – than unsecured transactions. Thus, these deals can produce enormous benefits by making valuable information available to investors. In addition, the preparation of a future-flow transaction often involves reforms of the legal and institutional environment that facilitate domestic capital-market development and encourage international placements.

Most of the benefits of future-flow deals are common to public and private sector entities alike in developing nations. During crises, however, like the current one, the latter are usually reluctant to take on new debt, and the use of the securitisations of future cash flows to raise financing is likely to be limited to public-sector entities. Furthermore, in difficult times, public-sector entities that have kept investors engaged during good times will benefit, keeping the asset class accessible during a crisis for deals in the pipeline or planned deals. Mexico, due to its positive history in the asset class over the past half-decade, falls into this category.

Early 2000s: Mexican sub-nationals wade into future flows

Securitisation of future tax revenue in Mexico is a fairly recent financial innovation, borne partly of necessity. Mexico's 32 states, and its cities, have needed a way to finance infrastructure investments. But Mexico has a deep prejudice against borrowing, due to previous profligacy, and under Mexican law, sub-national state and municipal governments are limited in their ability to raise tax revenue. States and municipalities do not have the option, as they do in the US, of funding roads, schools and other infrastructure projects by borrowing at reduced rates in a tax-exempt bond market.

Exacerbating financing limitations on Mexican sub-nationals is the fact that in past years, Mexico has wanted to reduce sub-national governments' reliance on revenue transfers from the central government. The federal government has fostered sub-national governments' broadening and diversification of funding sources as an attempt to reduce such governments' reliance on the transfer of revenues from the central government.

However, economic volatility and the lack of political will have often limited the success of these attempts. As a consequence, sub-national governments, particularly those with a weaker credit profile, have continued to access funds through different means, including more expensive banking lines that usually have unfavourable terms and rates.

Nevertheless, one of the most successful financing alternatives for these sub-national issuers has been securitised debt. Indeed, reforms to allow securitisations backed by tax revenue in Mexico, including new laws on transparency and regulations, have been changing deal activity away from international transactions towards more domestic work. Furthermore, the development of domestic capital markets has shifted activity toward in-country rather than cross-border deals, as well.

The proceeds of such deals have been used exclusively in public project finance or in existing credit restructuring of public works. These deals have allowed sub-nationals to improve their finance management, directly linking capital-market financing with different infrastructure works and service improvements, without having to resort to a higher number of intermediaries in the process. Solid management and financial practices, relatively high levels of institutionalisation and transparency characterise highly rated entities, such as those in the 'mxAA' category. Entities with these characteristics could potentially issue other unsecured debt.

How the deals work

The first step in the securitisation of tax-participation transactions is to determine the underlying risk of the entity issuing the bonds. This risk is determined by the entity's issuer credit rating, which assesses the entity's capacity and willingness to meet all of its financial obligations, regardless of the pledge attached to these obligations.

To obtain a better credit standing, and therefore higher risk ratings and lower financing costs, most of this state indebtedness has involved structuring and securitisation processes and techniques. To achieve this objective, in each evaluation process, rating agencies carry out a quantitative and qualitative analysis of such debt structures.

In the quantitative analysis, the focus is on the asset to be securitised, and in Mexico's case this asset is mostly constituted by a tax (federal tax-revenue sharing, payroll tax, real estate tax, etc), which is subsequently transferred to a trust to be used as the payment source of a debt issue. In this analysis, it is important to evaluate the type of tax that is being securitised, and the impact of the true sale of the assets. In the cash flow analysis, rating agencies stress some key variables such as inflation, interest rates and historic collections that can affect the indebtedness of future payment flows.

On the other hand, in its qualitative analysis, rating agencies thoroughly review the legal documentation, mostly focusing on the evaluation of the tax nature and the legal effects prior and subsequent to its being transferred to a trust to be used as a payment source for the debt. Additionally, in this legal analysis rating agencies consider the characteristics specific to the legal framework of each state or municipality, which can allow it to increase its debt by using its own resources as a payment source.

State and municipal governments have been securitising, or borrowing against, future tax collection, in particular, as a way of raising needed funds to pay for infrastructure projects and to refinance prior public debt since 2002. The trend is towards federal tax-participation flows. The principle behind these federal tax-participation transactions is to use incoming tax flows from the federal government to somewhat isolate the transaction from risks associated with the general creditworthiness of the state or municipality. Currently, there are a large number of local and sub-national governments that benefit from good creditworthiness and therefore have been tapping the capital markets as one of their primary funding source.

Institutional investors, who have demanded greater transparency regarding the credit and financial risks and protections inherent in these deals, have embraced most of the securitised debt that has been issued. Consequently, various sub-nationals in Mexico have managed to structure debt more soundly, with increased protection against several types of financial and legal risks in most cases outperforming sovereign bonds issued by the Mexican government.

Within the broad range of enhancements and structures used, special-purpose vehicles, or trusts, are offering the requested higher transparency and comfort to the local investors' market. These vehicles have been found to provide the mitigation, by and large, of various financial and credit risks, as well as the redirection of those flows that serve as a payment guaranty, as in the case of the federal or local tax co-participation.

The most popular structured technique used in Mexico in the last two years has been transferring the flows from Fondo General Participable del Ramo 28 – that is, the income budget of the federal government – to a trust. We believe that by using this technique, some sub-nationals may be limited in broadening their financing sources, especially in the event of having high revenue-sharing flows already committed to other debts and financings. In such cases, the financial, legal, and political complications could jeopardise the completion of public works projects, the typical objective pursued in these processes. Also, many local governments are strong generators of their own taxes. This alternative allows them to build solidly structured issuances that help them to mitigate different risks and to reach higher rating levels.

In a typical transaction, the state or municipality first requests authorisation from the local Congress to carry out the intended securitisation, then a trust is formed. The government assigns the right to 20–30 years of tax revenue to the trust. The government commits to the trust to collect the revenues and not to change the tax rate. No commitment is made about the amount of tax collections.

In these transactions, the securitised taxes are generally revenue-sharing payments to states out of federal tax collections by the central government. However, securitisations of state taxes such as payroll taxes and vehicle ownership taxes are being securitised more often in the last couple of years. The typical transaction raises between Ps1bn and Ps3bn. The typical use of funds is for state infrastructure projects. The counterparties in the transactions are Mexican institutional investors.

The state or municipality issues debt securities, called *certificados bursátiles*, through the trust. The bondholders have no recourse against the state or municipality; the trust is the only obligor. The revenue collected is used by the trust to repay the securities. The securities are placed on the Mexican Stock Exchange, called the Bolsa Mexicana de Valores. Only Mexicans are allowed to acquire such securities directly from the Mexican Stock Exchange. However, there are legal structures that make it possible for foreigners to acquire the securities – for example, by using a special-purpose Mexican company to acquire the bonds and then issue US bonds collateralised by the Mexican bonds. The US bonds used in such structures are not very liquid; there is no secondary market for them.

The typical security is the debt instrument with a term of 20–30 years that bears floating interest at a market rate. The average rate for such securities is currently 9%. There is usually only one tranche of securities issued with a single maturity date. The government assigns

only a percentage of the expected tax collections. Securitisations are done typically at a 50% level of expected tax collections to address the risk that tax revenue might vary.

If tax collections fall short of what is required in any period to pay debt service, then the bonds become subject to cash sweeps until the bonds have been repaid in full. The main risks for the holders of the securities are the risk that tax collections might fall short of what is expected due either to an economic downturn or inability of the government to collect fully from taxpayers and the risk that the government might decide to abolish the tax. There is nothing to prevent the state as a sovereign entity from abolishing the tax, but it would have to pay damages to the bondholders. The debt would be accelerated, and the bondholders would have recourse against the state. The indemnities in such deals have a wide scope; in general, the state must indemnify for all harm caused by its actions.

The securities are rated by Standard & Poor's, Moody's and Fitch Ratings. The key to getting an investment-grade rating is the legal strength of the structure and the level of collateral.

There are a number of recurring legal issues that come up in deals. One of the biggest issues is isolation of the funds derived from securitised taxes from the control of the state or municipal government. This is done by requesting the taxpayers to pay the relevant taxes directly to a bank account owned by the trust. So far, there have not been any legal changes to isolation, nor have any states or municipalities ignored their obligations. Each state and local government has its own mechanism for collecting taxes.

There are limitations, however. Securitisations are only possible in states and municipalities that have the right legal framework. One of the first steps for the investment bankers and lawyers who are behind the transactions is to persuade the local Congress to put in place the right legal underpinning for a deal. The law must allow the state or municipality to assign the right to future tax revenue to a sole-purpose private trust that will receive the revenue and pay amounts due on securities. Any provision allowing administrative control by the state or local government must be avoided. The trustee is an authorised Mexican bank and is appointed by the bondholders.

Recent transactions

At least 40 such state and municipal tax securitisation transactions have been done to date after the first one in 2002. In the most recent transaction, in December 2007, the state of Oaxaca issued through a trust Ps2.8bn (approx US$209m) also backed by the vehicle ownership tax. This issuance was rated AA+(mex) by Fitch Ratings. The issuance consisted of 713.1m Unidad de Inversións (UDIs), around Ps2.9bn issued through an issuer trust (one UDI is equal to Ps4.1277). The issuance has a term of 30 years. The source of payment of the issuance is 100% of the collections derived from vehicle control expenses (vehicle inspection, plating), 100% of the future payroll tax collections and 100% of the future vehicle tax collections excluding the percentage assigned to the municipalities.

A few months earlier, in 2006, the state of Veracruz securitised an approximate amount of Ps6bn backed by the future flows derived from the Impuesto Sobre la Tenencia y Uso de Vehiculos (ISTUV, vehicle ownership tax). This securitisation was rated by Fitch Ratings AAA(mex). As mentioned, the principal source of payment of this issuance was 100% of the collections derived from the vehicle ownership tax, without including 20% allocated to the municipalities. The total amount issued was Ps6.3bn (82.4% denominated in UDIs and 17.6% in pesos, both issuances to expire in July 2036). In the Issuer Trust, the State is obligated in case that for any reason its right to collect the ISTUV is terminated, to substitute it for one of several taxes that impose the same or a similar levy, in a manner such that the same amount from the federal tax is collected.

Previously, in 2003, in what is still one of the most significant and largest examples of such transactions done to date using state taxes, the same state of Veracruz converted its future payroll tax collections in 2003 into Ps6.3bn. The securitisation covered 30 years of future tax collections.

Outlook and conclusion

State and local Congresses in Mexico continue to approve these transactions because most states have few other options for financing needed infrastructure. The holders of the securities bear the risk that tax collections will fall short. Also, future-flow securitisation increases an issuer's – and a country's – inflexible debt, perhaps jeopardising its creditworthiness.

While this is a valid concern, the present issuance of securitised debt does not appear to have approached this critical level. For instance, rating agencies have not downgraded sovereign credit ratings of either Mexico or Venezuela on account of their rising securitised debt. Mexico's securitised debt of US$19.3bn is about 16% of its total debt, and Venezuela's securitised debt of US$6.1bn is 18% of its total debt. Thus, it appears that securitised debt can rise to around 15% of a developing country's total debt without necessarily jeopardising the sovereign's overall creditworthiness. Nevertheless, when combined with debt owed to other preferred creditors, it could eventually reduce a borrower's ability to service its debt.

Public policy to facilitate future-flow-backed securitisations should focus on removing constraints. Issuers may reduce transaction costs by planning a series of issues (a so-called master trust arrangement), which would allow them to reap economies of scale. Establishment and use of indigenous credit rating agencies to obtain domestic credit ratings can also reduce transaction costs, although care has to be taken in mapping local rating scales to international scales. Pooling receivables may work in some instances. Certain segments of this asset class – such as securitisation of tax receivables – may be amenable to standardisation. Clarification of bankruptcy laws would be helpful for all financial deals including securitisation. Educating policymakers and potential issuers would also help promote this asset class.

In the current global credit crisis, in particular, governments may find this asset class attractive because it can provide a way for countries such as Mexico to continue to access capital markets. Because of their investment-grade rating, future-flow deals attract a much wider class of investors than unsecured deals. Thus, future-flow deals can improve market liquidity and reduce market volatility, making them even more attractive to international investors in other asset classes. As to how this type of deal will behave in the current global crisis, it is still too early to tell, but the history of this type of deal in earlier financial crises has proved them to be resilient. However, the crisis we are currently witnessing has never been experienced before in this magnitude, so it is still uncertain how they will behave.

For many other developing countries, such as Peru and Argentina, securitisation of future-flow receivables may be the only way to begin accessing international capital markets.