UN Department of Economic and Social Affairs
Innovative Finance for Sustainable Development

New York, October 18-19, 2007

The role of international credit ratings in financing utilities

The case of Mexico

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Relevant Background of Mexican Subnational Financing Market

Relevant Background

> 31 States & the Federal District

> 2,444 Municipalities
- *Only 250 municipalities have a higher per capita income than the national average (US$8,900)*

> State & Municipal Decentralized Enterprises
- Federal Agencies – wide coverage of public services
- S & M owned – 500 water and sewer utilities

> Hitherto, subnational borrowing is forbbiden in foreign currency and can not be taken by foreign investors
- May change in the future
- Favourable aspect due to present stage of development

> Federal Revenue Sharing (FRS)
- High proportion of S&M Total Revenues
- Traditional resource to collateralize Mexican subnational debt

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Significant changes in the legal-financial scheme used for subnational financing (April 2000)

Former Debt ⟺ April 2000 ⟺ **New Debt**

Environment Former Debt

- “Mandate” Scheme prevailed
- Ministry of Finance (SHCP) - active role in guarantees execution
- In case of default:
  - SHCP paid banks directly on behalf sunbationals pledging their FRS
  - Admnistrative and Bureaucratic Process
  - Chronological order of precedence
- Unlimited borrowing backed with FRS

Environment Former Debt - Implications

- Banks' perception for these credits as "Federal Risk"
- Little development of credit culture:
  - Banks not interested in credit analysis
  - Not credit risk differentiation among entities
- Low level of transparency regarding disclosure of financial information
- SHCP - role in guarantees execution- high potential risks
  - Under a situation of generalized crisis
  - When public finances of an entity decline
- Administrative process for guarantee execution
- Possible legal intervention when executing the mandate
- Overindebtedness cases

No access to debt securities market

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Environment New Debt

> Subnational debt contracted after April 2000
> "Mandate" mechanism was eliminated
> Subordinated to Former Debt
> Limited % of FRS for each financing
> Capitalization Requirements for subnational bank loans
  – Are based on 2 credit risk ratings from authorized rating agencies
  – Endorsement option for municipalities and decentralized agencies
  – Based on the number of levels below the Federal Government Rating [AAA(mex) on the local scale]
  – Weighted risk percentages based on credit risk ratings

Environment New Debt - Implications

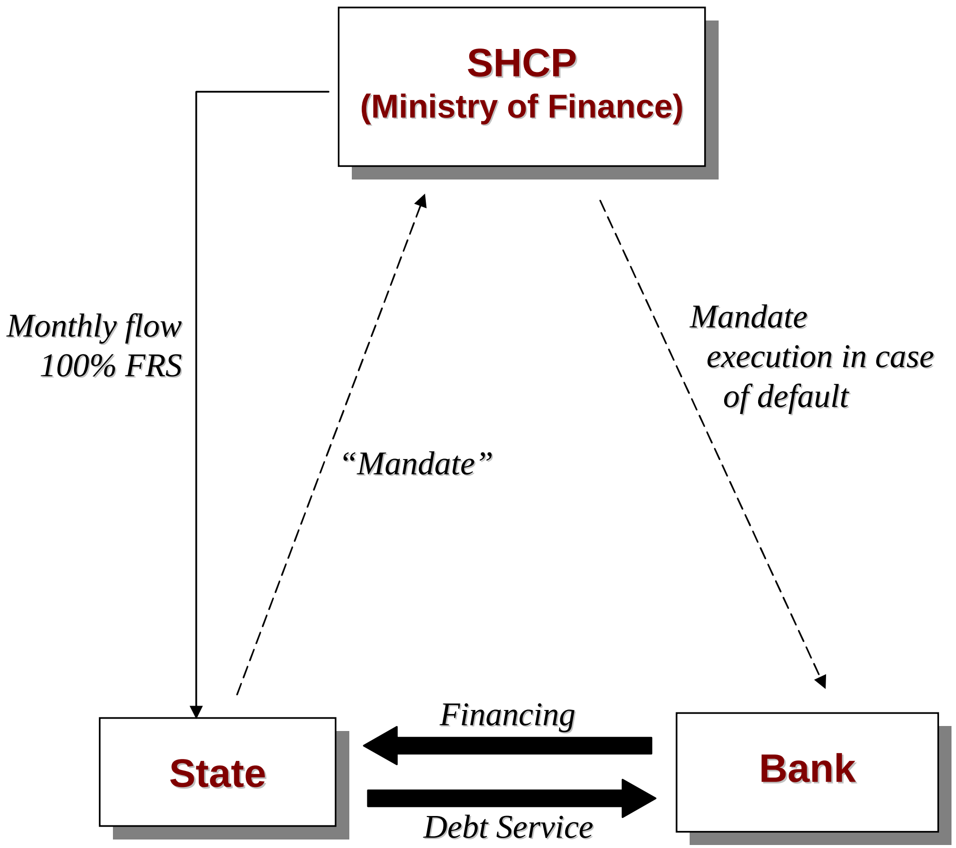
- No intervention of SHCP in an event of default
- More independence and responsability in entities (public finances and debt)
- Discourage possible extraordinary support and financial bailouts from Fed Gov
- Guarantees scheme changed and promotes the use of Trusts of Administration and Source of Repayment (TASR)
  - Delimit FRS for each financing
  - Unconditional payment and irrevocable mandate (State – SHCP)
  - Opening of the debt securities market as a financial option / diversifying financing alternatives / terms and conditions more competitive
- No Chronological order of precedence among credits
- Credit risk ratings encourage transparency vs. mistrust perception of S&M finances
- Credit Risk differentiation among rated & non-rated entities

Backing scheme for Financings

Mandate Mechanism

Limitations:

- ***Weak mechanism for debt securities market***
- ***Probability of Judicial Interference***

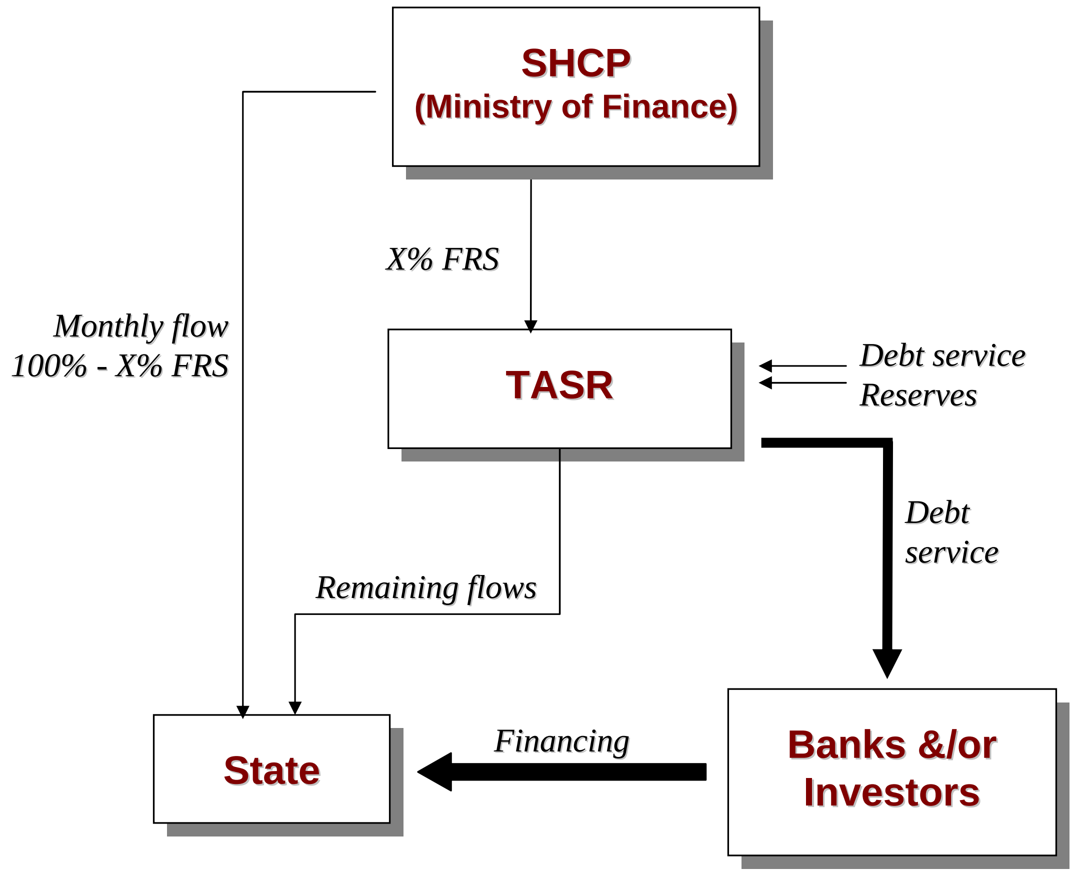


Backing scheme for Financings

New scheme

Key Factors:

- **_Irrevocability_**
- **_Legal opinion required – issuer & rating agency_**



Regulation Bank's preventive reserves against subnational loans in December 2004

> Based upon credit risk ratings
> Penalize long term unsecured bank loans / promotes the use of structured mechanisms to back bank loans (TASR's)
> More impact than the capitalization requirements in terms of financing cost
> Relevant for bank loans over US $10 million

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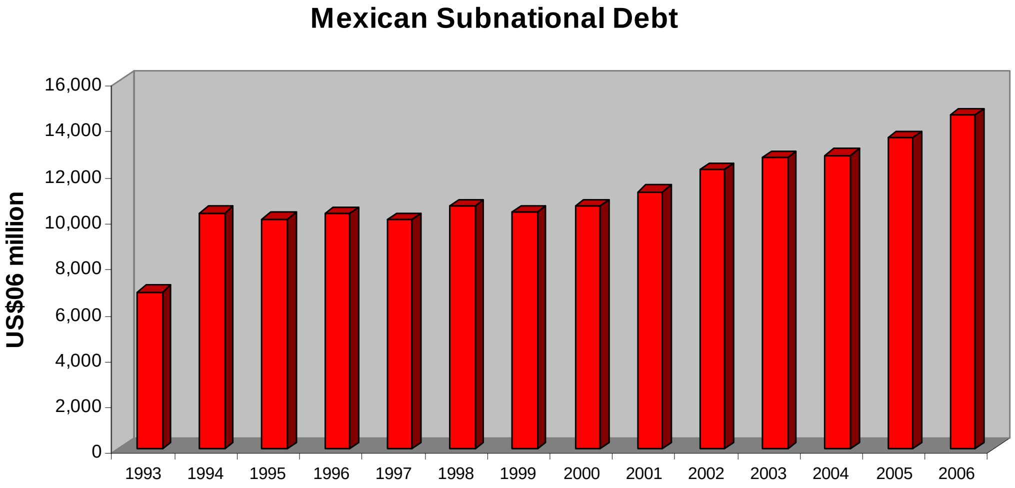
Evolution of Mexican Subnational Financing Market

Debt of Federal District, States, Municipalities and Decentralized Bodies (State and municipal owned)



	SD (US$06 million)	Growth %
1994	10,283.8	
2000	10,555.6	2.6
2006	14,554.0	37.9

	SD % of GDP
1994	2.0
2001	1.9
2002	2.0
2003	2.0
2004	1.9
2005	1.7
2006	1.8

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Subnational Finanicng (2000 y 2001)

> Uncertainty / low financing / Banobras (Mexican Development Bank)

> Issuer Risk Ratings (mainly States)

> December 2001: first 2 debt issuances
  – First specific financing ratings
  – First financing using a TASR

> Financings backed w/ FRS continued

Composition of Mexican Subnational Debt

US million $Dec '06	**1999**		**2006**	
Subnational Debt	**10,298**	**100%**	**14,554**	**100%**
States	7,414	*72%*	11,934	*82%*
Municipalities	412	*4%*	1,310	*9%*
Dec. Bodies	2,471	*24%*	1,310	*9%*

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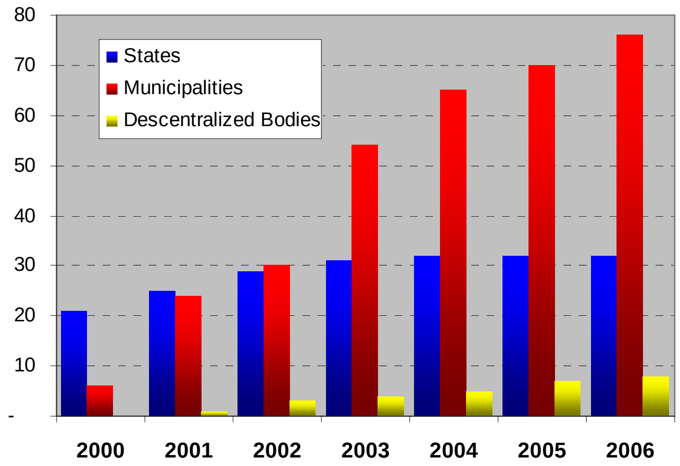
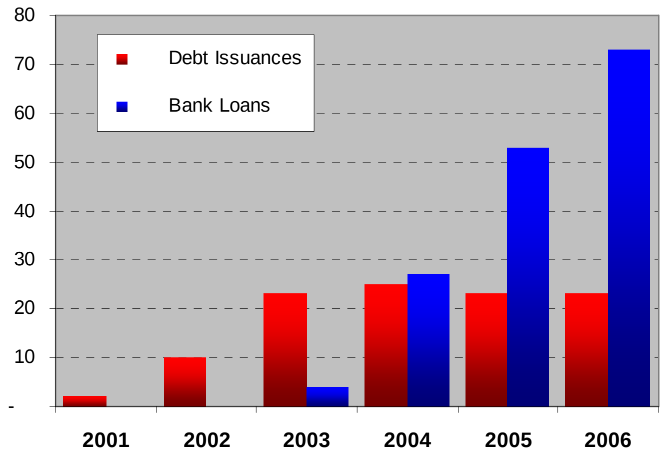
Subnational Debt Maket Ratings

Entities: 2 Issuer Ratings



	2001	2003	2006
States	25	31	32
Municipalities	24	54	76
Dec. Bodies	1	4	8
	49	**85**	**108**

Financings Ratings



	2003	2004	2006
Debt Issuances	23	25	23
Bank Loans	4	27	73
	27	**52**	**96**

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Balance / 7 years of Regulatory Changes

> Diversification of alternative borrowing sources (debt market / more participation of commercial banks)

> Better terms and conditions

> Diversification of resources of payment (Payroll tax revenues, vehicle control fees, vehicle tax, water fees, revenues from highway tolls, etc.)

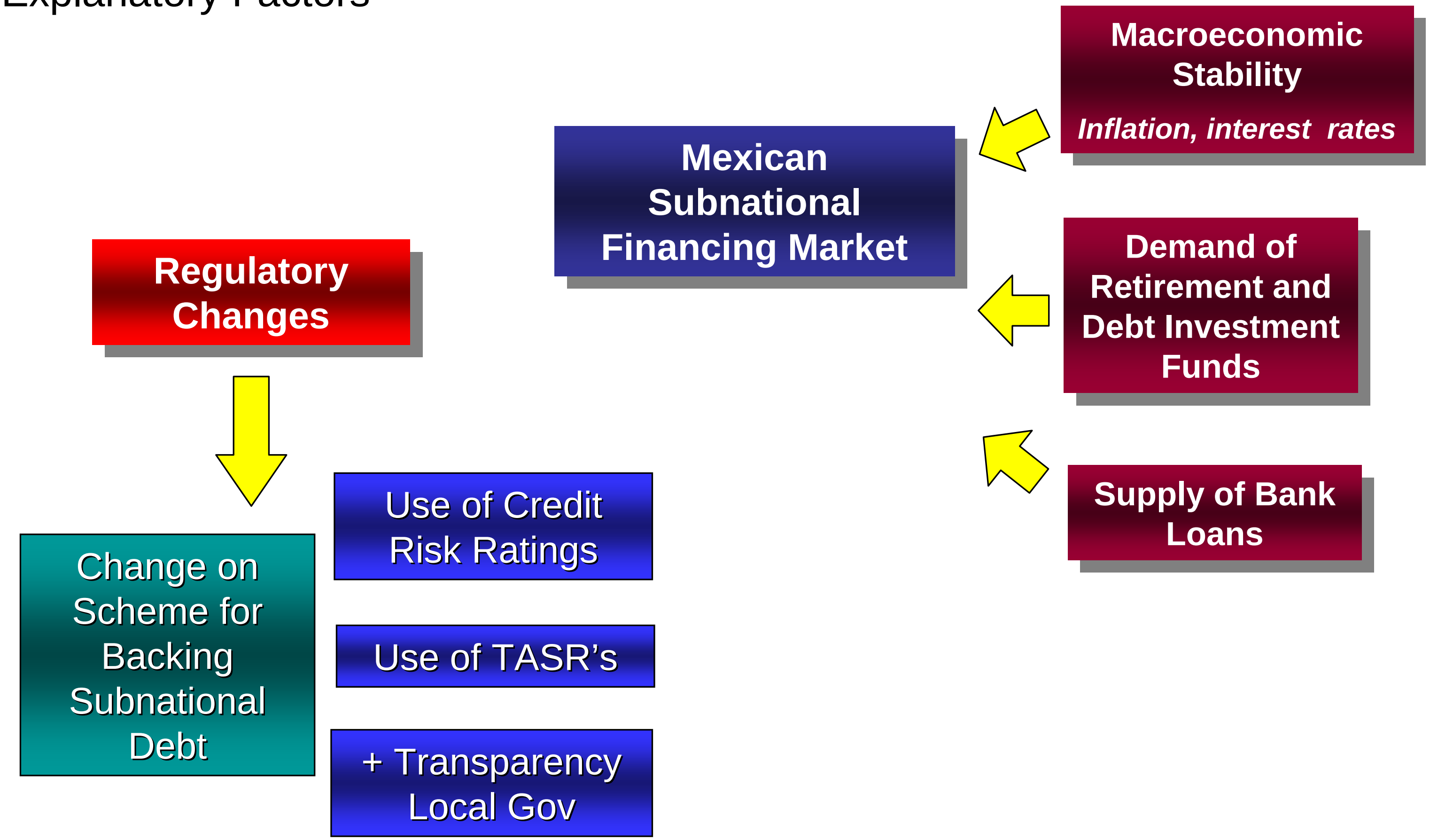
> Important debt restructuring projects (↓ Former Debt)

> Pooled financing structures (using a single TASR) for debt of medium and small size municipalities

Additional Benefits

- More exposure of subnationals's finances in Mexico
- Better risk differentiations among entities
- Important growth of entities with external audits
- More developed market / increasing interest of other participants (struture agents, guarantors, lenders, etc.)

Explanatory Factors



Limitations and possible risks

- Need to implement prudential debt limits, expenditures covenants, and criteria when affecting future flows for backing debt.
- High dependence of federal revenues / low incentives for strenght local collection
- When the financial flexibility of an entity declines
- A lack of consistency between credit risk and financing costs by creditors
- Low incentives of Debt Investment Funds for investing in subnational debt issuances
- Homogeneity, Quality & Opportunity of financial information
- Presentation's quality of Financial Statements

Credit Risk Ratings Perspectives

> States

- Mature Market, 32/32 entities
- Trend to have 3 ratings (10 cases so far)

> Municipalities

- Continuing growth during the following 5 years until reaching a total of 120 - 150 municipalities rated
- The remaining municipalities will continue using endorsements form its State Governments or will participate in pooled financing structures (3 cases so far)

> Water Agencies

- Most agencies have a “weak financial position” presenting recurring “deficits”
- Very slow and marginal growth in credit ratings (11 cases so far)
- Financing structures will continue depend upon their sponsor support

Financing Ratings Perspectives

> Debt Securities Market

- The main issuers will be S&M / Consolidation as a financing alternative

> Bank Loans

- Due to "Preventive Reserves" regulation bank loans have been more attractive than debt issuances (aggressive banking strategy, low spreads)

> New Financing Structures

- Pooled structures for medium and small size municipalities to reduce costs and diversify risk (3 cases so far)
- "Bond Banks": State decentralized Institute responsible for bring financing nearer to small municipalities and decentralized bodies mainly water utilities (1 case and 1 in process)
- Financing backed with non-traditional resources (such as the property-tax)
- Use of partial or total guarantees by a third party to increase ratings and reduce interest rates
- PPP's: now at Federal Level, option for States

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