

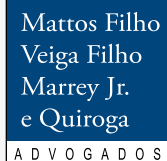


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# The Brazilian Securitization Market: A Primer

## Special Edition

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## *Introduction*

In 2006 the Brazilian domestic securitization market registered its fourth consecutive year of new records. The solid and consistent growth presented to date is transforming the way companies, financial institutions and investors evaluate both their funding and investing alternatives.

The paradigm of financial intermediation represented by securitization is entrenched in the Brazilian market. New originators, investors and service providers continually entering the market are compelling evidence that growth will continue in the future, and create enormous opportunities. With this in mind, Uqbar is delighted to present to the international financial community *The Brazilian Securitization Market: A Primer*.

This first edition is divided in three chapters, each describes one phase in this market's evolution. Apart from presenting the hard data that substantiates its defining characteristics, this publication also includes a brief introduction to the legal and regulatory framework and a glossary of terminology specific to securitization in Brazil.

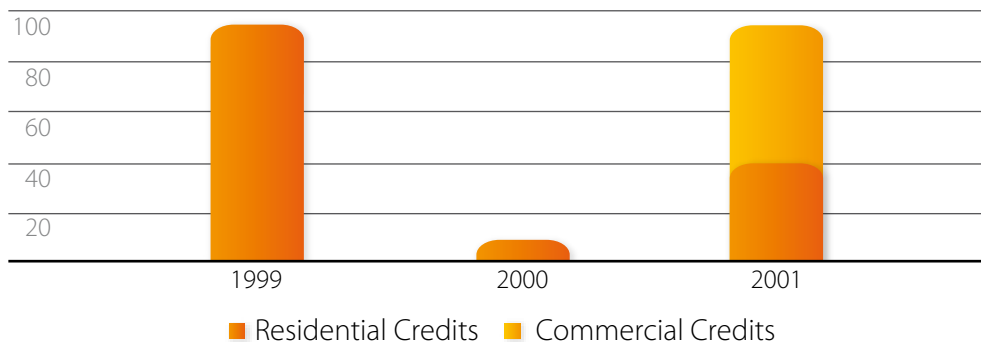
### PHASE I: 1997 – 2001 The Foundation for Growth

The foundations of the Brazilian securitization market were first set with federal law nº9,514 of November 20, 1997, which established a new approach to real estate finance and a legal framework for real estate securitization. The law, and its subsequent regulations by the country's Central Bank and securities authority (*Comissão de Valores Mobiliários, CVM*) are milestones, representing the legal basis for nearly all real estate transactions that have been done in this market since its passage.

Despite a broad, flexible and robust legal framework, it took two years for the first issuances of securities backed by real estate receivables to occur. In 1999, Cibrasec, a securitization company founded by some of the country's largest financial groups immediately after the enactment of the law, issued US\$9.0 million of certificates of real estate receivables, referred to in the local jargon by the Portuguese acronym CRI. During this same year, Cibrasec executed four other transactions amounting to US\$85.5 million. In 2001, the first transaction with a senior-subordinated structure was concluded. Brazilian Securities, a securitization company formed by the Ourinvest Group, a financial conglomerate with its roots in the supply of gold and gold-based financial instruments, and the Rossi Group, a construction and real estate development conglomerate, issued US\$1.7 million in two tranches of CRI. **Chart 1** plots the amount of CRI issued annually from 1999 to 2001 by type of credit. Those classified as residential are transactions backed by portfolios of credits arising from the sale of residential properties, while those classified as commercial are transactions backed by the credit of a single corporation.

Two key factors explain the low volume of securities issued during this period. Lack of knowledge within the local investor community as to how to analyze and

CHART 1 – CRI Amount Issued by Type of Credit – 1999 to 2001 (US\$ millions)



price asset-backed securities is the first. Because of this problem, the first ever senior tranche of a CRI issue was acquired by the Inter-American Investment Corporation, a multilateral financial institution that is part of the Inter-American Development Bank Group. While the local investor market has grown in sophistication over the years, the second factor, the lack of standardized financing documents among originators, persists.

While law nº 9,514 established a strong legal foundation for securitization transactions backed by real estate receivables, there was not an efficient legal vehicle for securitization transactions backed by any other type of collateral until four years later. On November 29, 2001, Central Bank resolution nº 2,907 created the receivables investment fund, also known by the acronym FIDC, funds that invest in shares of FIDC and established the broad parameters for their operation.

The creation of the FIDC was a watershed event in the Brazilian market. It marked the end of a period characterized by insignificant amounts of asset-backed securities issued, small numbers of transactions and few market participants, and opened a new capital market alternative for companies operating in a wide range of market segments across the Brazilian economy.

### ***The Brazilian Real Estate Finance System***

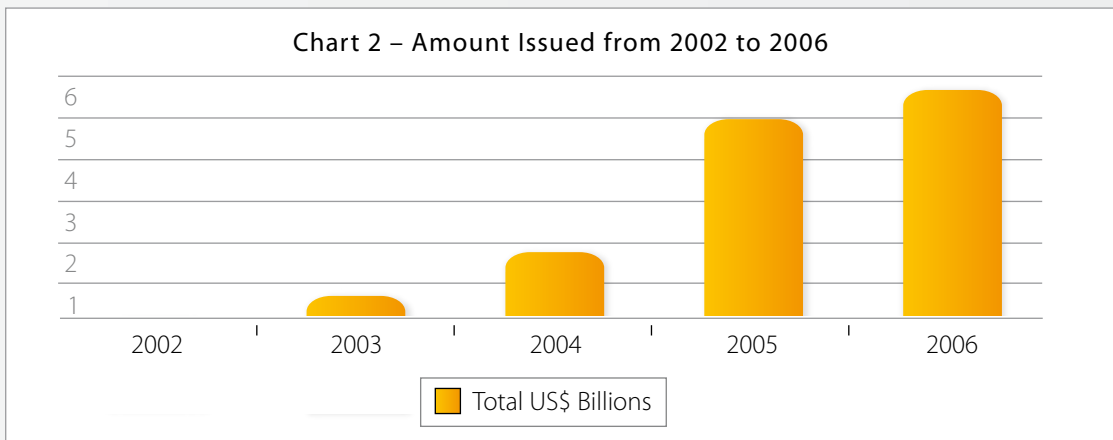
The outdated real estate finance system's (*Sistema Financeiro de Habitação, SFH*) inability to address the country's housing needs combined with increased macro economic stability in the mid 1990s cleared the way for a new approach to real estate finance. In November of 1997 the National Congress enacted law nº 9,514 which instituted the Brazilian Real Estate Finance System (*Sistema de Financiamento Imobiliário, SFI*).

The new legislation aimed to create the legal structure for a capital market based system of real estate finance. Unlike the previously existing, highly regulated and savings and loan-centric household finance system, SFI is entirely voluntary. Under the system, the parties are free to determine the terms and conditions of their own financing arrangements, and there is no specific funding mechanism required for lending.

It also created a securitization vehicle, the real estate securitization company, a specific security, certificates of real estate receivables, referred to as CRI, and legal concepts commonplace in many other markets, but previously non-existent in Brazil, such as fiduciary title of real estate, a guarantee similar to a "deed of trust" in the English and U.S. legal systems. For more information about these terms and others introduced by law nº9,514, please refer to the **Glossary**.

**PHASE II: 2002 – 2006**  
**Initial Growth and Defining Characteristics of the Brazilian Securitization Market**

After one year dedicated to studying the new rules and structuring the first transactions, the market sparked to life in 2003. As can be seen in **Chart 2**, from 2003 to 2006 the market grew six times, from less than US\$1.0 billion in 2003 to nearly US\$6.0 billion in 2006. The uninterrupted growth in issuances that began during this period was observed even when local interest rates were rising.



In addition to rapid growth, seven defining characteristics have emerged over the past four years. Each of these are described below.

**(i) A broad range of collateral classes and originators.**

Different from many other countries that first developed a mortgage-backed securities market before diversifying into other collateral classes, the Brazilian securitization market had transactions with five different collateral classes in 2003, the first relevant year in terms of the amount of securities issued. By 2006 that figure had more than doubled. The list includes asset classes common in most other markets, either emerging or developed, such as mortgages and auto loans. It also includes

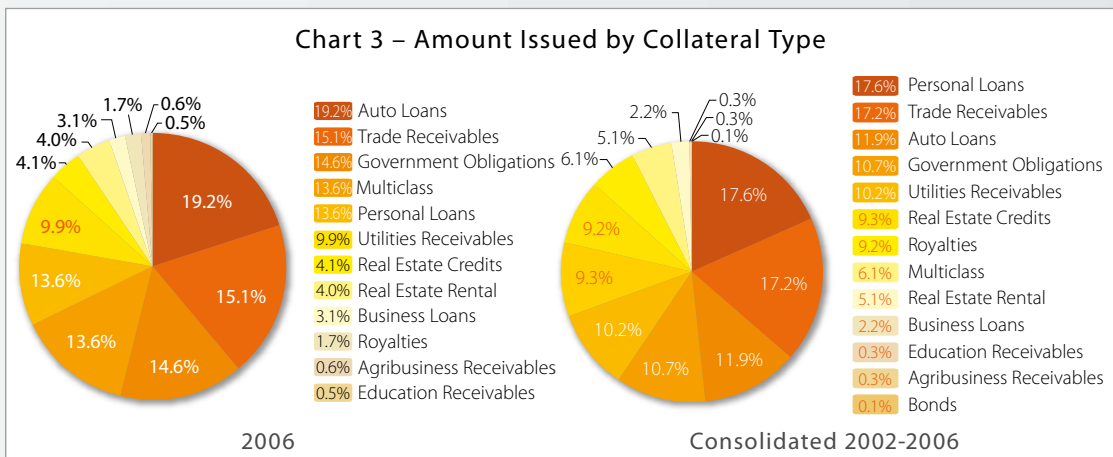
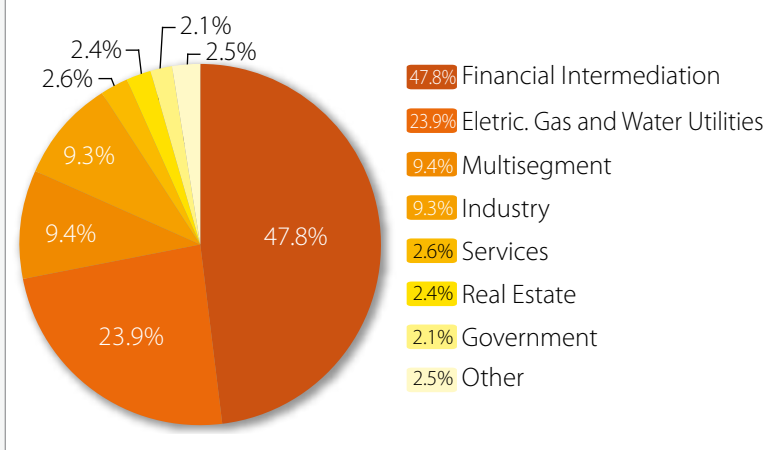


Chart 4 – Amount Issued by Economic Segment of Originator in 2006



others that are typically found only in the more developed markets, such as royalties and education receivables. **Chart 3** breaks down amounts issued by collateral type in 2006 and consolidated from 2002 to 2006.

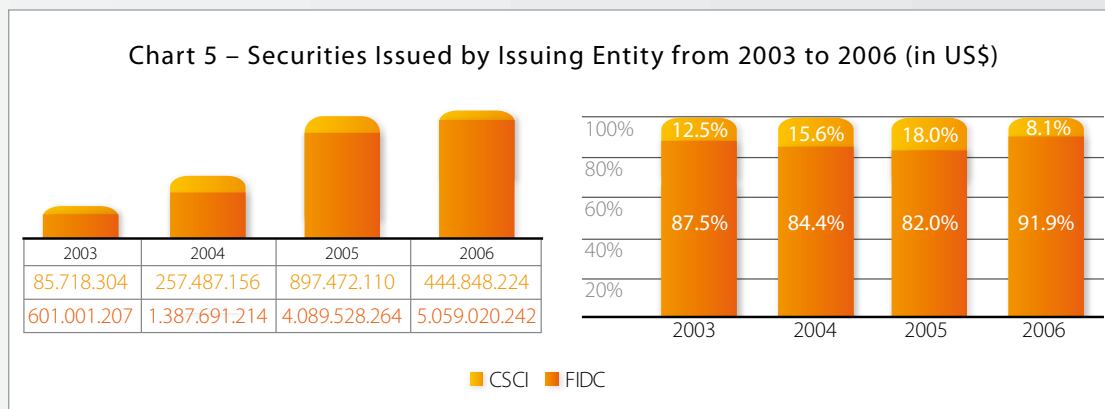
As for the originators, large industrial companies and some retailers were the first to take advantage of the new rules and executed the largest transactions, making trade receivables the top ranked

collateral class in 2003. However, following the growth in the country's credit markets, featuring a prominent role played by small and medium sized banks, collateral classes originated in the financial sector, such as personal loans and auto loans, have since assumed the top positions in the ranking of collateral classes. Eletric, gas and water utilities are the second largest originators of securitized assets. These companies have securitized not only assets originated from their core businesses, but also credits they held against the government. **Chart 4** shows the distribution of securities issued in 2006 according to the originators' economic segment.

**(ii) A leading issuing entity**

Receivables investment funds are by far the dominant issuing entity in the Brazilian securitization market. Please see the box on the next page for more information on these funds. From 2003 to 2006 they were responsible for 86.7% of the total amount of asset-backed securities issued. As a testament to their flexibility and receptivity in the local market, issues include transactions backed by real estate receivables, despite the fact that these funds do not benefit from some features intrinsic to real estate securitization companies, such as the ability to issue fixed-rate securities.

Chart 5 – Securities Issued by Issuing Entity from 2003 to 2006 (in US\$)



## ***Brazil's Leading Vehicle for Issuing of Asset-Backed Securities - The Receivables Investment Fund***

A number of factors have helped turn FIDC into the dominant issuing entity of asset-backed securities, such as a simplified structuring process, a relatively straight-forward registration process for public offerings of securities issued from these funds, and an efficient tax treatment, together with the country's large, well established and highly disseminated fund industry.

The regulatory backbone is Central Bank resolution nº 2,907 that created the instrument on November 29, 2001. It determined that FIDC investments should be predominately in credit rights and that they should be administered by financial institutions subject to Central Bank regulations. It also authorized the CVM to regulate this activity.

The first CVM regulation governing FIDC was ruling nº356 issued on December 17, 2001, which determined that Receivables Investment Funds could purchase collateral from virtually any sector of the economy, including real estate, and that those purchases could be from the originators of those credits or third parties. Among other provisions, it also provided that receivables investment funds (i) may be either open or closed-end, (ii) may have their shares traded on the secondary market and (iii) may issue securities publicly, targeted to qualified investors, as defined by the CVM.

In subsequent years additional regulations have been issued, and further built confidence among both investors and originators. Initiatives include: increased disclosure of information, definition of third party responsibilities and establishment of portfolio composition and concentration limits.

Receivables investment funds, like all other Brazilian investment funds, are pooled investment vehicles that have no legal identity. This feature gives them a very interesting characteristic: they cannot enter into bankruptcy, thus mitigating issuer risk. Additionally, they can not issue or contract debt. The only securities they issue are shares, which can be of different classes. Senior securities usually pay a benchmark rate of return determined at the time of issuance.

The combination of the nature of the security that FIDC issue (shares, not fixed income instruments) and the possibility of issuing different classes of securities have important implications for determining share value. While individual receivables investment funds employ different formulas to calculate their data, all follow the same general methodology to calculate share value. The value of senior shares is the lower of the fund's net asset value divided by the number of shares in this class and the value of the senior share adjusted by the share's benchmark rate of return. The value of subordinated shares is the quotient of the fund's net asset value less the value of the senior shares, and the number of shares in this class.

Finally, a high level of tax efficiency has also contributed to the receivable investment funds' popularity. In a clear sign of the government's interest in developing a robust securitization market, FIDC have a number of important tax advantages. The movement of monies within them are not subject to the financial transaction tax and earnings are not subject to withholding tax. Furthermore, since receivables investment funds have no legal identity, they are not required to make social contributions that are obligatory for corporations and limited liability companies.

**(iii) Duration mismatch and revolving structures**

CRI usually have pass-through like structures, that is, distributions to investors closely match collections of the underlying real estate credit.

Transactions done through receivables investment funds are usually pay-through structures, that is, distributions to investors have no correlation with the payment dates of the underlying asset pool. The majority of FIDC collateral pools are short term, typically less than one year, while the securities issued are medium term, ranging from three to five years. In order to mitigate this duration mismatch, these transactions employ revolving structures, whereby the proceeds of maturing receivables are used to acquire new credits from the originator rather than for amortization of the securities issued.

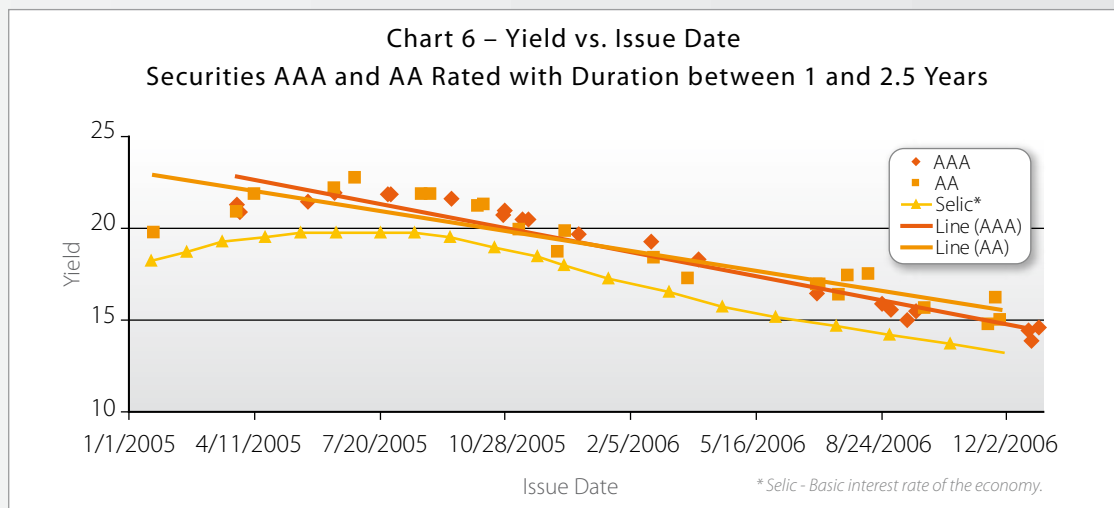
**(iv) Remuneration linked to inflation and the inter-bank deposit rate**

Practically all securities issued in the Brazilian securitization market have their remuneration linked to an index. In some cases, the securities have the same remuneration index as the collateral. This is normally the case of securities issued by real estate securitization companies, which restate both their assets and liabilities by a broad based market price index or a reference rate calculated by the Central Bank.

On the other hand, the assets and liabilities of receivables investment funds are usually mismatched. For the most part, the collateral have fixed rates of return and are not restated by any index, while the senior securities have a benchmark remuneration based on the interbank deposit rate, or the CDI (*certificado de depósito interbancário*) in market jargon. (Subordinated securities issued by these vehicles usually do not have a benchmark remuneration.) This mismatch is usually mitigated by structural features, such as the revolving nature of these funds and derivatives.

**(v) Declining Yield and Tightening Spreads**

Yields of senior securities issued by FIDC have followed market based rates and trended downward. **Chart 6** includes data from all publicly issued securities issued by receivables investment funds in 2005 and 2006, rated either AAA or AA or equivalent on the scales of the various rating agencies and with durations between 1.0 and



2.5 years. Each curve presents the nominal benchmark rate determined at the time of issuance over the two year period. The nominal rates were calculated using the forward CDI curve at the time each respective security was issued.

In addition to declining overall rates, spreads (the minimum and maximum number of basis points over CDI), though still wide, are tightening. While there is still a significant overlap between the AAA and AA spreads, **Table 1** indicates that the market is beginning to correct for pricing inconsistencies.

	2005		2006	
Rating	Min. Spread	Max. Spread	Min. Spread	Max. Spread
AAA	1.67	2.16	0.29	2.11
AA	0.73	2.97	0.81	2.86

#### (vi) Growing investor base

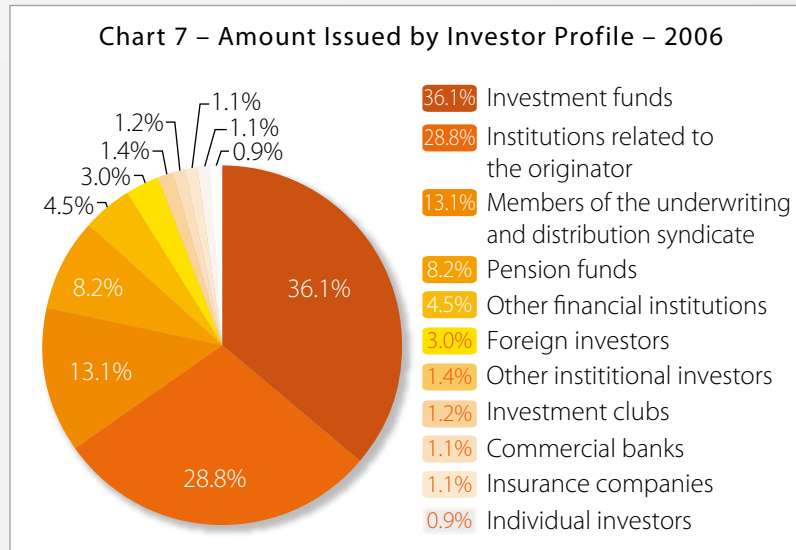
The investor base for asset-backed securities has changed dramatically over the last years. From a modest beginning with only a handful of investors and a multilateral institution trying to foster local demand, the Brazilian securitization market grew to eleven different investor categories in 2006.

As can be seen in **Chart 7**, which consists of data collected from public announcements and Uqbar's proprietary research, investment funds under professional management and financial institutions that participate in asset-backed security underwriting groups are the investors of approximately half of the total amount issued. To understand better these figures, a few qualifying remarks are appropriate: (i) a portion of the amount invested by the former category includes accounts managed on behalf of pension funds, which also have an 8.2% direct participation; (ii) the practice of distribution agents placing securities with members of their own financial group is prevalent in the CRI market, particularly when the collateral is a single corporate credit; (iii) foreign investors are under represented in this chart because many have acquired exposure to asset-backed securities through credit derivative transactions, leaving the securities themselves on the books of other entities, mainly financial institutions of the underwriting group.

Investors related to the originator also have a significant presence. Structural considerations explain most of this. Subordinated securities represent the principal form of credit enhancement in the Brazilian market and, to date, those securities have nearly always been acquired by the originator. Another factor are certain FIDC structured to be cash management tools for industrial conglomerates. These funds typically restrict the distribution of shares to members of the same economic group.

**(vii) Increasing competition**

The Brazilian securitization market is characterized by a large number of service providers in almost all major categories. For example, administrators, managers, and structurers of FIDC have respectively 19, 29, and 34 participants that have been mandated for at least one transaction in 2006. Segments such as custodians, until



recently dominated by three institutions, have started to face tough competition from new participants with a strong presence in security services either locally or internationally. At present, there are ten institutions offering custody services for FIDC.

Despite the fact that new competitors enter the market on a regular basis, several key market categories have a significant level of concentration. As an example, the top three competitors in administration, management and custody of FIDC hold market shares between 49.3% and 90.4%. However, when compared to 2005, these figures show that increased competition has caused a dilution in the leading player’s market shares.

### ***PHASE III: 2007 and Beyond - Where the Market Goes from Here***

The characteristics that define the Brazilian securitization market at present leave little doubt about the favorable prospects for continued growth. What form that growth takes and what factors will drive it are the most relevant questions.

Presented below are three important innovations that have been introduced to the Brazilian market over the past several months. In varying degrees, each contributes to lowering costs, which in turn opens the market to new participants, notably originators, thereby, increasing the quantity and variety of assets that are securitized. In Uqbar's view, these innovations will be the main catalysts to the next cycle of market growth.

The first is the emergence of increased credit tranching. The first mezzanine security appeared in the domestic market in the fourth quarter of 2006, breaking the previously omnipresent single-tier/two-tier capital structures utilized up to that time. Transactions with multiple classes of securities, more closely aligned with specific investor needs, result in more refined pricing and greater amounts of capital for originators. The expansion of this practice should bring additional investors and originators to the market as transactions previously considered marginal become feasible.

New forms of credit enhancement are another emerging trend. In the first quarter of 2007 a major European insurance company announced its entry into the Brazilian credit insurance market, specifically targeting securitization. Other insurance companies, including several based in north America, are expected to enter the market in 2007. It is expected that insurance will be utilized in conjunction with subordination, by far the most common form of credit enhancement in the market today. Like credit tranching, alternative forms of credit enhancement also tend to bring costs down and enable more transactions to come to market.

The third innovation is the securitization of future flows. The first such transaction in the domestic market that did not constitute a financial obligation of the originator was executed in the first quarter of 2007. Importantly, this transaction's originator is a government owned corporation. Given the debt restrictions these companies face, this is a ground breaking achievement and sets a strong precedent that should pave the way for other such originators to follow suit.

The three trends mentioned above are already in motion. Together with declining local interest rates, they will likely contribute to continued strong market growth, possibly of the same order of magnitude as that experienced in the recent past. Two other developments could lead to quantum leaps in market size: growth in the real estate securitization market and the emergence of a liquid secondary market for asset-backed securities. Neither of these are trends, and much uncertainty surrounds their development. Nevertheless, numerous market participants are working on each of these areas and continued progress is likely. Breakthroughs in either would be major events and could be catalysts to a doubling or more in the size of the Brazilian securitization market over the short term.

## GLOSSARY OF TERMS

**Brazilian household finance system (sistema financeiro da habitação, "SFH")** A special segment of the National Finance System created by law 4,380 in 1964 with the objective to provide subsidized housing finance for the lower income classes. SFH's main sources of funds are the Brazilian worker's severance fund, savings accounts, government repass loans and mortgage notes.

**Brazilian real estate finance system (sistema de financiamento imobiliário, "SFI")** A legal structure for a capital market based system of real estate finance created by law nº 9,514. One of SFI's objectives is the creation of a secondary market for real estate credits through securitization, thus establishing a link between the real estate and capital markets. It created several new concepts such as the real estate securitization company, certificates of real estate receivables, fiduciary relationship and fiduciary title of real estate.

**Certificates of real estate receivables (certificados de recebíveis imobiliários, "CRI")** Securities backed by real estate receivables. Only real estate securitization companies are permitted to issue CRI, which were created in order to allow these companies to raise funds from investors on terms compatible with underlying real estate transactions. They are negotiable, fixed income securities originated through receivables securitization contracts, which identify the real estate receivables backing them.

**CRI** See certificates of real estate receivables.

**FIDC** See receivables investment fund

**Fiduciary relationship (regime fiduciário)** A legal concept introduced to the real estate market in law 9,514 of November of 1997 that permits the establishment of a fiduciary relationship between the CRI and the receivables that back them. When instituted by the securitization company, this legal concept allows receivables to be separated from the company's other assets and their cash flow to be directed exclusively to pay interest and principal on the CRI to which they are associated, plus certain transaction expenses. Receivables covered under this arrangement are not accessible by the securitization company's other creditors.

A legal concept introduced to the real estate market in law 9,514 of November of 1997, similar to a "deed of trust" in the English and U.S. legal systems. Used as a form of guarantee to investors whereby real estate ownership is transferred from the obligor to the creditor until such time as the obligation has been

extinguished. Establishing fiduciary title consists of two legal relationships. The first is a contractual financial obligation. The second is the transfer of title to real estate from the obligor to the creditor, not for the purposes of securing ownership, but in order to guarantee payment of the contractual obligation established previously.

**Fiduciary title of real estate (alienação fiduciária da coisa imóvel)** The practical effect of this important legal concept is to abbreviate the time required to repossess real estate in the event of default by the obligor.

**Funds of FIDC** Funds that invest in shares of receivables investment funds.

**Real estate receivables** Though not a concept defined precisely in the law, the CVM has been considering real estate receivables to be those credits arising from either the sale of real estate to individuals or corporations, or from loan, lease or rental agreements for the purchase, construction or use of real property.

**Real estate securitization companies (companhias securitadoras de créditos imobiliários)** A legal vehicle created in law 9,514 of November of 1997. This securitization vehicle is a non-financial institution organized as a corporation. It's business objective is the acquisition and securitization of real estate credits, the issuance and placement in the financial markets of CRI and other fixed income instruments and the provision of related services.

**Receivables investment fund (fundos de investimento em direitos creditórios)** The most important asset-backed securities issuing entity in Brazil. These special purpose vehicles are investment funds regulated by CVM's ruling nº 356, nº 393 and nº 442. FIDC must invest at least 50% of their assets in credit rights or instruments representing such rights. Qualifying assets can be originated from transactions carried out in a wide variety of sectors including the financial, commercial and industrial sectors. They can issue senior and subordinated securities and can be organized as open or closed-end funds. Only qualified investors, as defined by CVM, can buy securities from these funds.

**Receivables securitization contract (termo de securitização de créditos)** A contract prepared by real estate securitization companies in which real estate receivables are explicitly linked to securities backed by these receivables. The securities are generally certificates of real estate receivables.

**Securitization of real estate receivables** Article eight of law nº 9,514 defines the securitization of real estate receivables as an operation in which the receivables in question are expressly linked to the issue of fixed income securities through a receivables securitization contract prepared and executed by a real estate securitization company.

**SFH** See Brazilian household finance system.

**SFI** See Brazilian real estate finance system.

**Special situation receivables investment funds** A CVM classification of receivables investment fund that can invest in distressed assets, future flow rights and receivables originated by Brazilian government entities, among other assets and rights. Special situation receivables investment funds are regulated by CVM's ruling nº 356 and nº 444.



Uqbar is Brazil's first knowledge based company specialized in advanced finance, with a focus on domestic securitization. Its mission is to transmit and generate knowledge for the financial market through the three pillars on which it is founded: education, information and technology.

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BCSul Verax Serviços Financeiros is an independent asset manager providing asset allocation services to individuals and corporations. Over the past 3 years the firm has expanded into the structuring and management of securitization transactions. As of Dec. 31, 2006, BCSul Verax placed 3rd in Uqbar's ranking of FIDC asset managers.

[www.verax.com.br](http://www.verax.com.br)



Brazilian Securities was created in 2000 for the purpose of developing the Brazilian market for real estate securities. It was the first company in Brazil to obtain an AA1.BR classification from Moody's Investors Service, for its issuance of CRIs. Total Brazilian Securities issues - dec/2006: R\$ 1,5 billion - 32% of market share.

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Integral-Trust is a financial advisory firm focused on corporate and structured finance. Integral-Trust also provides specialized solutions for treasury and risk management. According to Uqbar's ranking, it is Brazil's leading structurer of securitization transactions, with about 20% share for the year 2006, and more than twice the transactions as the runner-up.

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