

CHAPTER 4

The experience of project financing through stock market certificates: The Mexican case

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Mexico faces a major challenge in building infrastructure for economic development compared to their partners of the Latin American Integrated Market (MILA), which has already begun the modernization of infrastructure as one of their fundamental aspects of competitiveness in the global economy.

In the Mexican context, there are gaps between the needs of Mexican subnational governments have in the development of infrastructure and economic resources that could be provided, so that the search for new alternatives for financing public works projects constitutes a permanent challenge.

This document develops topics to discuss financing alternatives available to reduce infrastructure deficits in Mexico.

4.1 Regulatory framework for the issuance of securities in the stock market

In Mexico, local governments have a set of financing alternatives for project development and execution of infrastructure works for the provision of public services. Therefore, municipalities access to economic resources from two funds that are oriented to social investment, public security, financial restructuring and public works. Moreover, municipalities can finance development of works with future income generated from the operation of the project by the local government.

Contributions Fund for Social Municipal infrastructure and Contributions Fund for Municipal Strengthening

The background of both funds comes from the 1980s. In those years, the Mexican government had prioritized the decentralization of resources and powers as the backbone for the implementation of social development policies, so in 1982, in addition to the subscription of a set of Single Conventions of Development, it was established in the Expenditure Budget of the Federation (PEF) the Sector 26 "Regional Promotion", whose creation would serve to channel resources to the federal governments.

In 1996, Sector 26 acquires a new name and is subdivided into three funds that include the Municipal Social Infrastructure Fund. A year later, again, Sector 26 was divided into two funds: The Fund for Employment Promotion and Education, with 35% of resources in Sector 26, and the Municipal Social Infrastructure Fund with 65%. Later, in 1998, the Federal Congress created the Sector 33 "Federal Contributions for Federal and Municipal Entities" which integrated, among others, the Sector 26 and their respective funds.

The creation of Sector 33 meant the constitution of 7 funds that serve as economic sources for federal and municipal governments, which would be allocated to serve the education, health, social infrastructure, public safety and other sectors. Thus, the two main funds that were created for the provision of infrastructure at the subnational level are: i) Contribution Fund for Social Infrastructure (FAIS), which divides in two levels: municipal and state level; and ii) Contribution Fund for Strengthening Municipalities and Territorial Demarcations of the Federal District (FORTAMUNDF).

Today, in accordance with the regulations and amendments of Sector 33, the Fiscal Coordination Law and the General Law of Social Development, the FAIS aims to finance social infrastructure that benefits primarily the reduction of extreme poverty in priority places with social backwardness. Besides, the FORTAMUNDF aims to transfer to states and municipalities the necessary resources to strengthen their capacity for governance and for meeting priority demands in the area of their jurisdiction.

Stock exchange certificates

Indebtedness mechanisms of state and municipal governments to finance project development and execution of infrastructure works constitute alternatives that make possible the rapid access to financing for such works. Therefore, an additional source of economic resources is the banking and stock exchange indebtedness, which involves the participation of the private sector through banking and stock market channels.

Regarding the first, according to the Interamerican Development Bank (2009), saving surplus agents in the financial market place their surplus in banking so that it is channeled to infrastructure projects. In the second case, an investor purchases bonds issued by governments to finance infrastructure projects.

In the current regulatory framework, paragraph VIII of Article 117 of the Mexican Constitution empowers governments to undertake obligations with third parties as long as the resources obtained will be used to execute productive public investments, as well as financing or restructuring. Indeed, this article establishes that the approval of these obligations will be

performed by local legislatures or council boards of state and municipal governments. These local legislatures with the vote of two thirds of their present members must authorize the maximum amounts, payment capacity, guarantees or establishing the source of payment.

It should be mentioned that the empowerment of federal and municipal governments involves strengths and weaknesses. On the one hand, the strengths are based on flexible access to financing for the execution of infrastructure projects. On the other hand, weaknesses lie in the management of resources and projects since there are poor management skills or likelihood of corruption. Thus, it is key to monitor and control the destiny of economic resources obtained through the issuance of obligations with third parties to finance infrastructure projects.

4.2 Operational mechanics of the issuance of stock market securities in local governments or municipalities

The Mexican Constitution¹⁷ stipulates that municipalities are responsible for the functions of provision of public services such as water and sanitation, public electricity, public security, among others. To this end, municipalities may associate for the best performance of their duties, after approval by the legislatures of the interested municipalities. Therefore, municipalities are responsible that the population of their jurisdiction access to public services.

Thus, according to the provisions of the Mexican Fiscal Coordination Law¹⁸, it is stated that the economic resources that each municipality access should not be lower than 20% of

¹⁷ Article 15.

¹⁸ Article 16.

total resources allocated to the State to which they belong. The transfer of resources is performed by the Mexican Federal Government to the States, so that the latter deliver them to the municipalities. In addition to the regular resources at the disposal of Mexican municipalities, they access to the funds in social infrastructure and municipal strengthening under the framework of Sector 33 "Federal Contributions for Federal and Municipal Entities".

Trusts

In relation to the creation of the concept of trust as guarantee for obligations acquired with third parties by municipalities, Article 9 of the Fiscal Coordination Law and its regulations are the legal framework in force that ensure the payment of obligations incurred by municipalities with third parties. Thus, the trust is a tool comprising the flow of shares or own income that each municipality has¹⁹.

Then, the trust is a mechanism that regulates and ensures, through specific operational procedures, the payment for debt issues, which have to guarantee the flow of revenues of municipalities (own income or contributions by the Funds of Sector 33).

¹⁹ It should be mentioned that this trust is a tool used for public borrowing, not only to issue fixed income security (bond) but also for banking, securities and commercial financing.

Table 17
Trust actors

Fiduciary	Settlor	Trustee
<ul style="list-style-type: none"> • Economic agent who receives income from the municipality for trust constitution. 	<ul style="list-style-type: none"> • Municipality that requires the creation of trust. 	<ul style="list-style-type: none"> • Beneficiary of trust constitution, that is, third parties who issue the instrument in favor of the municipality.

Prepared by the author.

Credit Rating for municipalities

The creation of trusts with the entry into force of the Regulation of Article 9 of the Law of Fiscal Coordination constitutes new opportunities and additional financing alternatives to traditional sources. These trusts facilitated for municipalities the access to the stock market.

Therefore, it was necessary to incorporate other concepts that contribute to the inclusion of municipalities in the stock market. Access to the stock market also involved the issuance of credit rating for municipalities to provide information to potential investors interested in acquiring the securities issued by them.

The Mexican government has involved rating agencies as evaluators in the credit rating of the municipalities, so that they can access to lower interest rates and more favorable terms with the issue of their fixed income instruments. The issuance of these ratings became mandatory for all municipalities that have a mechanism of stock market indebtedness.

Today, there are four rating agencies in the Mexican stock market that have the function of providing credit rating to municipalities requiring the issuance of financial instruments in the stock market. They are:

1. Fitch Ratings
2. HR Ratings
3. Moody's
4. Standard & Poor's

Table 18
Credit Rating of the municipality of Cajeme, Sonora, México

<p>FitchRatings</p> <hr/> <p>Fitch Ratifica la Calificación de 'A+(mex)' del Municipio de Cajeme, Sonora; la Perspectiva es Estable</p> <hr/> <p>Fitch Ratings - Monterrey, N.L. - (Abril 29, 2016): Fitch Ratings ratificó la calificación de la calidad crediticia del municipio de Cajeme, Sonora en 'A+(mex)'. La Perspectiva crediticia es Estable. Asimismo, se ratifica la calificación específica de dos financiamientos bancarios contratados por el Municipio.</p> <ul style="list-style-type: none">- Interacciones 13, monto inicial de MXN208.0 millones, con saldo de MXN200.2 millones al 31 de diciembre de 2015, se ratifica en 'AAA(mex)vra'.- Bancomer 14, monto inicial y saldo de MXN323.0 millones, se ratifica en 'AAA(mex)vra'. <p>FACTORES CLAVE DE LAS CALIFICACIONES</p> <p>Los factores que apoyan la calificación específica del Municipio son las prácticas y políticas administrativas que se reflejan en una mejora en la generación de ahorro interno (AI; flujo libre para el servicio de la deuda o realizar inversión). Al mismo tiempo, la calificación considera el nivel bajo de deuda directa de largo plazo (DDLPL) y la gestión importante de recursos estatales y federales para inversión. Por otro lado, la calificación está limitada por el gasto operacional abultado (GO; gasto corriente más transferencias no-etiquetadas), el dinamismo bajo de los ingresos propios y las contingencias en relación a su sistema de pensiones.</p> <p>Fitch considera el endeudamiento de Cajeme como bajo, en relación a su capacidad financiera. Al 31 de diciembre de 2015, el saldo de la DDLPL ascendió a MXN520.5 millones o 0.48 veces (x) los ingresos fiscales ordinarios (IFOs; ingresos de libre destinación). La totalidad de la deuda se compone por dos créditos contratados con la banca comercial, Interacciones 13 y Bancomer 14. Ambos están bajo un Fideicomiso Irrevocable de Administración, Inversión y Fuente de Pago, lo que fortalece la estructura. Las coberturas de los créditos son elevadas. Durante el ejercicio 2015 y a marzo de 2016, Interacciones 13 presentó una cobertura natural promedio de 19.9x. Por su parte, de enero de 2015 a marzo de 2016, Bancomer 14 presentó una cobertura natural promedio de 13.4x y 20.2x al considerar el fondo de reserva, debido al período de gracia. El Municipio planea reestructurar su deuda, a fin de mejorar sus términos y condiciones, a lo cual Fitch dará seguimiento.</p>
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Source: Fitch.

Structuring the instrument

Securitization of future income of municipalities is a source of additional funding to existing mechanisms. The constitution of trusts is the main guarantee for potential investors in financial securities (bonds or stock exchange certificates), and the risk rating helps to reduce the credit risk of the financial transaction. This causes lower interest rates and better access to credit conditions for municipalities.

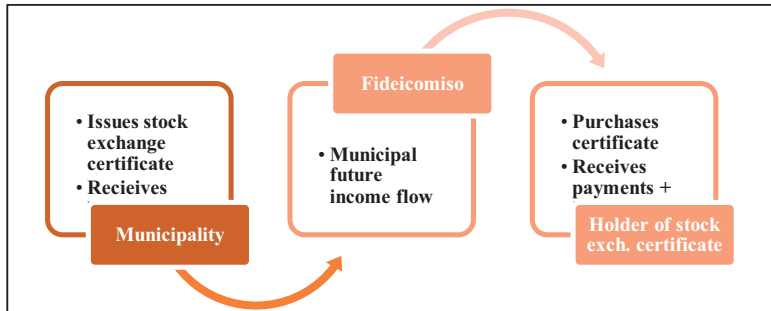
According to article 62 of the Law of the Mexican Stock Market, the concept Stock Exchange Certificates is incorporated to denominate financial securities issued by municipalities. The current legal framework governing the issuance of these certificates establishes that prior to the issuance of the certificate, it is mandatory that municipalities have succeeded in creating a trust.

Furthermore, article 63 of the same law states that only entities categorized as credit institutions, brokerage firms and investment companies may act as fiduciaries in trusts involving the Stock Exchange Certificates issuance.

Hence, the role of the fiduciary is to place debt in the stock market, considering the flow of future income of the municipalities that belong to the trust, and to provide the raised resources in the stock transaction to the municipalities. It is important to emphasize that the Mexican mechanism is flexible because it allows municipalities to form their trusts with federal contributions (funds from the federal state), own income (generated by the municipality itself) or contributions of funds for social infrastructure and municipal strengthening (Sector 33).

Graph 4

Financing mechanism through the issuance of stock exchange certificates



Prepared by the author.

It is necessary to emphasize that the mechanism and structure of the issuance of stock exchange certificates are a viable alternative to be acquired by investors due to the aforementioned factors such as a regulatory framework that allows the transparency of the instrument issuance, the relevant role of credit ratings to reduce credit risk of financing municipalities in the stock market, and the establishment of trusts comprising the future income of local governments.

4.3 Infrastructure deficit in Mexico

According to the Mexican Constitution²⁰, it establishes that the provision of basic public services is the responsibility of municipalities. Municipal governments have the function to allocate and execute the necessary resources so that people can access to drinking water, public electricity, public security and others. The provision of these services involves having the necessary infrastructure to ensure access.

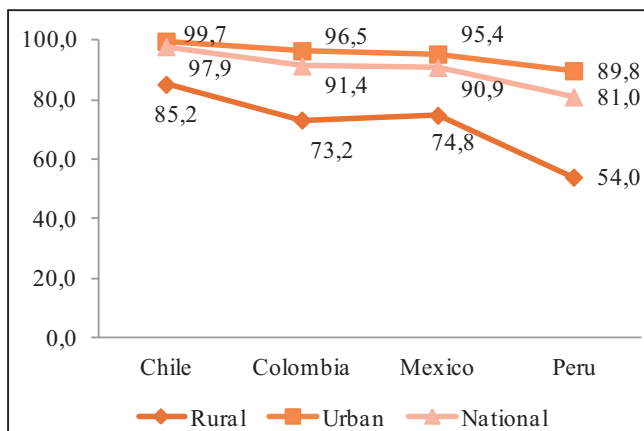
²⁰ Numeral VII, article 17.

In the Mexican case it can be proved that, despite the creation of infrastructure funds that serve and are intended precisely to the development and execution of projects and infrastructure works, it can be noted that it is still pending the execution of more projects.

Water and sanitation sector

Regarding access to drinking water by area of residence, Mexico has relatively lower levels than Chile and Colombia, countries also members of MILA. These countries, like Mexico, have been implementing strategies that accelerate execution of public works.

Graph 5
International comparative of access to drinking water by
area of residence 1/
(Percentage of total households)

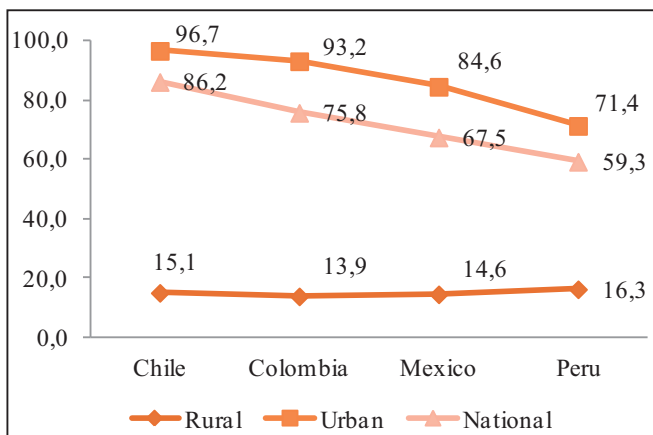


1/ Data for Peru, Chile and Colombia belongs to 2013; México, 2012.

Source: Social economic Database for Latin America and the Caribbean, SEDLAC, World Bank.

In the sanitation sector, Mexico has a pending task to develop public works to provide drainage and sewerage access, mainly for households in rural areas of the country. It is relevant to point out that its MILA pairs have higher levels of access to sanitation services such as Peru (67.5% of the population nationwide to receive this service), while it is only 59.3 % of the national population for the Mexican case.

Graph 6
International comparative of access to sanitation service by
area of residence 1/
(Percentage of total households)

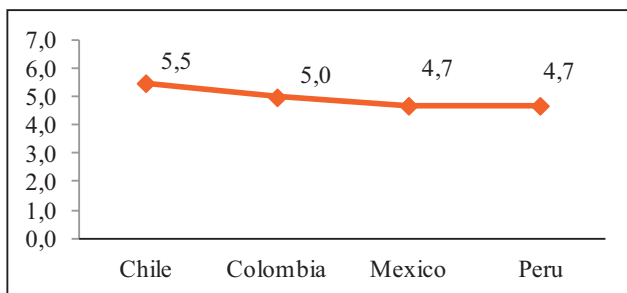


Source: Social economic Database for Latin America and the Caribbean, SEDLAC, World Bank.

Electricity Sector

According to the Competitiveness Report 2015 - 2016, Mexico received a score of 4.7 in terms of the quality of infrastructure for the provision of electricity service. It is important to highlight that its MILA pairs, Chile and Colombia, are also with better levels of quality infrastructure in electricity, compared to Mexico. Regarding its Peruvian counterpart, both countries have the same levels of quality.

Graph 7
International comparative: quality indicator of
infrastructure in electricity, WEF 2015 – 2016
(Values of index between 1 and 7)



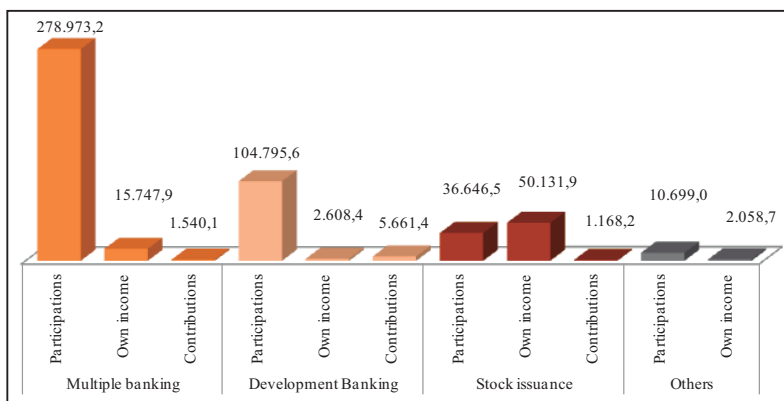
Source: Global Competitiveness Report 2015 – 2016, World Economic Forum (WEF).

4.4 Current scenario of financial obligations

The regulatory framework for the issuance of stock exchange certificates by state and municipal governments in Mexico is a quick way to access to financing that will be necessary to continue closing the infrastructure gaps in water and sanitation and electricity sectors, which are in the jurisdiction of the municipalities.

The data recorded in March 2015 shows the levels of financial obligations of the states, municipalities and their agencies with respect to creditors and sources of income that are assigned as collateral or trust to access financing. It can be concluded that stock issuances have a significant participation in financial debts incurred by subnational governments (17,2% of total financial obligations).

Graph 8
Financial obligations of state entities, municipalities and
their agencies by type of creditor and income
source, 2015 1/
(Millions of pesos)



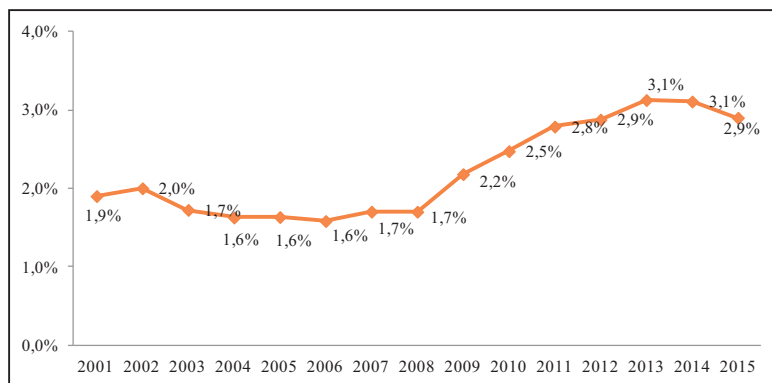
1/ Available information at 1Q2015.

Source: Secretariat of Finance and Public Credit.

Regarding financial inclusion of subnational governments in Mexico, it is possible to conclude that the accumulated amount until 2015 represents more than five times the amount reported in 2000. This is explained by the dynamism of access to financing sources that allow greater levels to finance activities and projects of subnational governments.

Likewise, as percentage of the Mexican GDP, financial obligations of subnational governments have an important relevance in the economic activity of Mexico. In a period of fifteen years, one can affirm that the evolution has been increasing until 2,9% of financial debt as percentage of the GDP of 2015.

Graph 9
Evolution of financial obligations of state entities, municipalities and their agencies, 2015 1/
(Percentage of GDP)

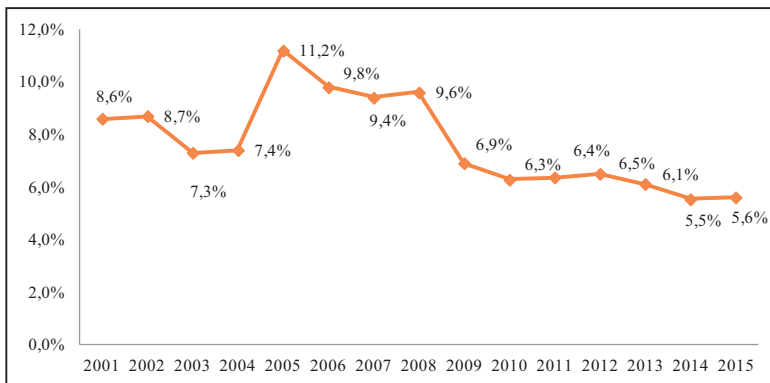


1/ Available information at 1Q2015.

Source: Secretariat of Finance and Public Credit.

Finally, it is important to know the levels of average interest rates that are being negotiated in the Mexican financial market for subnational governments. According to information from the Secretariat of Finance and Public Credit of Mexico, falling interest rates for sub-national governments are around 5.6% for 2015.

Graph 10
Average interest rate of financial obligations of state entities, municipalities and their agencies, 2015 1/
(Percentage)



1/ Available information to 1Q2015. The interest rate is annually nominal.
 Source: Secretariat of Finance and Public Credit.

In conclusion, we can say that financial inclusion of sub-national governments has been increasing. Important reforms such as access to the stock market through the issuance of stock exchange certificates, participation of rating agencies and the creation of trusts to guarantee future income of subnational governments, has increased competition in the market, and access to various financing alternatives with lower interest rates.

4.5 Analysis of supply and demand of Stock Exchange Certificates

Economies of scale and consolidation of several municipal settlers have led states to take a more active role in the issuance of stock exchange certificates. Nowadays, the issuance of certificates is carried out by states, by grouping a number of municipalities benefiting from access to these financial instruments.

Table 19
Credit Rating for 199 municipalities of Veracruz State

The image shows a press release from HR Ratings. The header includes the HR Ratings logo and the text 'Credit Rating Agency'. The main title is 'Municipios del Estado de Veracruz HR AA+ (E) Certificados Bursátiles Fiduciarios VRZCB 08 / VRZCB 08U'. Below this, it states 'Finanzas Públicas 15 de julio de 2016'. The body of the text includes a table of ratings, a detailed announcement in Spanish, and contact information for three individuals: Rodrigo Martínez, Roberto Soto, and Roberto Ballínez.

Calificación	HR AA+ (E)	HR AA+ (E)
VRZCB 08	Estable	Estable
VRZCB 08U		
Perspectiva		

HR Ratings ratificó la calificación crediticia de HR AA+ (E) con Perspectiva Estable de los CEBURS Fiduciarios, VRZCB 08 y VRZCB 08U, de 199 municipios del Estado de Veracruz.

La emisión de los Certificados Bursátiles Fiduciarios (CEBURS Fiduciarios) con clave de pizarra VRZCB 08 y VRZCB 08U se realizaron al amparo del Fideicomiso Irrevocable Emisor, Administración y Pago No. F/998, en el que participan como fiduciario Deutsche Bank México, S.A., Institución de Banca Múltiple, División Fiduciaria, y como fideicomitente, 199 municipios del Estado de Veracruz (el Estado y/o Veracruz). La fuente primaria de pago para el cumplimiento de las obligaciones financieras de ambas emisiones corresponde al 7.5453% de las participaciones federales del Fondo General de Participaciones (FGP) de los 199 municipios fideicomitentes. La fecha de vencimiento de los CEBURS Fiduciarios es en julio de 2036.

La ratificación de la calificación de HR AA+ (E) es resultado, principalmente, del análisis financiero de los flujos futuros de la estructura estimados por HR Ratings bajo escenarios de estrés cíclico y estrés crítico. Este último análisis arrojó una Tasa Objetiva de Estrés (TOE) de 91.2%, en comparación con la TOE obtenida el año anterior de 90.7%. Esto indica que los ingresos por FGP correspondientes a los CEBURS Fiduciarios podrían disminuir 91.2% adicional respecto a los flujos en un escenario de estrés cíclico y serían suficientes para cumplir con las obligaciones de pago. El cálculo de la TOE supone el uso de las reservas de tal manera que se podría garantizar su reconstrucción posterior al periodo de estrés crítico, incorporando restricciones adicionales debido al saldo objetivo del fondo de reserva y que el pago de capital se realiza de manera anual cada julio.

De acuerdo con nuestras proyecciones de flujos, el semestre de mayor debilidad sería julio de 2026 con una...

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Source: HR Ratings.

The placements of financial instruments in the Mexican stock market are conducted by state governments, which bring together municipalities within their jurisdiction. This form of structuring stock exchange certificates in the market allows that, in a single issue, several municipalities simultaneously may access to financing. Besides, there is greater monitoring

and involvement by state governments since they are the channels through which the Mexican federal government transfers resources allocated to each municipality.

In the following table, there is information about securities in circulation issued by state and municipal governments.

Table 20
Securities in circulation issued by state and municipal
governments 1/
(Millions of Pesos)

Year	State	Municipality	Total
2002	3.901	1.315	5.216
2003	10.213	1.622	11.835
2004	16.603	1.533	18.137
2005	17.850	1.102	18.952
2006	35.373	316	35.688
2007	43.905	80	43.985
2008	50.976	42	51.018
2009	54.754	-	54.754
2010	59.430	-	59.430
2011	66.636	-	66.636
2012	70.955	-	70.955
2013	86.244	-	86.244
2014	95.927	-	95.927
2015	96.007	-	96.007

1/ The information is for the month of December of each year.

Source: Bank of México.

In conclusion, subnational governments are issuing debt by grouping several municipalities in the same state, so the issue and placement on a larger scale of stock exchange certificates

is facilitated. By December 2015, the certificates issued by subnational governments amounted to 96.007 million pesos, representing 6,5% of total securities in circulation in the Mexican stock market.

4.6 Conclusions

The use of funds via trusts will be relevant in closing the infrastructure gap, since it will represent a financing alternative that encourages and promotes the participation of the private sector. Statistical information confirms that the need to provide infrastructure still persists.

Moreover, it should be emphasized that the government at various levels can contribute to closing these gaps by identifying priority infrastructure projects for the private sector may participate in them.

Finally, it is important to mention the need to count on an information platform and detailed knowledge in the financial, technical, legal and environmental fields that will allow the formulation and implementation of new and better projects that will attract new technology.

CONCLUSIONS AND RECOMMENDATIONS

The experiences of our neighboring MILA countries are relevant to formulate and propose public policies that will help reduce our infrastructure deficit. To date, there are a number of mechanisms that serve to the implementation of projects, such as regulations about the promotion of public-private investment in Peru. However, statistics of the infrastructure gaps in our country show that these regulations are still insufficient. Therefore, it is appropriate to analyze and implement other funding alternatives for infrastructure development, such as the issuance of fixed income instruments.

It is important to highlight the Chilean experience in the use of resources called Infrastructure Fund, and how this applies in situations like ours; so that these resources are directed not only to public works projects, but extended to finance projects in sectors such as railways, digital infrastructure, urban infrastructure, transportation projects and water distribution, as well as tourism infrastructure, among others.

In this context, the use of funds via trusts will be relevant in closing the infrastructure gap, because they represent a financing alternative that encourages and promotes the participation of the private sector; so the government can contribute at different levels, identifying priority infrastructure projects for the private sector to participate.

Also, as happened in Colombia, legislation is the key to generate incentives for private sector participation, because without it is difficult to encourage an investor or any financial institution to get involved in this mechanism. Therefore, those regulations should help ensure the repayment of financing to

the investor; that is to say, to provide legal certainty and predictability to investment.

Financing mechanism issuance of debt instruments

In Peru, we are able to develop alternative financing schemes structured for the long term. We are in competitive conditions, through the national and international financial system, to implement investment projects in infrastructure for subnational governments.

Subnational governments must approve via their respective regional or municipal councils, their rights and future flows of the funding source of resources –Fix Resources– to a trust; whose sole purpose is to support the payment of the financing obtained, with technical approval of the General Directorate of Indebtedness and Public Treasury of the Ministry of Economy and Finance (MEF), with conformity of the General Directorate of Public Budget and the Comptroller General of the Republic.

Subsequently, the role of an Intermediary Financial Institution (IFI) will be critical to the management of the trust, the cancellation of payments for advance works to the builder, to the investor owner of the debt instrument, prior the MEF approval and conformity, and the Comptroller. Aforementioned scheme is detailed in the following flow chart.

The strength and economic sustainability of the mechanism is based on the synergy of actors to implement investment projects in infrastructure. Then, the mechanism comes from a lack of financial resources by subnational (regional or municipal) governments to implement projects.

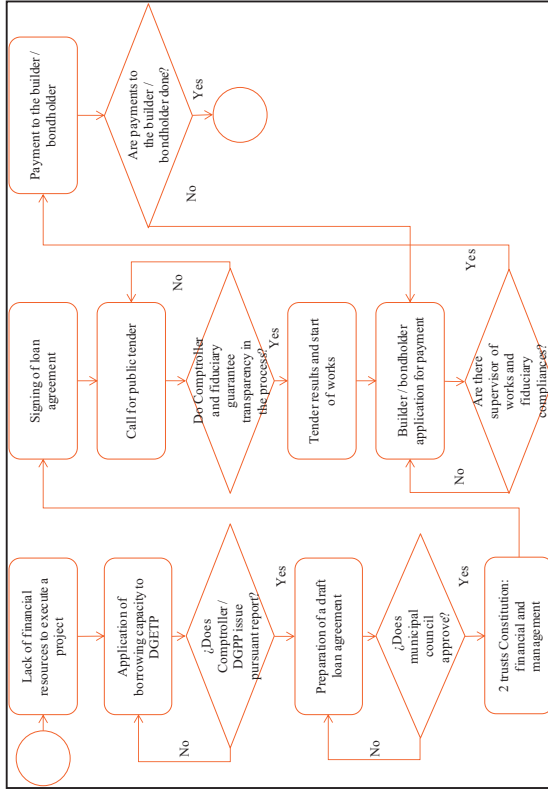
Firstly, the subnational government will submit an application to the General Directorate of Indebtedness and Public Treasury of MEF (DGETP), for the issuance of securitized debt. Then, the DGETP will evaluate, according to fiscal rules, as well as the Directorate General of Public Budget MEF and the Comptroller General of the Republic.

Once, the actors have released their conformity in the technical and budget field, a draft of a loan agreement will be drawn in favor of the subnational government, which includes the creation of two trusts. The former is responsible for the financial management of debt flows, and the second will manage the project implementation. The aforementioned trust must be approved by municipal or regional council.

After signing the loan agreement, the Central government will call for a public tender to hire the builder of public works. In order to ensure transparency of the process, it will be necessary to guarantee the thoroughness of the bases, and the participation of the Comptroller as a process observer.

Finally, whenever the constructor or the borrower / bondholder request their payments, payment for work progress in the case of the builder and payment loan to the bondholder, there will be needed the conformity from both the supervisor of the work and the trustee of project management. Finally, disbursements are made.

Graph 11
Financing mechanism flowchart with issuance of fixed income instruments



Prepared by the author.

Final comments

It is important to mention that following the COFIDE participation in the International Seminar, that entity is in a position to be the main actor in the development of a Infrastructure Financing Program for subnational governments for the five years 2016-2021; as part of a concerted effort to finance infrastructure subnational governments projects, duly approved by a reformulated National Public Investment System (SNIP), which should be a priority in educational infrastructure, health, water, sanitation, among others.

Coverage costs of the co-structuring financing program that the stakeholders develop must be supported by a critical mass of subnational governments who have completed the legal and budgetary documentation required, prior approval and conformity of the MEF and the Comptroller.

Finally, legal devices will actually set objectives to innovate the existing mechanisms with conforming instruments of a financing structure, to close the infrastructure gap in shorter terms, improving the quality of services that are provided, and that can be achieved very quickly, under current regulations.

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