DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

MEXICO

CCLIP FOR THE DEVELOPMENT OF EFFICIENT AND INCLUSIVE MORTGAGE MARKETS IN MEXICO
(ME-X1006)
AND
FIRST GLOBAL CREDIT PROGRAM FOR MORTGAGE MARKET DEVELOPMENT UNDER THE CCLIP
(ME-L1063)

LOAN PROPOSAL

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1. Operating Regulations (draft)
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2. Monitoring and evaluation arrangements
   Evaluation Framework and Results Indicators (see paragraph 2.6)
3. Environmental and social management report (ESMR)
   Not applicable.
4. Annex II, Safeguard Screening Form for classification of projects (SSF)
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=1668803

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1. Housing Demand in Mexico
   http://idbdocs.iadb.org/wsdocs/getDocument.aspx?Docnum=1668785
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ABBREVIATIONS

CCLIP	Conditional credit line for investment projects
CNBV	Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission]
CONSAR	Comisión Nacional del Sistema de Ahorro para el Retiro [National Commission of the Retirement Savings System]
FOVISSSTE	Fondo de Vivienda del Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado [Housing Fund of the Government Worker Social Security and Services Institute]
GDP	Gross domestic product
HITO	Hipotecaria Total (a Mexican mortgage securitization company)
INFONAVIT	Instituto del Fondo Nacional de la Vivienda para los Trabajadores [Institute of the National Housing Fund for Workers]
MBS	Mortgage-backed securities
OR	Operating Regulations
SAR	Sistema de Ahorro para el Retiro [Retirement Savings System]
SHCP	Secretaría de Hacienda y Crédito Público [Ministry of Finance and Public Credit]
SHF	Sociedad Hipotecaria Federal, SNC
SNC	Sociedad nacional de crédito [national credit institution]
SOFOL	Sociedad financiera de objeto limitado [limited-purpose financial institution]

PROJECT SUMMARY

MEXICO
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Financial Terms and Conditions					
Borrower: Sociedad Hipotecaria Federal, SNC				Drawdown period:	10 years
Executing agency: Sociedad Hipotecaria Federal, SNC				Amortization period:	25 years
Guarantor: United Mexican States				Grace period:	5 years
				Disbursement period:	5 years
Source	**First program (in US$ millions)**	**CCLIP (in US$ millions)**	**%**	Interest rate:	LIBOR
				Inspection and supervision fee:	*
IDB (Ordinary Capital):	Up to 500 million	Up to 2.5 billion	100%	Credit fee:	*
Local:	0	0	0%	Currency: United States dollars from the Single Currency Facility	
Total:	500 million	2.5 billion	100%	Conversion to Mexican pesos: Local Currency Facility (LCF) (document GN-2365-6)	

Project at a Glance

Project objective/description:
The **objective** of the proposed CCLIP and first program is to promote the development of efficient and inclusive mortgage markets in Mexico.

The **purpose** of the CCLIP is to support Sociedad Hipotecaria Federal, SNC (SHF) with tools enabling it to provide liquidity and stability to the primary and secondary mortgage markets. The purpose of the first program is to provide SHF with funding so that it can better support and develop the primary and secondary mortgage markets, and strengthen the structure of its balance sheet.

Special contractual clauses:
As a condition precedent to disbursement of the funds of the first program, the Credit Regulations must be in force with the Bank's no objection (see paragraph 3.9).

Special execution conditions:
A midterm evaluation will be conducted after 24 months, or once 50% of the loan has been committed, as described in paragraph 3.13.

Exceptions to Bank policies:
Retroactive financing, chargeable against the loan proceeds, may include expenditures incurred during the 18 months prior to the loan approval date (see paragraph 3.9).

Revolving fund. The revolving fund will be for up to 20% (see paragraph 3.10)

Project consistent with country strategy: Yes.
Project qualifies as: SEQ [X] PTI [ ] Sector [X] Geographic [ ] Headcount [ ]
Procurement: Bank policies will be applied.
Verified by ESR on: Not required.

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference, problem addressed, and rationale for Bank support

1. Frame of reference

1.1 **Macroeconomic environment.** The Mexican economy has experienced stable performance in recent years, combining economic growth with lower external debt and a positive trade balance. However, as a result of the volatility of global markets and the financial crisis in the industrialized markets, the Mexican economic environment has been deteriorating in recent months, as reflected by higher inflation, increased unemployment, and slower growth caused in part by the decline in residential investment. Without ruling out the possibility that financial uncertainty in the United States may have more pronounced repercussions, the authorities of the Ministry of Finance and Public Credit (SHCP) and Banco de México, as observers of the private sector, have scaled back growth forecasts for 2008 and 2009 to around 2.4% and 2.0%, respectively. Fear of worse contagion has heightened risk perception in Mexico, as shown by the country's widening public and corporate debt margins. The downturn of the United States economy, particularly in the construction industry, has also reduced the volume of remittances, which are an important source of foreign exchange.

1.2 Despite the risks entailed by current international financial conditions, the Mexican economy is in a good position to weather the uncertainty and liquidity shortage in the markets. Thanks to a prudent economic policy, the country has sound fiscal management, an independent central monetary authority committed to keeping inflation in check, significant foreign exchange reserves, and an effectively regulated and well-capitalized financial sector.[1] The current government has made significant strides in reform of the public social security system and approval of the fiscal reform. The medium-term projected growth rate for Mexico is around 3.3%.

2. Problem addressed

1.3 The housing sector in Mexico currently faces significant challenges from the financial market downturn and illiquidity, and strong growth in the demand for mortgage financing stemming from rapidly increasing housing demand. It is estimated that in Mexico there is a historical backlog of 9.5 million homes, primarily households in the informal sector with revenues of less than three times the minimum wage, and that 650,000 homes are added to the housing market each year (see Housing Demand in Mexico.)

1.4 **Housing finance demand.** Sociedad Hipotecaria Federal, SNC (SHF) estimates that in the period 2007-2012 more than seven million households, largely in the informal sector, will demand access to housing finance. In 2008 alone, calculations are for this demand to be 1,159,000 households. Of this number, 300,000 will be new households that may seek financing due to their income level or geographic

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[1] The Capital Adequacy Ratio for banks in Mexico is around 16%, with low delinquency rates and prudent reserve policies.

location; 765,100 (or 66%) will be households from the historical backlog; 71,500 will be families that already have a home but want a bigger one or one with higher value; and 22,700 will be households whose first earlier applications were rejected but will be authorized later. Given the backlog, this would mean that in 2008 more than eight million Mexican households with housing needs will not be in a position to seek financing, due either to their geographic location or inability to pay.

1.5 If this trend continues, meeting the demand will require raising significant resources and broader access to housing finance for lower-income families. The investment of national and regional housing institutions and private intermediaries between 2001 and 2006 was Mex$854 billion, for 3.1 million home purchases or improvements financed. Projected to meet 2007-2012 needs, this investment translates into financing requirements of about Mex$1.8 trillion. According to SHF projections, the mortgage loan portfolio should increase from US$79.6 billion in 2006, to US$338.3 billion in 2020, with the mortgage loan portfolio/GDP ratio increasing from 11% in 2004 to 27.7% in 2020.

1.6 According to federal government estimates, and given the projected demand for financing, deposits and borrowings by banks will be insufficient to fund the required growth of the mortgage loan portfolio. However, the Mexican economy does produce sufficient savings through institutional investments, primarily concentrated in pension fund management companies. The resources managed by institutional investors increased from 9.3% of GDP in 2000 to 22% in 2007. According to SHCP projections, in the future most of the growth in financial saving will come from the increased resources managed by institutional investors, set to reach 31.9% of GDP in 2012. Of this total, the amount corresponding to the Retirement Savings System (known by its Spanish-language acronym, SAR) was equal to 11.2% of GDP in 2007, more than double the amount managed in 2000 (5.3% of GDP). This figure is expected to rise to 15.9% of GDP by 2012.[2] Therefore, in order to finance the growth of the mortgage market and meet the demand for credit, the country's strategy,[3] which the Bank supports, is to develop the capital markets to efficiently mobilize the resources of institutional and foreign investors. See Developments in Financial Saving.

1.7 **The mortgage market.** Generally speaking, the mortgage markets in Mexico are small, partly as a result of the 1994 financial crisis. In 2005, Mortgage lending in Mexico accounted for 11% of GDP, compared to 51.9% in Spain (2001), 42.6% in Canada (2001), and 16.7% in Chile (2002). Stated another way, at the end of 2006, according to SHF estimates, Mexico's housing stock was valued at approximately Mex$14.6 trillion. At that same date there was a total mortgage loan portfolio of

2 Significantly, financial saving rose by 7.4% per year on average between 2000 and 2007.

3 See *Programa Nacional de Financiamiento del Desarrollo 2008-2012* [2008-2012 National Development Finance Program], Section III. http://www.apartados.hacienda.gob.mx/pronafide/documentos/pronafide_%202008_270508.pdf

Mex$861 billion. Thus, less than 6% of the housing stock was leveraged with some type of credit, which is extremely low compared to other countries.

1.8 Following the collapse caused by the 1994 crisis and several years of minimal participation by the banks, the Mexican mortgage markets have had a decade of recovery and expansion, with a cumulative annual growth rate of 9.8% since 1996. SHF reports that in 2007 there were 965,000 housing operations with a total value of Mex$279 billion, which represents a 124% increase since 1998. Mortgage debt increased some 55% between 2000 and 2005, although, as already noted, it accounted for just 11% of GDP that year.

Annual Housing Finance Indicators

Number of loans and subsidies granted (thousands)

	2001	2002	2003	2004	2005	2006
Total	**461.9**	**704.5**	**735.2**	**763**	**545.6**	**633.3**
INFONAVIT	205.3	275	300	306	371.7	418
SHF/Government Housing Finance Fund (FOVI)	47.6	46.1	54.2	65.3	54.4	37.1
FOVISSSTE	26.6	11.1	68.3	60.3	48.4	74.2
Commercial banks and SOFOLs	3.7	9.7	17.6	35.8	101.8	166.5
Others**	178.7	342.9	295	295.7	22	15.2
Reduction***					-52.8	-77.7

** *Fonhapo, Sedesol, government agencies, Banobras, Issfa, Pemex and CFE.*

*** *Refers to financing arrangements (loans and subsidies) that are considered in two or more institutions.*

1.9 In terms of lenders, the Mexican mortgage market is characterized by significant participation on the part of official financial institutions. As seen in the preceding table, Instituto del Fondo Nacional de la Vivienda para los Trabajadores [Institute of the National Housing Fund for Workers] (INFONAVIT) is the most important institution in terms of providing mortgage finance, with nearly 66% of the market in 2006. Financing provided by this institution is restricted to workers in the formal sector, and contains subsidized interest rates. INFONAVIT has undertaken a major modernization process, and has grown its total market share. SHF, by contrast, experienced a reduction in 2006 as it began prioritizing guarantees to support mortgage portfolio securitization on the part of the limited-purpose financial institutions known as SOFOLs, thereby driving the origination of mortgages by these institutions, as reflected in the line in the above table on commercial banks and SOFOLs. The Fondo de Vivienda del Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado [Housing Fund of the Government Worker Social Security and Services Institute] (FOVISSSTE) is an institution similar to INFONAVIT, restricted to federal government employees. Until late 2006, SHF was the conduit through which FOVISSSTE originated all of its transactions.

1.10 In terms of private sector participation in the mortgage market, most loans originated by private institutions between 1995 and 2007 were through SOFOLs, funded by SHF or its predecessor.[4] Along with banks, which began originating loans again in 2005, the SOFOLs contributed to a substantial increase in housing finance, which on average increased 19% annually between 2001 and 2007. The contribution of the SOFOLs, which are geared to the middle income market, is the result of accessing competitive sources of funding from both SHF and capital markets. The banks, whose business focuses on the middle/residential housing market, has also benefited from access to the capital market (see paragraph 1.11). Macroeconomic stability and the growing participation of commercial banks has increased competition and led to better mortgage lending terms: in recent years, the average interest rate fell from 18% to 12.1% (rising again slightly to 12.3% since mid-2008), with the average loan maturity lengthening from 15 years in 2004 to 20 years in 2007.

1.11 **The secondary market.** The development of a mortgage-backed debt market was a strategic decision of the federal government, implemented through SHF. The core objective of this policy (see paragraph 1.6) was to mobilize the domestic savings in the portfolios of institutional investors (particularly the SAR) in order to meet the growing need for resources to cover the housing backlog. Until SHF was created in 2001, there was no institution that promoted homogeneity in the loans to be securitized. The first security issue took place in 2003. In the last three years, the compounded annual growth rate of the outstanding market was 119%, peaking at 33 issues totaling Mex$29.891 billion in 2007, which was 61.6% higher than in 2006. In 2007, 25% of the mortgage portfolio of the SOFOLs was financed through securities. The outstanding balance at the end of the first quarter of 2008 was Mex$57.847 billion in 79 issues: 48% backed by the portfolio securitized by the mortgage SOFOLs and SOFOMs [multiple-purpose financial institutions], 29% by INFONAVIT, and 23% by commercial banks. Despite progress, the total amount of mortgage securitizations is relatively small, less than 7% of the outstanding balance of mortgage loans in the country, a fraction of the 66% in the United States.

1.12 The secondary market has not been spared the turbulence of recent months. In late 2007, given its role as market maker (see paragraph 1.19.b), SHF had to purchase more than 50% of two issues of mortgage-backed securities (MBS). Since then, the markets have once again opened to other issues, but uncertainty persists. Even without any foreseeable risk of collapse in Mexico, the dislocation in the United States has led to: (i) a perception of higher risk that pushes up margins, since investors are demanding up to 100 basis points more than before in secondary market security auctions;[5] (ii) the disappearance of monoliners; and (iii) slowdown and postponement of MBS issues on the securities exchange, declining by 42% in the last 12 months (from 19 to 11, although the average amounts per issue have

[4] In mid-2008, there were 10 mortgage SOFOLs.

[5] It is worth noting that the wider margin sought for MBSs is similar to the rise in Mexico's country risk, indicating that they are attributable to greater risk aversion, not doubts as to their quality.

increased). Consequently, securitization forecasts have been tempered. In early 2008, SHF projected that securitizations would total about Mex$50 billion; it lowered that estimate to between Mex$25 billion and Mex$30 billion, which would still finance 70,000 homes. The tangible impact is that there is a significant shortage of funding in the sector, coinciding, as noted, with considerable growth in the demand for housing finance.

1.13 It should be emphasized that, despite the temporary uncertainty, there is no reason why mortgage securitizations in Mexico would behave like those in the United States, since there are no securities backed by junk or high-risk mortgages (and loan origination criteria have not been relaxed). Issues in Mexico comply with the rules of the Comisión Nacional Bancaria y de Valores [National Banking and Securities Commission] (CNBV) and the Comisión Nacional del Sistema de Ahorro para el Retiro [National Commission of the Retirement Savings System] (CONSAR), which are stricter than for subprime issues in the United States. Moreover, the entire portfolio securitized and backed by SHF meets their origination standards, which are strict in terms of loan-to-value, require mortgage insurance, and are fully documented. An analysis of the differences between the two markets is attached as an annex (Link). In general, the Mexican mortgage market has not demonstrated solvency problems similar to those in the United States, but it has experienced liquidity problems that have begun affecting the ability of private operators to meet market demand. If the liquidity problems are not addressed with well-targeted actions, Mexico runs the risk of undoing a good part of the progress made in recent years towards an efficient and inclusive mortgage market. Mexican MBS Markets.

1.14 **Challenges in the mortgage sector.** The sector faces four major challenges in the short and medium term: (i) maintaining the flow of funding to the sector's private institutions for individual loans; (ii) sustaining activity on the MBS market; (iii) deepening the development of a sound and efficient secondary market to channel the funding necessary to meet long-term demand to private intermediaries; and (iv) reaching the unserved population through new financial products and intermediaries.

1.15 The illiquidity and continued uncertainty in international and local financial markets has translated into greater complications for institutions in the private sector in terms of obtaining funding for mortgage activities, given that direct funding and funding from the secondary market has tapered and become more expensive. This cooling and the widening of secondary market margins is more burdensome for the SOFOLs, which by not directly taking deposits from the public have limited options to obtain funding for new loan origination or to refinance short-term liabilities. In this context and given the turbulence in global financial markets, direct funding from SHF has become even more critical.

1.16 Demand is concentrated in the low-income rural or semiurban sectors (see Housing Demand in Mexico), which are underserved by market operators and public housing institutions due to price, the difficulty of verifying income, or geographic location. SOFOLs and banks have barely entered the market of households with

incomes under seven times the minimum wage, and although the INFONAVIT and FOVISSSTE programs reach lower-income families, labor formality requirements limit their coverage. An estimated 50% of urban families cannot access housing finance from the available sources. Thus, the current context of illiquidity and heightened risk perception further hamper the expansion of access to mortgage financing to the unserved segments of the population. It is therefore essential to reach these segments with new types of financing and financial products through financial intermediaries that possess the necessary technology, knowledge, and ground-presence, such as savings banks and other low-income savings and loan institutions.

B. SHF and its promarket and countercyclical role

1.17 Sociedad Hipotecaria Federal, SNC (SHF) operates as a second-tier "national credit institution" to promote the development of the primary and secondary housing finance markets, with a predominantly social orientation. SHF's institutional strategy is to develop housing markets in Mexico, chiefly by: (i) promoting access to credit in the unserved market (population with an income of less than seven times the minimum wage); (ii) promoting greater efficiency in housing credit for the population that already has access to financing; (iii) increasing the private sector's participation in risk-sharing in the housing market, and attracting the participation of more intermediaries; (iv) promoting the development of secondary markets for housing credit; (v) promoting a sufficient supply of low-income housing as part of a sustainable urban environment. These objectives are set out in the SHF's strategic plan (see SHF Strategy), which also includes other goals of efficiency, capacity, and internal processes.

1.18 SHF is backed by a full sovereign guarantee for obligations incurred through January 2014, as established in transition article 2 of its charter, but it uses market mechanisms to set its prices, and seeks a 10% return on equity (ROE) in real terms. In June 2008, SHF had Mex$67.850 billion in assets, of which Mex$49.795 billion correspond to its loan portfolio (net of reserves), and a net worth of Mex$18.146 billion. In 2007, SHF generated profits of Mex$1.754 billion, which represents a return on assets of 3.1% and an ROE of 10.3%. For that year, the arrears rate was 0.78% with a wide margin in the coverage rate of the portfolio in arrears (more than 1000%). SHF has generated positive earnings every year since it was founded, which is consistent with its objective of obtaining AAA(mex) credit rating without sovereign guarantee in the year when that guarantee will be lifted. (See Financial Statements).[6]

1.19 True to its mission, SHF has played a decisive role in promoting mortgage financing under market conditions in Mexico, and has been a catalyst in the expansion of private participation and offerings in the sector:

[6] Taken from the financial statements published by the CNBV.

a. In the primary market, SHF has financed growth of the SOFOLs,[7] established credit scoring mechanisms, promoted the standardization of mortgage agreements, and introduced mortgage insurance, encouraging private-sector participation in the market.

b. In the secondary market, SHF has set rules for standardizing securitization criteria, furnishes guarantees of timely payment for MBS issues, and serves as market maker, offering to buy or sell MBSs on the secondary market and committing to buy at least 20% of new issues.

c. In addition, SHF recently formed a Mortgage Insurance Company to stimulate the markets, capitalizing it with Mex$2 billion, and holds an interest in HiTo, a private vehicle for speedy issues of mortgage securities (BonHiTos) based on Danish technology, which is expected to deepen the market and increase its liquidity.

d. Through financing of SOFOLs, SHF has decisively contributed to opening the market toward the segment with incomes from five to ten times the minimum wage, which has also begun to be served by the commercial banks, albeit at the upper end, attracted by the experience of the SOFOLs.

1.20 These activities have a marked countercyclical value. In good financial times, supported by the reforms promoted by SHF, the primary market has sufficient liquidity, and SHF financing is less important. But now that the financial markets are turbulent and funding is scarce, SHF has become the primary provider of liquidity on market terms, both for individual loans on the primary market and for purchasing MBSs and furnishing guarantees on the secondary market.

1.21 The countercyclical role puts significant demands on SHF's balance sheet. As a result of the evolution of the markets, at end-June 2008 SHF had nearly Mex$11.6 billion in MBSs and a primary market funding portfolio of Mex$44.8 billion.[8] Its commitment to serve as MBS market maker has entailed an increase of Mex$4.7 billion in these instruments in one year. Since these purchases were intended to be for a short period, and the costs of obtaining long-term funding have increased, especially with a prepayment option, they were financed with short term liabilities. Prepayments of amounts owed by SOFOLs purchased by banks, combined with the acceleration of securitizations in 2007, have created a maturity mismatch between assets and liabilities in SHF's peso-denominated portfolio. In addition, SHF needs to grow its assets so that it can continue to offer funding to the markets (mainly securities and the individual loan portfolio).

1.22 Looking ahead and in response to the social challenge entailed by the shallowness of the mortgage markets in Mexico, SHF's institutional strategy, approved in March 2008, makes the institution's primary objective to reach households with

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[7] SHF's support of mortgage SOFOLs has translated into an increase in the participation of these intermediaries in the private mortgage market from 1% in 2001 to 20% in 2006.

[8] These values represent about US$1.1 billion and US$4.1 billion, respectively.

incomes under seven times the minimum wage. To that end, it is firmly committed to working with new financial intermediaries other than the SOFOLs, such as savings banks and the community finance companies known as SOFIPOs, but using the same approach: operate on the second tier and support development of products and technologies for loan origination and portfolio monitoring. The legal reform recently approved by Congress, which governs the opening of access to SHF resources to new financial intermediaries, calls for a significant expansion in the number and type of institutions that may receive funding to originate mortgages.

1.23 Given these circumstances, the Bank's support will be extremely important, making it possible to: (i) finance new lending operations using liabilities with a similar maturity, currency and optionality; and (ii) replace short-term funding with liabilities more in line with the profile and rate of peso-denominated assets. By strengthening SHF's balance sheet, the Bank will enable it to meet growing demand for its resources on the markets, and help it continue to offset the effects of the financial slowdown on housing finance.

1. Rationale for Bank support

1.24 The CCLIP is designed as a flexible tool to give SHF the funding necessary to diversify its balance sheet to meet growing demand, continue its countercyclical role in the market, and expand the mortgage loan horizon to unserved sectors. The conditional credit line and global credit program structure was selected to give SHF the flexibility to meet rapidly changing market needs, whose drag on financial markets may become substantial, as recent experience shows.

1.25 The CCLIP and its first program are intended to lend stability to the capital markets that supply the housing finance market in Mexico. The mortgage infrastructure in the country is still in its infancy, relatively speaking, but essential to address the significant housing backlog (see Housing Demand in Mexico). For this reason, it is important to provide stability for the housing finance sector, and specifically low-income housing, in the current environment of mortgage and financial volatility that, if not properly addressed, may well reverse all the progress made over the last decade.

1.26 The proposed operation reflects the Bank's commitment to the federal government's efforts to make the mortgage sector more inclusive and formalized (see paragraph 1.28). This commitment has a successful precedent in the form of the collaboration between the Bank and SHF to develop mortgage markets, through loan 1298/OC-ME to facilitate the lower-income population's access to the mortgage market. Under this loan, US$460 million of the investment component has been disbursed, exceeding the targets for mortgages issued, as well as nearly US$5 million in technical assistance for institutional strengthening of SHF and modernization of public property registers (see Low-income Housing Program). The proposed operation complements the partial loan guarantee facility for private issues currently in preparation by the SCF, which is being designed in conjunction with the International Finance Corporation (IFC) of the World Bank. It also

complements the World Bank effort to loan US$1 billion to SHF to refinance its short-term liabilities. In addition, MIF operation ATN/MT-9138-ME supports the use of remittances for the payment of mortgage loans.

1.27 **The Bank's country strategy.** The CCLIP and its first program are consistent with the Bank's current country strategy with Mexico, which identifies support for modernization of the mortgage sector and mortgage finance intermediaries as tools to enhance competitiveness and encourage private sector development. The Bank's strategy also seeks to give lower-income groups access to the formal mortgage market, continuing the work successfully begun with loan 1298/OC-ME mentioned above (see document GN-2181-1 Corr., paragraph 4.23). Because of its ultimate intention of facilitating the development of solutions to the housing needs of the sectors excluded from the formal market, the CCLIP and its first program also contribute to the Bank's efforts to direct 40% of its lending volume into social inclusion and poverty reduction (SEQ).

1.28 The CCLIP and its first program are consistent with the objectives of the 2008-2012 National Housing Program, derived from the 2008-2012 National Development Plan and the National Development Finance Plan. Its objectives are: (i) to increase the coverage of financing offered to the population, particularly for lower-income families; (ii) to promote sustainable housing development; (iii) to strengthen the National Housing System by improving public management; and (iv) to establish a policy of federal government support to help the lower-income population access housing finance, and foster sustainable housing development.

II. PROGRAM PURPOSE, COMPONENTS AND DESCRIPTION

2.1 The **general objective** of the proposed CCLIP and first program is to promote the development of efficient and inclusive mortgage markets in Mexico. The **purpose of the CCLIP** is to support Sociedad Hipotecaria Federal, SNC (SHF) with tools enabling it to provide liquidity and stability to the primary and secondary mortgage markets. The **purpose of the first program** is to provide SHF with funding so that it can better support and develop the primary and secondary mortgage markets, and strengthen the structure of its balance sheet.

2.2 The CCLIP will have a drawdown period of 10 years and a total amount of US$2.5 billion. The first program under the CCLIP is a global credit program of up to US$500 million, with a credit component and a technical assistance component, and a 5-year disbursement period, although given the liquidity needs of the market and the client the full amount is expected to be disbursed in the first 12 months. The CCLIP will draw on resources from the Single Currency Facility in United States dollars of the Bank's Ordinary Capital, subject to the Operational Framework for Lending in Local Currency (document GN-2365-6).

2.3 **Credit component (up to US$495 million).** The credit component is designed to enable SHF to respond nimbly to developments in the mortgage markets with financing more in line with the makeup of the liabilities on its balance sheet, as well

as enable it to: (i) offer lines of credit to the intermediaries authorized by SHF for individual mortgage loans, primarily SOFOLs, which are not allowed to take deposits directly from the public and face rising costs of funds due to international financial conditions; (ii) maintain the liquidity of secondary markets through the purchase of mortgage-backed securities; and (iii) meet the demand of lower-income families with innovative housing finance products offered through intermediaries with which SHF has not worked before but which possess coverage and knowledge of the target market, such as savings banks and other low-income savings and loan institutions.

2.4 **Technical assistance component (up to US$5 million).** The technical assistance component will enable SHF to conduct studies and other activities to strengthen or ensure the viability of the actions to be financed with the credit component, and in general to pursue the mission stated in its charter and strategic planning. This will include support for: (i) implementation of methodologies and systems to expand the number of financial intermediaries authorized to receive long-term funding from SHF for mortgage lending; (ii) establishment of a methodology for the socioeconomic evaluation of SHF operations; (iii) studies on the current state of housing and the mortgage market; (iv) design of new financial products for the mortgage market; (v) continuation of work to modernize property registers; (vi) support for the evaluation and monitoring of sustainable integrated urban development.

2.5 **Successive programs under the CCLIP.** The CCLIP will enable SHF to make steady progress in meeting financing and technical assistance needs, as the demands of its role in the mortgage markets and liquidity and risk perception circumstances change. Subsequent programs under the CCLIP will seek to attract foreign investors to the market by setting up a public guarantee facility (with SHF counter-guarantee) for MBS.

2.6 **Evaluation framework and results indicators.** The proposed program will be evaluated using a monitoring and evaluation system based on the SHF's own performance indicators. For several years, SHF has been using a balanced scorecard system that collects detailed data on how its performance is aligned with its mandate.

a. With respect to support and development of the primary housing market, the following will be verified: (a) changes in the SOFOL portfolio of loans originated using the resources of the SHF lines; (b) the growth of the microcredit market; and (c) the increase in the amounts of mortgage credit and microcredit (an expected 30% will be financed with Bank funding). To determine whether actions have resulted in deepening of the primary market, the percentage of housing operations involving households that earn less than six times the minimum wage, with respect to total operations, will be reviewed.

b. With respect to the secondary market, the following will be verified: (a) the net increase in the amount of mortgage-backed securities (an expected 38.8% will be attributable to Bank funding); and (b) the volume of issues in the SHF portfolio.

c. With respect to strengthening the structure of SHF's balance sheet, it will be determined whether the SHF's capital duration index remains within the band stipulated for extraordinary circumstances.

III. RISKS AND EXECUTION MECHANISM

A. Main risks and mitigants

3.1 This operation has been designed in the midst of a serious international financial crisis. That crisis, caused by a series of imprudent practices in the United States mortgage market, poses certain challenges, given both the psychological connection between the mortgage markets of Mexico and the United States, and the close relationship between the growth of these two countries' economies. Consequently, the most significant risks are the macroeconomic and financial risks. Other risks are described in an annex (see Comparison of Mortgage Markets).

3.2 **Macroeconomic risks.** The Mexican economy is characterized by a close relationship with the economy of the United States that has become even closer since the North American Free Trade Agreement (NAFTA) entered into force.[9] The financial crisis in the United States and its potential aftermath in the real economy is already having an impact on Mexico's growth projections. A significant economic slowdown could reduce demand for mortgage financing, increase the arrears rate of the mortgage portfolio, and complicate the sale of MBSs. Because of the countercyclical nature of SHF's activities, slowing economic growth would not diminish the importance of its funding, but, on the contrary, would make it even more important. How these resources are used could change—more would be used in direct lines for qualified financial institutions, and less to purchase MBS. However, the countercyclical nature of the housing markets which has been emphasized by the government, and the key role played by SHF in sustaining those markets, will remain critical. Significantly, the consistent application of prudent macroeconomic policies in recent years has had a positive effect on reducing public debt as a percentage of GDP, as well as inflation (although it has suffered from external shocks in recent months). In addition, Mexico has a flexible exchange rate system, and the federal government is funded in pesos. Lastly, the financial regulation and oversight system has been strengthened, and the financial system shows no signs of decapitalization. For these reasons, the internal and external stability of the Mexican economy is expected to hold.

[9] Sosa, Sebastián. "External Shocks and Business Cycle Fluctuations in Mexico: How Important are U.S. Factors?" IMF WP/08/100 (2008).

3.3 **Financial risks**. It should be pointed out that because this program is guaranteed by the federal government, no credit risk to the Bank is anticipated. Furthermore, as previously noted (see paragraph 1.13), the risks associated with the subprime market are not present in Mexico. However, the activity per se of providing funding for mortgage loan origination entails certain financial risks, including: (i) prepayment risk; (ii) market and liquidity risks; (iii) issuer risk; (iv) asset manager risks; and (v) risk of mortgage loan defaults or arrears. As shown in the Summary of Financial Risks, SHF exists to help mitigate these risks, none of which represents a threat to meeting the objectives of the operation.

3.4 **Environmental and social risks.** The CCLIP and its first program pose no significant environmental risks, since they will not finance housing construction, only mortgage financing or the purchase or guarantee of mortgage-backed securities. Because this is a CCLIP, no environmental and social review is required pursuant to policy directive B.13 of the Environmental and Safeguards Compliance Policy (document GN-2208-20 and Operational Policy OP-703). The first program has been classified as category "C."

B. Summary of implementation arrangements

1. Borrower and executing agency

3.5 The borrower and executing agency will be Sociedad Hipotecaria Federal, SNC (SHF), with the United Mexican States acting as guarantor.

2. Execution and administration

3.6 SHF will execute the program within the setting of its existing organizational structure. The rules of operation governing program execution will be established in the Operating Regulations agreed upon between the Bank and SHF for each of the programs under the CCLIP, in accordance with the policies and procedures of SHF and of the Bank, as well as the applicable laws and financial practices in the country.

3.7 The participation of financial intermediaries, as well as individual eligibility for mortgage loans will be governed by the existing policies of SHF and stated in the program Operating Regulations. For the purchase of mortgage-backed securities, SHF will apply the rules agreed upon in the Operating Regulations, which will be consistent with its existing rules of operation.

3.8 In terms of procurement for the technical assistance component, SHF must follow the rules and procedures established by the Bank. The selection and contracting of consultants will be conducted in accordance with the Bank policy established in document GN-2350-7. In Mexico there are existing standard procurement documents approved by the Bank and the Secretaría de la Función Pública [Civil Service Department], which will facilitate the application of Bank policies and procedures in this area. For purposes of paragraph 2.7 of the policies on consultants, for consulting contracts with an estimated value of less than US$500,000 equivalent per contract, the shortlist may comprise entirely national consultants.

3. Disbursement conditions, execution period, and timetable

3.9 **Disbursements and execution period.** The program resources will be committed in a period of 48 months, running from the effective date of the loan contract, and are expected to be disbursed in a period of no more than 60 months, running from the same date. Any expenditures incurred in the 18 months prior to the loan approval date may be included and charged against the loan proceeds, regardless of the date on which the project officially enters the Bank's project pipeline, in order to meet the immediate resource availability needs of SHF and the mortgage market, which is consistent with the program's objectives.

3.10 **Revolving fund.** The Bank may advance resources, chargeable against the loan proceeds, to open, increase, or replenish a revolving fund to cover expenditures related to program execution that are eligible for financing with such resources, pursuant to the contractual terms and conditions. Given the expected expeditiousness of such disbursements, the requested amount of the revolving fund is for up to 20% of the total of each program under the CCLIP.

3.11 **Disbursement procedure.** There will be two disbursement mechanisms in the first program: (i) disbursements against financial advances to furnish mortgages and/or to purchase mortgage-backed securities; (ii) discounting of the portfolio generated by SHF up to 18 months prior to the signature date of the loan contract.

C. Monitoring and evaluation arrangements

3.12 **Reports.** The execution of the program will be monitored using six-monthly progress reports prepared by the executing agency and delivered to the Bank within 60 days after the end of each six-month period. The reports will use as a reference the commitments reflected in the Results Framework and the financial progress reports specified in the General Conditions.

3.13 **Evaluation.** Within 24 months from the date of the first disbursement of the loan proceeds, or once 50% of the loan has been committed, whichever occurs first, the borrower and the Bank will perform a midterm evaluation of objectives met and outcomes achieved, based on the Results Framework, to identify corrective action. The borrower has not elected to perform a final ex post evaluation at the end of the program, but has committed to furnish the necessary information in the event that the Bank wishes to do so. Developments in the program indicators will be reported to the Bank in the usual manner during program execution.

3.14 **Information.** SHF will collect, store, and retain all information, indicators and parameters, including annual work plans and the midterm review and final evaluation, that are necessary for the Bank prepare the project completion report (PCR).

3.15 **Audits.** SHF will keep records to record the program expenditures according to a chart of accounts approved by the Bank, and shall produce evidence that it has instituted the proper accounting, administrative, and financial control systems to the Bank's satisfaction. SHF will deliver the program financial statements to the Bank,

duly audited by an independent audit firm acceptable to the Bank. The audit will be conducted pursuant to terms of reference previously approved by the Bank, and the Bank's policy and requirements for external audits (documents AF-100, AF-300 and AF-500). The annual audit report will be delivered within 120 days after the close of the fiscal year, and the final audit report within 120 days after the date of the last disbursement.

RESULTS FRAMEWORK

CCLIP FOR THE DEVELOPMENT OF EFFICIENT AND INCLUSIVE MORTGAGE MARKETS IN MEXICO (ME-X1006)

AND

FIRST GLOBAL CREDIT PROGRAM FOR MORTGAGE MARKET DEVELOPMENT UNDER THE CCLIP (ME-L1063)

CCLIP Objectives
The general objective of the CCLIP and first program is to promote the development of efficient and inclusive mortgage markets in Mexico.
The purpose of the first program is to provide Sociedad Hipotecaria Federal, SNC (SHF) with funding so that it can better support and develop the primary and secondary mortgage markets, and strengthen the structure of its balance sheet.

Results Framework for the First Program
Matrix of Indicators

	Base[1] (Dec/08)	Year-end 1 (Dec/09)	Year-end 2 (Dec/10)	Year-end 3 (Dec/11)	Year-end 4 (Dec/12)	Observations
Specific objective 1: Support and develop the primary mortgage market						
Output:						
New SOFOL loans financed with SHF lines (annual new placements)	30,800	35,000	37,000	32,000	30,000	
New mortgage microloans (annual new placements)		95,000	102,000	110,000	120,0000	
Amount of mortgage loans and microloans (annual increase in millions of pesos)	10,700	12,100	12,800	11,200	10,600	
Outcome:						
Deepening of the primary market						

[1] Projected.

Results Framework for the First Program Matrix of Indicators						
	Base[1] (Dec/08)	Year-end 1 (Dec/09)	Year-end 2 (Dec/10)	Year-end 3 (Dec/11)	Year-end 4 (Dec/12)	Observations
(Number of mortgages for households with income up to 6 times the minimum wage + Number of microloans) / (Total number of mortgages + Number of microloans) *100%	78%	79%	80%	80%	81%	
Specific objective 2: Support and develop the secondary mortgage market.						
Output:						
Net increase in MBS balance (in millions of pesos)	13,000	6,900	13,800	13,000	11,300	As of 24 October 2008, SHF has US$13,453 million pesos.
Volume of issues in SHF portfolio	50%	27.1%	24.9%	22.8%	20.6%	
Specific objective 3: Strengthen the structure of SHF's balance sheet.						
Output: Capital duration[2] **Outcome:** Asset structure more in line with the structure of liabilities and less capital sensitivity.	Normal situation: ≥ -2 and ≤ +2 Abnormal situation: ≥ -4 and ≤ +4					

[2] Refers to the presentation to the Investment and Financing Committee of SHF.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE- ___/08

Mexico. ME-X1006. Conditional Credit Line for Investment Projects (CCLIP) for the Development of Efficient and Inclusive Mortgage Markets in Mexico

The Board of Executive Directors

RESOLVES:

1. That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank to enter into such agreement or agreements as may be necessary with Sociedad Hipotecaria Federal, S.N.C. (SHF), as Borrower, to establish a Conditional Credit Line for investment projects (CCLIP) for the development of efficient and inclusive mortgage markets in Mexico (the "Credit Line") for up to the sum of US$2,500,000,000, chargeable to the resources of the Single Currency Facility of the Bank's Ordinary Capital.

2. That the establishment and utilization of resources under the Credit Line shall be carried out in accordance with: (a) the objectives and regulations of the Conditional Credit Line for Investment Projects established by Resolution DE-58/03 of July 16, 2003 as amended by Resolution DE-10/07 of January 31, 2007; and (b) the specific provisions set forth in document GN-2246-4 and the Loan Proposal Executive Summary.

3. That the amounts authorized to finance individual operations chargeable to the Credit Line shall be granted as individual operations subject to the usual financial terms and conditions applicable to financing from the resources of the Single Currency Facility of the Bank's Ordinary Capital, in force at the time that each individual operation is approved. Such terms and conditions shall be specified in the executive summary of the corresponding loan proposal.

4. That the effectiveness of the agreement or agreements executed by the Bank with Sociedad Hipotecaria Federal, S.N.C. (SHF) to grant financing for each individual operation shall be subject to the effectiveness and validity of the cooperation agreement for the establishment of the Credit Line.

(Adopted on __ _________ 2008)

LEG/SGO/CID/IDBDOCS#1724213
ME-X1006

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/08

Mexico. Loan ____/OC-ME to Sociedad Hipotecaria Federal, S.N.C. First Global Credit Program for the Development of Mortgage Markets under the Conditional Credit Line for Investment Projects (CCLIP) for the Development of Efficient and Inclusive Mortgage Markets in Mexico

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Sociedad Hipotecaria Federal, S.N.C. (SHF), as Borrower, and the United Mexican States, as Guarantor, for the purpose of granting it a financing to cooperate in the execution of the first global credit program for the development of mortgage markets under the Conditional Credit Line for Investment Projects (CCLIP) for the development of efficient and inclusive mortgage markets in Mexico, approved by Resolution DE-__/__. Such financing will be for the amount of up to US$500,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Executive Summary of the Loan Proposal.

(Adopted on ___ _________ 2008)

LEG/SGO/CID/IDBDOCS#1724214
ME-L1063