Asset-Backed
Special Report

2009 Latin American Structured Finance Review and Outlook

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Related Research

- *Mexican Low-Income Housing Construction Bridge Loan Securitization Rating Criteria, Jan. 20, 2009*
- *Mexican RMBS Performance Quarterly Report, Nov. 10, 2008*
- *Rating Review of Emerging Markets, Nov. 10, 2008*
- *Underestimated Risk in Brazilian Investment Funds Backed by Payroll Deductible Loans, Feb. 26, 2008*

Summary

The U.S. economy is entering a severe recession driven in part by a contraction in credit. The negative effects being seen in Latin America erode the argument for decoupling that was common a year ago. There are few historical parallels from which to gauge the possible depth and length of this downturn. The complexity also makes it difficult to determine the ultimate impact on the various economies of Latin America. As is common in emerging markets, in turbulent times risk factors express themselves along a spectrum that is both economic and political. While only a limited number of negative structured finance ratings actions have been taken to date, Fitch remains cautious with expectations for asset performance in 2009.

In the past three or four years, Latin America witnessed significant credit growth in most segments of the economy, from consumers to corporates. The 2008 market turmoil that followed and the ensuing liquidity crisis have created dislocations to varying degrees across the major structured finance markets. Although certain individual market sectors remain resistant, such as cross border future flows and Mexican bank originated residential mortgage securitizations (RMBS), no major sector is expected to be completely immune from the turbulence in the financial markets.

Despite the global backdrop, when defined by the number of ratings actions, 2008 was a relatively balanced year in Latin America. Fitch Ratings affirmed approximately 616 tranches from its securitization portfolio, upgraded 47 and downgraded 61. The region remains quite diverse economically, and as a result, upgrades and downgrades occur for differing reasons that will be explored in greater detail in the market-specific sections below. Overall, recognizing the regional challenges exacerbated by a quiet capital market, lower commodity prices and limited growth, Fitch expects Latin America to have an increase in the ratio of negative to positive rating actions in 2009 compared with 2008.

This report will focus on the four largest capital markets in Latin America: the international cross border market and the local markets of Mexico, Argentina and Brazil. It then concludes with a general comment on the pressures facing emerging market sovereigns.

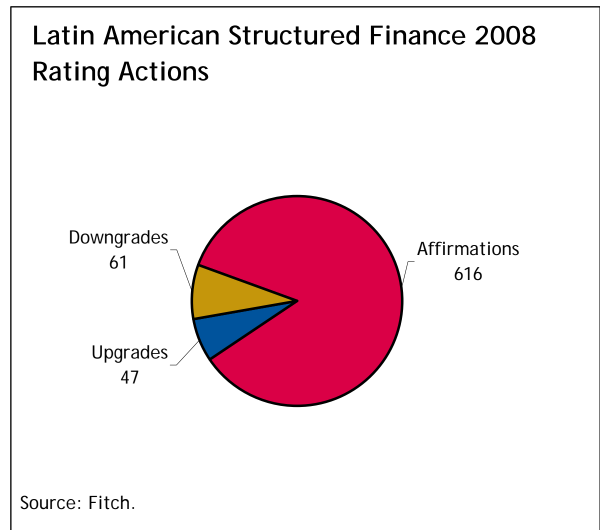
International Cross Border

In 2008 approximately $3 billion of rated securities were placed in the international cross border market. These totals compare negatively to the historical average issuance levels of approximately $4 billion. While a large degree of annual variance is not uncommon from Latin America's cross border market, the 2008 results are certainly reflective of a muted investor appetite for emerging market risks. From a credit perspective, access to market and lack of liquidity have historically merited concern and when protracted, generally lead to increased defaults at the bank, corporate and consumer level.

2008 saw a resurgence in the demand for future flow securitizations, an asset class that has been repeatedly credit tested over the previous decade throughout various periods of emerging market stress. 2008 will likely be remembered for the disappearance of

monoline issuance wraps on future flow programs. All issuances this year were unwrapped. Only a limited number of issuances were true market placements. Semi-private bilateral loans between Latin issuers and international banks were common. Unique credit-related requirements, such as the ability to increase bond interest rates based on a material change in lender costs of funds, appeared for the first time in the Latin American market.

Latin American Structured Finance 2008 Rating Actions



Source: Fitch.

In 2008 Fitch only took seven negative credit rating actions on internationally placed structured finance from Latin America. Interestingly, five were within the real estate construction sector: two actions on Cap Cana in the Dominican Republic, one on Trump Ocean Club in Panama and two for Metrofinanciera in Mexico. Most of the concerns related to these deals can be directly connected to the global slowdown in the real estate sales cycles and a lack of liquidity in the markets (whether to finance operations or the purchase of real estate). In addition to the seven downgrades mentioned above, Fitch adjusted the ratings to seven monoline-wrapped future flow tranches reflecting downgrades to monolines.

Conversely, in 2008 Fitch upgraded 17 different structured financings from a handful of different programs. Sovereign upgrades in Brazil and Peru drove most of these actions. The perceived credit quality of Brazilian bank-related future flow programs from Itau, Unibanco, Santander and Visa Net all benefited from an improved sovereign environment. Similarly, Peruvian supported CRPAO infrastructure programs related to the IIRSA Sur and Norte road networks were upgraded in step with the sovereign upgrade.

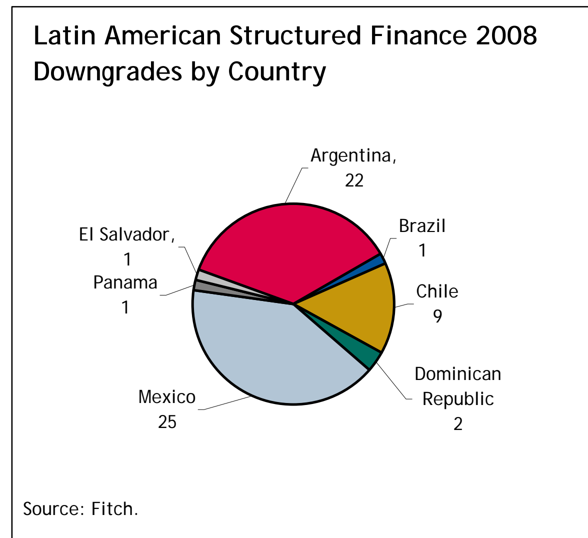
In 2009, Fitch will closely watch the effects of the global financial crisis on Latin American economies and future flow securitizations. In particular, many future flow programs are supported by a bank's underlying trade finance business and overall foreign direct investment, each of which are expected to continue to suffer in 2009. Similarly, commodity price declines can have a material impact on the dollar volume of financial remittances generated by these programs. At present, Fitch-rated Latin American future flows remain insulated from such declines given the considerable levels of debt service coverage (commonly in the range of 75x–100x) exhibited in each program. Fitch is also closely monitoring the related effects these concerns cause in the macroeconomic environment and the ability of governments to successfully maneuver while liquidity remains scarce.

Mexico

Mexico, similar to other Latin American markets, has not been immune to the global credit crisis. By the third quarter of 2008, signs of deterioration had begun to show in asset performance. In addition to an economic slowdown and an increase in inflation, the contraction in credit has caused liquidity concerns for most of the Mexican market. These factors have impacted the level of new structured finance issuance, particularly

RMBS, as well as the performance of existing transactions. Fitch is watching Mexico's dynamic economic climate closely and is particularly focused on the country's ability to remain resilient during less favorable times. In the last five years Mexico has witnessed an auspicious economic expansion, bolstered by high oil prices, record levels of remittances from abroad and significant credit growth in every economic segment. This backdrop has unsurprisingly supported a historically strong asset performance in the context of securitizations. With a less benign macro-environment for the future and signs of deterioration already apparent, Fitch is cautious about 2009's asset-performance expectations. Current indicators, such as a recent announcement that the government will raise minimum wages at a pace lower than inflation, suggest increased pressures on consumer's debt service capability related to auto loans, credit cards, consumer loans and mortgages. As a consequence, Fitch expects an increase in ABS downgrades for 2009.

Latin American Structured Finance 2008 Downgrades by Country



Source: Fitch.

Despite this adverse environment, Fitch believes that the majority of existing transactions are well structured to weather the current conditions. In 2008 Fitch Mexico issued 58 tranche affirmations and 23 total downgrades locally across the Mexican structured finance portfolio. It is worth mentioning that 16 of the 23 downgrades were related to Metrofinanciera's construction bridge loan securitizations. Of the 23 downgrades, there were multiple rating actions on 10 tranches.

Regarding RMBS, Fitch saw a fairly large increase in delinquencies during the second half of 2008. While some increases are attributed to specific events of particular portfolios, many are linked to the pressures on economic growth and rising inflation. Over the course of 2008, Fitch took a total of five negative rating actions on three different RMBS tranches in Mexico. Fitch affirmed 41 RMBS ratings in 2008 but currently maintains a Negative Watch on 15 RMBS ratings. In general, RMBS delinquencies are still in line with Fitch's original expectations. Several credit perceptions became increasingly evident in 2008 that will likely differentiate RMBS performance and analysis for the future: transactions issued by banks outperformed the ones issued by SOFOLES; recent INFONAVIT transactions fare better than older ones due to higher origination standards; older vintages (2004 and 2005 transactions) tend to perform better than recent ones, partially due to higher seasoning and stronger underwriting; and UDI transactions perform worse than Peso transactions. For more detailed information on the Mexican RMBS market, please see "Mexican RMBS Performance Quarterly Report," published Nov. 10, 2008, at www.fitchratings.com.

2008 was also a challenging year for construction bridge loans and the related securitizations. For the year, Fitch affirmed 12 tranches and downgraded 18 (eight of the 18 downgrades represent second, follow-up rating actions to previously downgraded Metrofinanciera tranches). Additionally, five remain a necessary element for the reduction of the Mexican housing deficit, and the federal government, through SHF, has demonstrated a strong commitment to securing the necessary resources for SOFOLES to continue originating these loans. However, the market has experienced significant changes since 2001–2003. After being accelerated by liquid capital markets and readily

available funding lines, origination standards became increasingly less diligent. The more recent past saw an increase in competition between construction bridge loan originators. Lending strategies strayed from the original housing-deficit-based, low-income focus to broader developments funding middle-income, high-income and even second-home oriented projects. These factors contributed to an increase in the construction and sales cycle of certain projects, as well as an oversupply of inventory levels in certain states.

These issues are present in the securitizations backed by construction bridge loans, however, they have not been observed across the board. Fitch has noted that transactions with stronger originators and tighter criteria limiting concentrations and the ability to extend loans have outperformed the general market. With the challenging macroeconomic environment lying ahead, and prospects of increased unemployment in 2009, Fitch expects these differences to be increasingly more evident going forward. For more information on Fitch's view of construction bridge loans, see "Mexican Low-Income Housing Construction Bridge Loan Securitization Rating Criteria," published Jan. 21, 2009, at www.fitchratings.com.

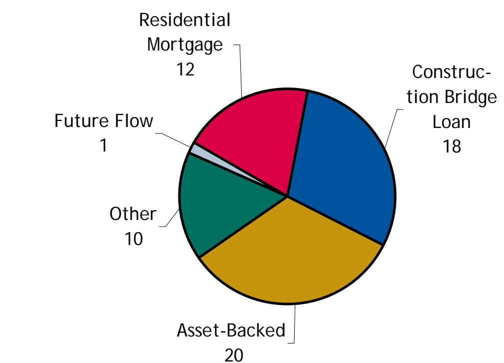
An important recent development in the overall Mexican housing markets was SHF's announcement of support mechanisms aimed at ensuring continued market access for the SOFOLES. In relation to this, Fitch released a statement on Oct. 22, 2008, which describes the importance of the SHF support to the systemically important SOFOLES. The program involves a variety of products to ensure the SOFOLES will have funding during these increasingly difficult markets. These products include secured lines of credit and partial guarantees. In addition to SHF, various multi-lateral institutions including the FMO, IDB and IFC have increased their participation within the housing market.

Argentina

The 2008 Argentine local market structured finance issuance was primarily in the asset classes of consumer loans and credit card receivables. The engine for growth within the consumer loan securitization segment has been underpinned by a rise in domestic consumption, the availability of securitization as an efficient funding mechanism for originators, and a strong investor appetite. The majority of the deals have four conservative characteristics in common: static pools, fully sequential structures, flexible amortization schedules and very short terms (i.e. the senior notes usually have a maturity less than a year).

In contrast to other Latin American markets, 2008 Argentine securitization issuance levels were strong through the third quarter and almost reached 2007 levels of $2.9 billion by year end. The conservative nature of Argentina's market development after its crisis in 2001 partially explains its resiliency. However, three new developments during the last part of the year reduced the pace of growth and created a questionable future. Two of them are government related and politically driven, and the other is a market

Latin American Structured Finance 2008 Downgrades by Asset Class



Source: Fitch.

condition. The three developments include changes in tax codes, the nationalization of the pension fund system and overall asset performance.

Tax Exemption

In August of 2008 the government eliminated the income tax exemption for securitization trusts with certain characteristics (public offerings with static pools, homogenous credits, and strictly turbo structures). All the ABS consumer loan trusts and some of the ABS credit card receivables trusts were affected. This change has two consequences: i) for the outstanding issuances, a reduction of the cash flow for the securities, and ii) for the new trusts, a change in the capital structure reflecting the additional tax-related burden on cash flows. In the first case, the reduction of the cash flow to the securities has not resulted in any downgrades to senior notes. Because of their short-term nature, most existing senior notes will be paid in full prior to the time the trustee has to pay the tax (May 2009). However, Fitch did downgrade 15 junior notes due to this change and timing concern.

Pension-Fund Nationalization

The private pension funds (AFJP) represent the largest institutional investor in Argentina, on average buying approximately 30%–40% of each capital market issuance. In October of 2008, the government announced a bill in congress that would eliminate AFJPs. The law passed, and in mid-December existing and future AFJP portfolios were transferred to the ANSeS (National Social Security Agency). It is not yet clear what effect this transfer will have on the Argentine capital markets or the economy in general. Concern exists that the government will use these newly acquired resources to fund their own budgetary needs. The "crowding out" effect of obligating the pension fund system to focus investments on government securities could greatly reduce access to credit and liquidity in the private sector. Such a change is also likely to impact an originator's ability to finance its borrowers, which over the long run could bring into question their own viability.

Officially, the government has stated intent to invest ARS600 million over the next six months at below market interest rates in new ABS consumer loan issuances but with the condition that the originator pass on the interest rate reduction to the consumers. Several unknowns still exist, including how the government will choose which instruments to buy, if they will buy the whole issuance considering the market rate is much higher and if the originators are willing to lend money at a lower rate without tightening their credit approval process.

Delinquency

During 2008 delinquency levels increased for many originators as a result of a worsening economic environment. Increases in indebtedness and inflation led to erosion in consumer income. The potential for asset deterioration depends on the specific sub-market, origination and collection policies and monitoring and follow up systems. Recently, the market has seen an increase in transaction collateralization levels in order to compensate for higher delinquencies. Fitch estimates that these increases in credit enhancement will remain market practice, as delinquency levels continue to increase among different originators.

Fitch continues to monitor transactions on a case-by-case basis but does not expect significant rating actions in 2009, as these transactions are short term in nature and credit enhancement levels remain significant across the majority of the portfolio. During 2008 Fitch downgraded two tranches of a single program caused by an increase in the delinquency. For more detailed information on the Argentine securitization performance, see the report titled "Losses in Argentine Consumer Loan Securitizations:

Normal Increase or Dramatic Deterioration?" published July 22, 2008, at www.fitchratings.com.

Overall, in 2008 Fitch downgraded 24 ratings. In addition to those mentioned above, Fitch also downgraded five sovereign bond repackagings following the downgrade of Argentina in December. There were no upgrades in the Argentine local markets during the year. There were approximately 600 structured finance ratings outstanding in Argentina in 2008.

Brazil

Despite Brazil's sovereign upgrade to investment grade in the second quarter of 2008, the local capital markets remained volatile during the second half of the year. Nevertheless, the 2008 local structured finance issuance volume was significantly higher than 2007, nearing the 2006 peak of USD5.3 billion. However, 90% of 2008's volume occurred over the first three quarters. Although curbed issuance volumes and spreads widened over the course of 2008, the market was most significantly impacted in the fourth quarter. The overall global financial market volatility fueled liquidity concerns among mid-sized banks and a general contraction of credit to underlying borrowers. Many of these banks that actively tapped the securitization market were forced to sell large portions of their loan portfolios directly to the government and larger financial institutions in order to secure liquidity (Please refer to "Fitch Comments on Liquidity Among Brazilian Banks," published Oct. 14, 2008, at www.fitchratings.com).

In Brazil's local structured finance market in 2008, Fitch made one rating downgrade and four rating upgrades while affirming 34 ratings. Five ratings have also been placed on Rating Watch Negative and are expected to be resolved within the first half of 2009.

Consumer ABS Challenges Ahead

2008 Consumer ABS for used vehicle financing and payroll deductible loans continued to be an important funding source for niche, mid-sized banks in the local market. Nevertheless, several banks, which entered these segments during the double-digit consumer credit growth period (mainly 2006–2007), have recently discontinued these operations due to difficulties in maintaining a profitable business. Many of these banks partially funded themselves via securitization. In general, these mid-sized institutions attempted to increase market share by lower interest rates and loosening underwriting standards (lengthened loan terms, higher LTV's and high debt-to-income ratios). Since October 2008, the abrupt shift in credit market fundamentals has forced banks to tighten origination parameters to more selective borrower attributes. At the same time, consumer confidence and credit demand has been curbed due to the bleak economic outlook including fears of unemployment, rising interest rates and a weakening of the currency. The above mentioned shift in credit origination standards comes on the heels of an unprecedented rise in consumer indebtedness since 2004.

In 2008, Fitch-rated existing transactions' collateral performance had been mildly affected by loosened origination standards. However, Fitch expects consumer ABS collateral performance to continue under pressure in 2009, as a less favorable economic environment with rising unemployment puts pressure on payment capacity of increasingly leveraged borrowers. While these Brazilian borrowers have weathered various stress scenarios over the last two decades, the untraditional amount of leverage taken out by consumers over the past four years puts borrowers and creditors in uncharted Brazilian waters.

Implicit Seller Support Continues

The majority of consumer ABS transactions have several common characteristics: two-class senior/subordinate pro rata pay structures, varying degrees of "gain-on-sale" of collateral sold to the transaction and revolving collateral. Also, most structures use minimum subordination tests in which the seller will voluntarily post new collateral in order to maintain the minimum subordination to avoid a potential trigger of the transaction. It is commonplace for various sellers to frequently repurchase delinquent or prepaid loans from the securitization. These last two characteristics result in the seller implicitly supporting the transactions performance, and potentially mask true collateral performance, as surveillance information does not provide details related to this. This implicit support by the seller is not a contractual obligation and may become highly uncertain in times of originator liquidity constraints or other originator-affected events. Fitch expects this practice to decline during 2009 as liquidity continues to tighten overall origination levels, and this will curb the seller's ability to do this. Fitch does not consider this support in its assigned ratings, but we believe over performance statistics within the securitizations will start to reflect the true performance of the asset class during 2009.

Furthermore, ongoing "gain-on-sale" practice in collateral sales to many securitizations continues to overestimate credit enhancement levels available to protect investors from collateral defaults and prepayments. For more information on Fitch's view on the "gain-on-sale" effect in securitization structures, see "Rating Criteria for Consumer ABS in Latin America," dated Dec. 17, 2008.

Positively, with collateral performance deteriorating, investors and capital markets regulators are seeking measures to improve public disclosure of true securitization collateral performance and the effects of implicit seller support.

Asset Sale Consolidation Rules Postponed

With the liquidity crisis faced by the institutions that most frequently reverted to asset securitization (i.e. small- and medium-sized banks), the central bank has postponed the implementation date for new rules on consolidation of asset sales by financial institutions. This resolution (e.g. No. 3.533) was set to become effective as of January 2009, however, was postponed to January 2010 due to the current financial turmoil. This ruling directly affects off-balance-sheet treatment of mainly consumer ABS, introducing "risk retention" tests. For securitization transactions, non-consolidation requires, among other rules, that the seller retain a capital structure interest, which is no greater than two standard deviations of the collateral's average historical loss. To date, securitization transactions have not been structured to avoid these consolidation criteria.

Furthermore, in order to achieve non-consolidation, the seller's limitation in the transaction's senior/subordinate capital structure may constrain ratings of these classes if greater tranching above the "seller's piece" does not become market practice.

Emerging Market Sovereign Outlook

Fitch believes that the economic and credit outlook for emerging market economies has worsened dramatically, as the "credit crunch" that originated in the so-called "advanced" economies contaminates the developing and emerging world. The negative impact on emerging market economies of the recession in the G7 is magnified by the sharp curtailment of financing from international banks and investors and, for commodity producers, by falling export prices. Even with China's economy slowing — now forecasted to expand just 6% next year by Fitch, its lowest rate since 1990 — emerging markets are forecast to grow by just 2.5% in 2009 compared to more than 6%

in the first half of this year — only marginally faster than in the aftermath of the Asian and Russian crises in 1998.

Globally, Fitch believes the risk of multiple economic and financial crises across emerging markets is now greater than at any time since the Asian Crisis of 1997–1998, with the Central and Eastern Europe region at most risk. Several emerging market economies face outright recession, especially those with large current account deficits that international banks and markets are no longer willing or able to finance. Even for those with current account surpluses, capital outflows will add pressure to the balance of payments as non-sovereign borrowers struggle to refinance more than USD300 billion of foreign borrowing maturing next year.

Despite the unprecedented scope and scale of intervention in support of banking systems in advanced economies, their banks' access to medium-term financing remains constrained and pressured to improve capital ratios and reduce risk intense. Consequently, the ability and willingness of "Western" banks to extend credit to emerging markets, whether directly or via subsidiaries, has fallen sharply. Foreign subsidiaries', like their parents', banks are under pressure to shrink their balance sheets, contributing to a domestic "credit crunch" and exacerbating balance of payments stresses. This process is adversely impacting nearly all emerging market economies, especially in Central and Eastern Europe where international banks have been the dominant source of external financing and where the risk of country crises is greatest. Several sovereign ratings across the region have recently been downgraded and several remain on Negative Outlook (see Fitch's "Rating Review of Emerging Markets", Nov. 10, 2008). Though Central and Eastern Europe is most at risk, risks are also on the rise elsewhere. In Latin America, countries with weak credit fundamentals that are reliant on commodity exports are especially vulnerable, while growth in the export-orientated Asian economies is now forecast by Fitch to slow to just 3% compared to 8% annually over the last five years. Nonetheless, sovereign credit fundamentals across emerging market regions are stronger than during previous episodes of crisis, reflected in reduced government borrowing from international capital markets in recent years and the accumulation of large stocks of foreign exchange reserves that provide a buffer against the current economic and financial turmoil.

Fitch has previously noted that emerging market sovereign creditworthiness is more directly at risk than in "advanced" economies because of the prevalence in the former of foreign currency denominated bank liabilities, currency mismatches in private sector balance sheets and monetary regimes anchored by exchange-rate stability. Injections of local currency liquidity by EM central banks — a key pillar of sovereign support for the financial sector in advanced economies that benefit from "reserve" or "near-reserve currency" status — run the risk of triggering a currency crisis as investors and the public replenish foreign rather than local currency money balances, while sovereign guarantees of mostly foreign currency bank debt and deposits are less credible and more likely to be called.

In Latin America, Brazil and Peru were both awarded investment grade 'BBB–' ratings in 2008. Downgrades occurred late in the year to Ecuador (currently rated 'RD'), Venezuela (currently rated 'B+') and Argentina (currently rated 'B–' local currency). The Positive Outlook was also removed from Mexico and Chile.

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