

PROJECT ABSTRACT

There is an estimated housing shortage in Mexico of approximately 4.3 million units, or about 20% of the country's current housing stock of 21.9 million units. Current deficiency and demographic trends point to significant new housing needs well into the future. It is estimated that 750,000 housing units per year must be constructed to reach the approximately 42.2 million units which will be required to meet Mexico's housing needs for a projected population of 125 million by the year 2025. In this regard, one of the core objectives of the Government of Mexico is to reduce dependency on public funding for house financing. To that end, the government is implementing a strategy to shift from provider of direct credit, to the provision of loan guarantees through Sociedad Hipotecaria Federal (SHF). As governmental housing agency, SHF is responsible for the promotion of the mortgage-backed securities market to increase private funding for the housing sector. The government believes securitization is the way to provide lower mortgage costs and increase the availability of mortgages.

For the last seven years the Mexican banking sector has undergone dramatic changes towards consolidation. This process however has not been accompanied by significant growth of bank credit to the private sector. This resulted from a sustained effort, both by banks and corporations, to strengthen their balance sheet after the Tequila crisis. As corporations faced unmet demand for credit, they had to rely on alternative sources of funding (such as suppliers' credit, foreign financing, non-bank lending, capital markets, etc). Governmental housing agencies and private non-banks or Sociedades Financieras de Objeto Limitado (Sofoles) have undertaken the primary role in mortgage financing. Since 2001, the decline in domestic interest rates and the emergence of long-term instruments have been key elements in the favorable recovery in credit growth witnessed in Mexico.

Hipotecaria Nacional (HN) is a privately owned financial institution constituted in May 1994 that has grown to position itself as the largest Sofol housing in Mexico. The Sofoles (special-purpose non-deposit-taking financial companies also known as "non-bank banks") have been the key players in the housing market since their creation in 1993 as a result of the NAFTA agreement. HN has assets of around US\$2.4 billion Peso equivalent that represent 28% of the total credit portfolio of the market. HN services over 80,000 mortgages throughout its 78 branches throughout Mexico. Historically, HN has provided financing to over 199,139 residential homeowners throughout the country. HN expects to raise from the capital markets the equivalent in Pesos of US\$500 million to fund the origination of residential mortgages for the low and middle-income segments of the population. The local capital markets operation consists of a Mortgage Backed Securities Program (MBS or also referred as the "Program") for up to 25 years. The proposed structure consists of the creation of Special Purpose Vehicle(s) (SPV/Trust(s)) domiciled in Mexico that will issue certificates to private investors to fund residential mortgages of a predefined quality. The credit support structure of the transaction will consist of a net excess spread (interest rate differential between the average mortgage rate and the expected coupon rate on the MBS) and a first-loss guarantee provided by HN via a residual certificate. IDB will provide a partial credit guarantee to cover a portion of the principal and interest payments of the mortgage backed securities. Finally, all mortgages

will have a primary insurance coverage. The Bank's participation will enhance HN's ability to raise long term financing to match funding requirements of the mortgage market, and will provide support to local capital markets towards the standardization of MBS. HN will act as Servicer of the mortgage pools backing the proposed securitizations.

As envisioned, the Program presents an important developmental function by supporting the efforts carried out by the Mexican government and the Sofoles to diversify funding sources and establish the local capital markets as the primary source of funding for housing development in Mexico, thereby complying with the government's objective of reducing dependency on public funding for the housing market.

Environmental and Social Management Report

The principal potential environmental, social, health and safety, and labor impacts and risks associated with this operation are: (i) environmental and social direct and indirect impacts associated with the construction and use of the residential properties, and in particular potential impacts due to the construction of multiple housing units financed by HN under their commercial short-term loan program (*Crédito Empresarial*) program, and potential impacts to persons living in residential houses financed by HN under their residential loan program (*Crédito Individual*) or constructed under the HN commercial loan program due to environmental risks (e.g., asbestos, lead based paint, etc.); (ii) environmental credit risks to the IDB mortgages in the series guaranteed by IDB, which due to environmental risks have a lower than estimated value; and (iii) reputation risks to the IDB due to inappropriate HN or sub-borrowing construction companies environmental, social, health and safety, or labor practices.

HN Environmental and Social Management

While HN does not have a formal Environmental Management System (EMS) environmental and social aspects are evaluated, to a limited degree, in the current HN mortgage appraisal, approval, and monitoring processes especially associated with large housing developments.

In its current *Crédito Empresarial* appraisal process, HN hires an external consultant to assess the technical viability of any housing development that it may potentially finance. This consultant prepares a Feasibility Study that includes information on regulatory compliance with environmental permits and licenses, impacts to urban and public services, hydrological characteristics, soil mechanics, and confirmation of a revision of the Environmental Impact Assessment (EIA), when required. Once a development project is approved for financing, an external consultant accompanies the construction work progress, and every three weeks generates a progress report which if acceptable allows loan disbursements. When construction is completed, the consultant issues a works completion report. HN's portfolio management unit directly supervises the external consultant.

For *Crédito Individual* operations, evaluation personnel (external and/or internal) prepare a report, outlining property characteristics and associated monetary value (security value). These reports include some basic environmental information associated to availability of services (e.g., connection to sewers, septic systems, etc) and construction materials (e.g., bricks, concrete, etc).

Based upon information provided by HN, their facilities are in compliance with all relevant in-country environmental, health and safety legal requirements. No evidence for discriminatory or biased employment and credit practices was encountered. HN has documented non-discriminatory policies as part of their Ethics Code

Environmental and Social Requirements.

The Bank will require as part of the reimbursement agreement that HN: (i) complies with all applicable environmental, social, health and safety, and labor Mexican regulatory requirements; (ii) prior to financial closure, develop and implement a more complete Environmental Management System, in form and substance satisfactory to the IDB, associated with the HN mortgage appraisal, approval, and monitoring processes for residential and commercial loan programs to properly assess, mitigate and manage potential environmental, social, and health and safety impacts and risks (see Annex A.1 for proposed modifications); (iii) prior to financial closure, develop an Environmental, Health and Safety Action Plan, in form and substance satisfactory to the IDB, including at a minimum actions associated to credit and human resource non-discriminatory policies, gender equity, handicap access, and facilities efficiency program (see Annex A.2 for details); and (iv) establishment of an Environmental Correction Account to remedy any HN non-compliance with IDB environmental and social requirements or impacts associated with mortgages that have not been adequately mitigated (See Annex A.3 for details). The Bank will also require approval of all material changes to the HN EMS and the approval of the substitution of HN for another servicer.

Issuance of the IDB guaranty for the individual series will be contingent upon a certificate from HN and an independent environmental consultant stating that each given series (i) has been originated according to the EMS, (ii) the properties (mortgages) comply with the Environmental and Social Eligibility Criteria (see Annex A.4) and (iii) HN is compliant with the environmental and social provisions of the reimbursement agreement, and in particular the mortgages where developed in compliance with the EMS.

The Bank will monitor the environmental, social, health and safety, and labor aspects of the operation via internal Bank supervision actions (e.g. site visits, review of documentation, etc.) and the use of an external independent environmental consultant. In addition, if needed, the Bank shall have the right to perform an independent environmental, health and safety audit.

Annex A.1. Required Modifications to HN Environmental Procedure.

- a. *Estudio de Factibilidad*, checklists to assure properties or developments (i) compliance with basic safety systems (e.g. fire, earthquakes, floods, etc), (ii) identification of potential environmental impacts (e.g. deforestation, pressure of water source/services, impact on surface waters, waste generated, etc), (iii) identification of potential social impacts (i.e. impacts on archeological sites, risk of opposition with nearby affected communities / neighbors, potential displacement of people), and (iv) liabilities (e.g. near gas station, factories, landfills other contaminated land, materials used – no asbestos, lead paints, etc).
- b. *Resumen* (Summary): Include an Environmental and Social Risk section with brief description of environmental, social, and health and safety impacts and potential risks to HN, if any.
- c. *Encuesta al Promotor* (Developer Evaluation): Include a section associated with the company's history associated with its environmental, social, health and safety, and labor legal compliance and practices.
- d. *Avalúo* (Property Valuation): Include a specific section on environmental and social impacts and liabilities associated with the property or the housing project to be financed.
- e. *Supervisión Interna de Obra*: Include an additional section associated with the Client's compliance with environmental mitigation and pollution control practices, as well as health and safety practices during construction.
- f. *Control Measure*: A section describing (i) how to proceed in cases where significant environmental/social impacts/risks (during feasibility evaluation) or non-compliances (during supervision) are detected, and (ii) the environmental, social, and health and safety requirements included in the construction loan agreements between HN and the Developers.
- g. *Personnel/Resources/Training*: A section on organization structure describing those in charge of applying the EMS, human and economic resources allocated, associated responsibilities, and required training.
- h. *Audit/Revision*: A section on how the EMS will be revised and if necessary modified over time.

Annex A.2. Required Components of Environmental, Health and Safety Action Plan

- a. Credit and Human Resource (HR) Non-discriminatory Policies: Clearly articulate in the HN Credit (*Políticas de Evaluación de Crédito Individual*) and HR Policies (*Políticas de Compensación y Contratación*) non-discriminatory practices, making reference to Tile II, Article V of HN's *Código de Ética*.
- b. Gender Equity: HN will make a conscious effort to assure that female employees are promoted to equalize the gender ratio at the higher hierarchical organizational levels.
- c. Handicaps: In compliance with non-discriminatory policies for HN services and HR hiring policies, HN will develop an action plan to assure that HN facilities are handicapped-accessible. This effort will be programmed to start with the Main building in Mexico City, and progressive include the rest of HN facilities. Furthermore, HN will try, on a best efforts basis, to have their clients include units and prototypes that are specifically built for handicapped people (e.g. easy access, handicapped parking spaces, etc.).
- d. Facilities Efficiency Program: HN will develop a program to make the facilities more efficient, and whenever possible implement recycling programs (e.g. paper, fluorescent bulbs, printer cartridges, etc).

Annex A.3. Environmental Correction Account.

To provide the Bank with an additional remedy (other than termination of the PCG) for breaches of the Bank's environmental covenants, an Environmental Correction Account will be established. This mechanism could be used, at the Bank's discretion and would be used as a means of putting pressure on the company to comply with its obligations, and/or to fund remediation.

Mortgage Origination Phase: If HN in its role of originator and seller of the mortgage assets (i.e., until the last MBS series is issued) fails to comply with IDB's environmental and social requirements HN will be required to fund the Environmental Correction Account from its own resources. Also, the cure of such environmental breach would be a condition precedent to the occurrence of subsequent issuances. Therefore, IDB's total exposure under its guarantee facility would be limited to the issuances that had already occurred.

Servicing Phase: If a breach of IDB's environmental and social requirements occurs during the MBS servicing phase, HN would not be required to fund the Environmental Correction Account from its own funds. Instead the Bank will have the right to instruct the Trustee to trap in the Environmental Correction Account any funds that HN would otherwise be entitled to as a result of its residual interest in the bond certificates. The funds will be maintained in the account, and will be used solely for the purpose of implementing the required remedies.

Annex A.4. Environmental and Social Exclusion Criteria.

The IDB will not guaranty mortgages located:

- a. In areas of previous land use activities that may result in localized environmental risks, such as abandoned landfills or waste disposal areas, industrial facilities, etc;
- b. In contaminated buildings and/or lands which present a significant human health risk, such as soil and ground water contamination, lead based paint, friable asbestos containing materials, equipment containing polychlorinated biphenyl compounds, or presence of hazardous gases/materials;
- c. In important or sensitive environmental areas (e.g., containing threatened or endangered species, containing species of high economic value, tropical rain forests, natural parks, designated special protection zones/areas, indigenous territories, etc.);
- d. In areas susceptible to floods, hurricanes and tornados; or susceptible to earthquakes and fires that do not comply with applicable seismic and fire protection Mexican construction codes;
- e. In the influence areas of high environmental risk activities (e.g., storage and use of hazardous materials and wastes, high potential for explosions or fires, significant air emissions, etc.).