Tequila Sunrise: Has Mexico Emerged from the Darkness of Financial Crisis

Thomas W. Slover

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Tequila Sunrise: Has Mexico Emerged from the Darkness of Financial Crisis?

Thomas W. Slover*

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* Thomas W. Slover, J.D. (Southern Methodist University); LLM (University of London); Research Fellow, London Institute of International Banking, Finance and Development Law, Centre For Commercial Law Studies, Queen Mary and Westfield College, University of London; Research Fellow, Law Institute of the Americas, SMU School of Law, Dallas, Texas.
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Introduction.

In December 1994, Mexico's devaluation of the peso triggered a severe crisis in the country's financial system. The crisis created serious liquidity and solvency problems for the entire banking system, exposing its weak capital base and widespread portfolio problems. International financial markets reacted with panic, and investor confidence all but disappeared. The large inflows of capital that followed Mexico's economic liberalization and accession to the North American Free Trade Agreement (NAFTA) abruptly shifted outwards, prompting a massive rescue effort from the United States, the IMF, and Mexican authorities. The extent to which the Mexican peso crisis affected capital flow in Mexico and throughout the region is commonly referred to as the "tequila effect."¹

Although the peso devaluation proved to be the catalyst that triggered the crisis, it was widespread instability in the banking sector that created the environment necessary for a crisis to occur. Arguably, this instability transformed what should have been an economic adjustment into a full-blown, severe financial crisis.

This essay is divided into three main parts. Part One provides a legal and economic overview of the Mexican Peso Crisis. The first section outlines the legal and economic core issues that have affected the financial law systems of emerging market economies—paying additional attention as to how Mexico fits within the broader experience. The second section focuses on the historical development of Mexico's banking system and the government's financial liberalization under President Salinas's administration. The third section discusses several factors that analysts now view as the underlying causes of the banking crisis, paying particular attention to the macrroeconomic policy decisions and political events in Mexico during 1994 leading up to the peso devaluation. Finally, the fourth section describes the immediate economic effects of the crisis on the banking system and international rescue efforts.

Part Two provides a detailed analysis of the Mexican Government's law reform initiatives in response to the crisis and the extent to which these initiatives have fostered banking soundness in Mexico. The first section discusses some of the most significant short-term government initiatives, such as fiscal austerity measures, liquidity assistance, the temporary capitalization program, and debtor-relief programs. The second section describes several significant long-term structural reforms, such as the relaxation of foreign investment limitations under NAFTA, the facilitation of bank mergers and sales, and the establishment of peso futures markets. The third section explains some of the vast and far-reaching supervisory and regulatory reforms implemented, such as stricter lending standards, increased reporting and disclosure requirements, and proposed measures to amend the structure of the Mexican financial regulatory system.

Part Three consists of an assessment of Mexico's legal and economic reforms. The first section provides an analysis of some of the key successes of the new reforms and gives examples of recent positive developments. The second section discusses some of the deficiencies that remain in Mexico's financial system. Finally, the third section concludes the essay with a few comments regarding Mexico's financial system.

¹ The term "tequila effect" was apparently coined in the banking policy literature because of the need for recovery in the region after Mexico's overspending and overborrowing. The effect of the crisis is thus likened to the alcoholic "hangover" that can result from overindulging in tequila, a Mexican liquor.
PART ONE
LEGAL AND ECONOMIC OVERVIEW

I. Banking Crises in Emerging Market Economies.

A. Recent Trends.

The incidence of banking crises in the 1980s and 1990s has been significantly higher than in past decades. Indeed, from 1980 to 1996, seventy-three percent of the International Monetary Fund's (hereafter IMF) member countries experienced at least one bout of significant banking-sector problems. This trend is especially evident in emerging market economies. Banking crises in emerging market economies merit particular attention because they have serious repercussions for the domestic economy and also for other countries as international financial markets have become more integrated.

Despite the expansion of capital markets in emerging market economies, banks continue to hold the lion's share of financial assets and are by far the dominant financial intermediaries. The banks operate the payments systems, are major purchasers of government bonds, and provide liquidity to fledgling securities markets. Consequently, the banking sector is likely to remain the principal source of systemic vulnerability in the financial sector.

The cost to taxpayers of supporting, recapitalizing, and restructuring troubled banks can be enormous if authorities fail to bring the problems under control quickly. "Senior Mexican officials estimate that the tab for 'rehabilitating' the balance sheets of Mexican banks could run as high as 8.5 percent of GDP." Others estimate that the cumulative fiscal and quasi-fiscal outlays associated with bank restructuring could amount to as much as fifteen percent of Mexico's GDP.

B. Sources of Instability.

Although macroeconomic instability and external shocks have been significant factors in past financial crises, the root causes are generally to be found in microeconomic and institutional failings. Generally, problems begin with poor management within financial institutions, and more broadly, with weak internal governance by owners and managers. Poor internal controls, connected lending, insider dealing, and fraud are often the source

5. Fairlamb, supra note 3, at 4.
7. See Michel Camdessus, The Challenges of a Sound Banking System, in Banking Crises in Latin America 535 (Ricardo Hausmann & Liliana Rojas-Suarez, eds., 1996); see also Group of Ten, supra note 6, at 15.
of poor asset quality. Moral hazard\textsuperscript{8} worsens when owners do not face proper incentives to act prudently and to supervise managers, who may then be guided by objectives that are not compatible with sound financial practices and be shielded from external discipline.\textsuperscript{9} Weaknesses in the legal framework compound the problems of lax management and weak corporate governance, for instance by undermining the collection of collateral. Once credit quality has been compromised, regulatory shortcomings and supervisory forbearance can aggravate matters by failing to identify problems and preventing them from being addressed in a comprehensive and timely fashion.\textsuperscript{10}

Banking crises have frequently occurred following periods of rapid expansion in economic activity linked to the emergence of unsustainable macroeconomic imbalances, often combined with market distortions. A sudden correction in asset prices following the emergence of these imbalances exposes the underlying weaknesses of the financial sector and acts as the trigger for a crisis.\textsuperscript{11}

Financial liberalization can also contribute to financial instability during the transition period by increasing the exposure to credit and foreign exchange risks, particularly when undertaken in an unstable macroeconomic environment.\textsuperscript{12} Financial institutions in recently liberalized financial systems often lack the experience to manage these risks and, in the face of stronger competition, institutions will tend to be pushed towards riskier investments.\textsuperscript{13} Others take too many risks in the expectation that the authorities will step in if they run into trouble.

Weaknesses in accounting, monitoring, and reporting procedures are another culprit. Lack of adequate loan classification procedures undermines the internal governance in banks, as well as market discipline and official oversight.\textsuperscript{14} In some cases, weak classification and provisioning requirements for problem loans can even allow management to show adequate capital the day before a bank collapses.

Appropriate capital standards provide incentives to bank owners to temper high-risk gambles since their own money is at stake. Banking systems that do not force bank owners, managers, and creditors to suffer at least a portion of the losses created by the bank's insol-

\textsuperscript{8} "Moral hazard" might be defined as actions taken by economic agents to maximize their own utility to the detriment of others in situations where agents do not bear the full consequences of their actions. See William P. Osterberg, The Hidden Costs of Mexican Banking Reform, Fed. Reserve Bank of Clev., Jan. 1, 1997, at note 10.

\textsuperscript{9} Heavy government involvement in the banking sector or loose controls on connected lending also have been at the root of many emerging-market-country-banking crises, as the political objectives of governments or the personal interests of bank insiders come to supersede the commercial, profit-maximizing objectives of banks. See Morris Goldstein, The Case for an International Banking Standard, Institution for Int'l Econ., Apr. 1997, at 14; see also Group of Ten, supra note 6, at 16.

\textsuperscript{10} See Group of Ten, supra note 6, at 9.

\textsuperscript{11} Id. at 10.


\textsuperscript{13} A 1995 report by economists Kaminsky and Reinhart concerning the causes of banking crises revealed that the financial sector had been liberalized some time during the previous five years in 18 of the 25 banking crises in their sample. See Goldstein, supra note 9, at 14.

\textsuperscript{14} See Camdessus, supra note 7, at 537; see also Goldstein, supra note 9, at 16.
vency, and that do not give bank supervisors enough institutional protection against strong pressures for regulatory forbearance, share the blame for bank crises.\textsuperscript{15}

Mexico's banking system in the years prior to the crisis was plagued by all the inadequacies described above. In the recently liberalized banking system, bank managers and supervisors were poorly equipped to handle the increased exposure to credit and foreign exchange risks. Moreover, favorable capital flows during the early 1990s resulted in excessive lending to less-than-creditworthy borrowers. The lack of adequate accounting standards also contributed to the instability of the banking system by masking the true nature of banks' balance sheets and thereby reducing banking system transparency. These and other factors, discussed below, created a highly unstable and vulnerable banking system.

II. Historical Overview of Mexico's Banking System.

The recent history of Mexico's banking system is one of turbulence. Mexico has experienced several financial crises since the mid-1970s, and on a number of occasions has been forced to seek financial assistance from the United States and the IMF to help it manage such crises.

A. The 1982 Crisis and Nationalization.

The last major financial crisis prior to 1994 began in 1982 when Mexico announced that its reserves had run out and that, without financial assistance, Mexico would be forced to default on $80 billion in mainly dollar-denominated foreign debt obligations to U.S. and other foreign banks.\textsuperscript{16} The United States and IMF arranged a $4.55 billion rescue package, which entailed a substantial rescheduling of Mexico's debt obligations.\textsuperscript{17}

Soon after the crisis began, President Lopez Portillo nationalized all but two of Mexico's sixty private commercial banks, imposed exchange controls, and initiated a series of consolidations, which continued until only eighteen commercial banks remained.\textsuperscript{18} In addition, the Mexican Congress amended its constitution to provide that all banking and financial services activities were to be the exclusive domain of the government.\textsuperscript{19}

During this period of state ownership of the commercial banks, Mexico was severely "underbanked."\textsuperscript{20} The government's control of the banking system resulted in crowding out credit to the private sector as banks' investment portfolios shifted toward government securities, and loans were made to state-controlled enterprises rather than to private sector entities.\textsuperscript{21}

\textsuperscript{15} Goldstein, supra note 9, at 18.


\textsuperscript{17} The debt obligations were repeatedly rescheduled throughout the 1980s until eventually the remaining debt was converted into bonds under the Brady Initiative. See Rory Macmillan, The Next Sovereign Debt Crisis, 31 STAN. J. INT'L. L. 305 (1995).


\textsuperscript{19} See Nalda, supra note 18, at 386.


\textsuperscript{21} Eventually, nearly 100% of bank credit was directly or indirectly allocated by the government.
State ownership had several other adverse effects on Mexico's banking system. An immediate problem was that the commercial banks lost many experienced officers who strongly disapproved of the nationalization and subsequently resigned their posts rather than accept the government as their employer. Those bank officers who remained, or who were acquired to fill the vacancies created by the departing officers, did not receive proper training in the credit business since only a small fraction of loanable funds were channeled to the private sector.

Additionally, since the principal borrower was the government, a sovereign entity, the risk evaluation function was practically ignored during this period. Excluded from the capital markets, the Mexican banking system stagnated, and credit growth reached its lowest rate in years. Further, Mexico's insulation from foreign bank competition created an environment of lax complacency. Internal controls received little attention, and bankers failed to develop disclosure and informational systems in pace with their counterparts from other world banking systems. In such an environment, there was little incentive for either the public servants administering the commercial banks or the supervisory authorities to worry much about loan portfolio risk.

B. PRIVATIZATION AND LIBERALIZATION UNDER THE SALINAS ADMINISTRATION.

Since 1988, the Mexican financial system has undergone deep structural changes. During the first days of 1989, President Carlos Salinas de Gortari initiated comprehensive reforms in an effort to promote sustained economic growth while controlling excessive inflation, which stood at an annual rate of 160 percent.

A central aspect of the government's plan was the privatization of the state-owned Mexican banks and the encouragement of limited foreign investment in the banking system. The government hoped that foreign investment in the banks would encourage the transfer of technology and the modernization of the banking system and thus allow the banking system to reverse the decline in productivity experienced during the 1980s.

Bank privatization and financial liberalization began in earnest in 1990. Among the legal reforms made were the liberalization of deposit and lending rates, elimination of the mandatory requirement for commercial banks to hold long-term government paper to maturity, and the elimination of reserve requirements. By the end of 1992, all of Mexico's eighteen state-owned banks had been re-privatized.

The privatization of the banking system was far more successful than originally anticipated. The first eight banks, representing 56% of Mexico's nationalized bank assets, sold for a total of $7.68 billion at an average of 3.12 times their book value. Several reasons explain the high prices paid for the banks, including industrial growth, profit potential, and the desire to secure a place in the growing Mexican market. By the time that privatization process was completed in 1992, Mexico had garnered a total of $12.4 billion. See id.; see also Nalda, supra note 18, n.106.
purchased by holding companies, which were dominated by brokerage houses, and which generally have a higher risk tolerance than banks. Moreover, many of the new bank purchasers were far from seasoned bankers and they generally paid higher than average prices in order to acquire the banks.

In addition to the privatization of the state-owned banks, Mexico instituted numerous changes in the legal framework governing the financial sector. These structural changes were designed to encourage increased competition in financial services from foreign institutions, but at a gradual rate so that domestically controlled financial institutions could have time to adjust by adopting new technologies, internal infrastructure, and services.

In 1990, Congress enacted the Law for the Regulation of Financial Groups. This statute allowed conglomerate banking, whereby a single holding company could carry out separate commercial banking, brokerage, and other financial services activities. Unfortunately, the legislation lacked important prudential requirements.

The Mexican Congress simultaneously enacted the Law of Credit Institutions, which allowed majority private sector ownership of commercial banks. The statute created a legal framework for the capital structure and operations of the banking system, under which investors could acquire one or more of three different types of stock in Mexican banks, dependent upon the investor's status. The statute also dictated the maximum levels of foreign investment allowed for Mexico's domestically controlled financial institutions.


Mexico's financial reforms culminated in 1994 with the enactment of the North American Free Trade Agreement (NAFTA) between Mexico, the United States, and Canada. Under the agreement, Mexico agreed to allow U.S. and Canadian financial institutions to provide financial services through the establishment of subsidiaries or affiliates in Mexico. Mexico further agreed to provide both "national treatment" and "most-

29. "Ley para Regular las Agrupaciones Financieras," D.O., 18 de julio de 1990 (Mex.).
31. Such prudential requirements might include: producing consolidated financial statements, following credit exposure rules, and other practices designed to limit a holding company's exposure to the insolvency of one of its entities.
32. "Ley de Instituciones de Credito," D.O., 22 de julio de 1994 (Mex.).
33. See Nalda, supra note 18.
34. See Ayer, supra note 18. The law limited foreign ownership of a single bank's capital stock to 5%, but allowed up to 10% ownership with government approval and under certain conditions. These limitations were later amended to comply with the provisions under Chapter 14 of the NAFTA Treaty. Id.
36. See Garza, supra note 30, at 53-54. To facilitate the control of monetary policy by the Banco de Mexico, the Mexican Government chose not to allow foreign banks to establish branches.
37. See PAUL ET AL., NORTH AMERICAN FREE TRADE AGREEMENT 68 SUMMARY AND ANALYSIS (1993) (national treatment requires each NAFTA party to treat another party's financial institutions and investors no less favorably than domestic financial institutions and investors).
favored-nation treatment" to cross-border financial service providers and investors from other NAFTA countries.

Financial services are governed principally by Chapter 14 of NAFTA. Chapter 14 requires each party to permit individuals and companies from the other NAFTA countries to establish financial institutions in its territory and to expand the operations of such institutions throughout its territory. To be eligible for the benefits under Chapter 14, the foreign institution or investor must already be engaged in the business of providing financial services.

The agreement, however, also provided Mexico with several significant reservations. Section B of Annex VII (Schedule of Mexico) imposes capital limits during the six-year transition period following the effective date of the agreement. There are two types of capital limits: individual limits for each foreign-owned institution and aggregate limits for all foreign-owned institutions of the same type. The capital limits apply only during the transition period, with some exceptions. The original capital limit for individual institutions began at 1.5 percent. The aggregate industry capital limit began originally at eight percent. Both of these limits were to increase yearly throughout the transition period until the year 2000, at which point all limits would expire.

D. MEXICO'S FINANCIAL REGULATORY SYSTEM.

The Mexican financial law system is a purely national system. Accordingly, all of the authorities which are involved in the supervision and regulation of banking activities belong to the federal government. "Authority for regulating the activities of banks in Mexico is shared among the Banco de Mexico, the Ministry of Finance and Public Credit, and the National Banking and Securities Commission (CNBV)." The Ministry of Finance is considered the head of the financial sector and is the only authority with legal powers to interpret financial laws. Other principal functions of the Ministry of Finance

38. See id. Most-favored-nation treatment requires each NAFTA party to treat another party's financial services providers and investors no less favorably than financial services providers and investors from any other country. Id.
40. NAFTA, supra note 35, art. 1403.
41. Id. art. 1403(5).
42. Id. annex VII(B)(1)-(7)-Mex.
43. Id. annex VII(B)(2), (5)-(6)-Mex.
44. Id. annex VII(B)(1), (9), (C)(Definitions)-Mex.
45. Id. annex VII(B)(2)-Mex.
46. Id. annex VII(B)(5)-Mex.
47. The agreement included a further safeguard provision which permits Mexico, under certain conditions, to freeze for three years the aggregate capital limits.
48. "In June 1993, the Mexican Constitution was amended and legislation went into effect granting the Banco de Mexico greater autonomy and more clearly defining its functions as those relating to conduct of monetary policy and supervision of the payments system and foreign exchanges markets." See Karaoglan & Lubrano, supra note 20, at 43 n.6.
49. The CNBV was created in May 1995 through a merger of the National Banking Commission (CNB) and the National Securities Commission (CNV). Id. at 43 n.8.
50. Id. at 28.
include: determining the composition of capital in all banking corporations and providing
the legal basis to calculate the specific amounts of money available for loans and to diversi-
yfy the risks in all active operations of credit institutions.51

The CNBV's mandate is to perform the supervisory, remedial, and regulatory func-
tions concerning the operation of all financial entities.52 Under its supervisory authority,
the CNBV conducts liquidity and solvency examinations to evaluate the possible risks to
which banks may be subject. The CNBV also conducts periodic bank inspections and
establishes operative programs to reduce existing irregularities that may affect the liquidity
and solvency in banking corporations.53

The CNBV may impose monetary penalties against banking corporations and, in cases
of serious or repeated violations, may issue a decree for the suspension of the financial enti-
ty's charter.54 Additionally, the CNBV may recommend that bank managers and directors
be removed from office and may operate as administrative receiver of the institution.

Since April 1994, the Banco de Mexico has been an autonomous entity responsible for
the country's monetary and price stability policies.55 The Banco de Mexico also serves as
the depository, lending institution, and clearinghouse regulator for credit institutions.56
The Banco de Mexico is further authorized to impose sanctions against financial interme-
diaries, including civil monetary penalties and suspension of operations in foreign curren-
cies, gold, and silver.57

Beyond the primary supervisory authorities, the Law of Credit Institutions provides
for the establishment of the Banking Fund for Savings Support (Fondo Bancario para
Proteccion de Ahorro, or FOBAPROA) and defines the legal basis for its provision of "pre-
ventative support" to troubled banks.58

FOBAPROA's role goes beyond simple deposit insurance. FOBAPROA has broad pow-
ers to extend preventative support to banks to permit them to meet their obligations,
securing such support through a pledge of shares of the commercial bank recipient or its
financial holding company.59 Under amendments approved in February 1995, FOBAPROA
is further empowered to exercise the voting rights of shares that have been
pledged to it, take majority control of the bank or financial group, replace management,

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51. See Jose D. Guerra-Sanchez, Overview of the Regulation of Banks in Mexico (1996)
52. Id.
53. Id.
54. Id.
55. "Ley del Banco de Mexico," D.O., 23 de diciembre de 1993, arts. 1-2 (Mex.).
56. "Ley de Instituciones de Credito," D.O., 22 de julio de 1994, art. 122 (Mex.).
57. "Ley del Banco de Mexico," arts. 24, 29, 32 (Mex.).
58. "FOBAPROA is organized as a trust administered by the Banco de Mexico. However, Article 122
of the Law of Credit Institutions establishes that FOBAPROA's policies will be established by a
technical committee with its members appointed by the Ministry of Finance, the CNBV, and the
Banco de Mexico. A majority of the members of the technical committee are appointed by the
Ministry of Finance." See Karaglan & Lubrano, supra note 20, at 43 n.10.
59. "Under the Law of Credit Institutions, the fund is required to give notice each December of the
types of bank assets it will cover the following calendar year. Each year since its inception,
FOBAPROA has stated its intention to assure the payment of all liabilities of Mexican banks,
other than subordinated debt." Id. at 28.
write down the bank's capital in accordance with the results of a full audit, and sell the
bank if amounts extended as preventative support are not repaid or if serious undercapita-
larization or irregularities are uncovered in a bank.60

III. The Roots of the Crisis.

A. BANKING FRAGILITY AND UNSUSTAINABLE ECONOMIC EXPANSION.

The NAFTA agreement, and the financial liberalization which preceded it, sparked sig-
nificant foreign investment in the banking sector. With a rapidly expanding population of
almost ninety million people, most of whom were under-banked and under-leveraged,
Mexico's consumer market presented an attractive opportunity for the highly developed
retail banking industries of the Untied States and Canada.61 The period immediately fol-
lowing the agreement's effective date on January 1, 1994 saw exceptionally high growth.62

Not surprisingly, once privatized, Mexican banks competed fiercely to gain market
share in the provision of loans, both by increasing the volumes of their existing lines of
business and by venturing into relatively new financial services, such as home mortgages
and credit cards.63 The consolidation of public finances shifted banks' lending behavior
away from financing the government and toward riskier lending to the private sector. As
banks were privatized, their risk evaluation staffs, either brand-new or inherited from the
period when the government owned the banks, were ill-prepared to operate in this new
environment.64 As a result of both macroeconomic stabilization and financial liberaliza-
tion, a financial deepening occurred in which the availability of domestic loanable funds
increased significantly for Mexican banks.

In addition to the greater availability of domestic funds for lending, Mexico received
large inflows of capital from 1990 to early 1994 in response to the almost complete elimi-
nation of capital controls in 1989 and the global trend of capital flows to emerging mar-

60. "[T]he flexibility accorded FOBAPROA under the Law of Credit Institutions has permitted it to
function as the instrument for a number of the Mexican Government's responses to the effects of
the peso crisis on the banking sector." Id. at 30.
61. Id.
62. Several foreign institutions filed applications with the Ministry of Finance seeking authority to
invest in or establish Mexican financial services firms. By October 17, 1994, the Finance Ministry
had approved 54 applications from foreign financial services firms to operate in Mexico. The 54
firms consisted of 19 banks, 16 stock brokerage firms, 12 insurance companies, 2 financial leasing
firms, and 5 financial groups. See Fluckiger, supra note 28, at 77.
63. "As a consequence, between 1991 and 1994, aggregate assets of the commercial banks increased
by 111.3% in nominal terms, or by 64.6% in real terms, equivalent to a real annual growth rate of
18.1%. In 1994, assets of the commercial banking system averaged N$735 billion, equivalent to
58.8% of GDP, compared to 42.5% for 1991. The bank's loan portfolios grew at an even higher
rate than their assets. From year-end 1991 to year-end 1994, aggregate gross loans (excluding dis-
counted loans) increased by 142.9% in nominal terms, or by 89.2% in real terms, equivalent to
an annual real growth rate of 23.7% (more than eight times the rate of GDP growth during the
64. See Banco de Mexico, The Mexican Economy 1996, IV(2)(a) (1996)
Mexican Economy 1996].
NAFTA: Law and Business Review of the Americas

According to the IMF, Mexico attracted approximately $93 billion in net capital inflows from 1990 to 1994, more than half of the flows into all of Latin America. Naturally, the newly available funds found many eager takers in the private sector. Between 1988 and 1994, the ratio of bank credit to the private sector increased from 13.4 percent of GDP at year-end 1988 to 50.7 percent in 1994. Private sector demand for bank credit was strong for several reasons, including: (1) favorable expectations of Mexican economic performance; (2) the need to modernize and expand Mexico's industrial plant in light of increased competition resulting from a more open economy; (3) the appalling housing shortage; (4) higher perceived permanent income; (5) consumers wishing to replace obsolete stocks of durable goods; and (6) the need to finance the acquisition of public enterprises being privatized.

To a certain extent, the greater availability of credit and the increased private sector consumption of that credit were viewed favorably; they were the intended results of Mexico's financial liberalization policies. However, improved expectations about the future course of the economy caused inexperienced bank credit officials and bank managers to confuse good and bad credit risks. In such an environment, too many borrowers seemed to have profitable projects and reasonably good prospects for servicing their debts. Moreover, borrowers who had forgotten how to use credit prudently, or who had never had any prior experience in paying debts, often failed to practice caution.

Several developments accompanied the expansion of credit to the private sector. First, the structure of credits shifted conspicuously toward financing consumer and mortgage credit. Mortgage and consumer credit is riskier than a business loan because legal proceedings to recover the collateral in the case of default are particularly cumbersome, often rendering the collateral of little use. Additionally, credits denominated in dollars—which are subject to exchange rate risk—grew rapidly until 1992, when the central bank imposed restrictions on the increase of foreign currency liabilities of commercial banks. Overall, the imprudent expansion of lending to the private sector led to a significant drop-off in portfolio quality.

The "crawling peg" exchange rate system, although effective in controlling Mexico's high inflation, contributed to the current account deficit by overvaluing the peso and

65. See Mancera, supra note 22, at 229.

66. However, foreign capital inflows during this period were more heavily weighted to relatively liquid portfolio investment rather than to foreign direct investment. Portfolio investment from 1990 to 1994 constituted 60% of foreign capital inflows, compared to about 18% for foreign direct investment. See A. James Meigs, Mexican Monetary Lessons, The Cato Journal, Vol. 17 No. 1, (visited Dec. 9, 1997) <http://www.cato.org/pubs/journal/cj17n1-4.html>.

67. See Mancera, supra note 22, at 229.

68. Id. at 230.

69. See The Mexican Economy 1996, supra note 64, IV(2)(a).

70. See Mancera, supra note 22, at 230.

71. Aggregate past due loans of commercial banks grew from 4.09% of gross loans at the end of 1991 to 7.25% of gross loans at the end of 1993. See Karaoglan & Lubrano, supra note 20, at 26.

72. Under a "crawling peg" exchange rate system, the domestic currency is pegged to a foreign currency, such as the U.S. dollar, at a fixed rate, but the rate is allowed to fluctuate within a narrow band. This band can be adjusted periodically to accommodate upward or downward trends in the exchange rate. It is through these periodic adjustments that the peg "crawls." See Chun, supra note 25, at 2700 n.60.
thereby artificially increasing the price of Mexican exports and reducing the price of imports.\textsuperscript{73} Mexican imports exploded from 1987 to 1994, while exports grew more slowly during this period.\textsuperscript{74} Real GDP growth in Mexico was modest, averaging only 2.7 percent a year in the early 1990s.\textsuperscript{75}

These trends in Mexico were perceived as manageable since the system had sufficient flexibility in interest rates and the exchange rate band to manage macroeconomic imbalances. To subsidize its current account deficit, Mexico relied on portfolio investors to purchase short-term, peso-denominated treasury notes, called "cetes." Cognizant of the volatility created by the short-term nature of the cetes, the government nevertheless hoped that Mexico's continued attractiveness to foreign investors would prevent capital flight. The government fully anticipated that exports would expand as Mexico's competitiveness and productivity improved, and that this would lead to a reduction in the current account deficit and a decrease in the dependence on foreign capital.

Moreover, the Salinas Administration needed to present an image of stability to international investors and to the U.S. Congress during the NAFTA negotiations. The U.S. Congress had not yet embraced the prospect of entering into a trade agreement with Mexico and there was already mounting opposition to the agreement from the Senate and House Democrats. Any attempt to correct the current account deficit and shrinking foreign exchange reserves with a substantial peso devaluation before completing the NAFTA negotiations (or prior to the vote in Congress) would likely have resulted in an economic recession and could have easily derailed the negotiations and jeopardized the progress achieved during the previous five years. Those were risks that the government was unwilling to take.

The Mexican banking system was still in its infancy just a few years after privatization. Accordingly, banks were relatively fragile and were beginning to show signs of weakness toward the end of 1993. The supply of capital was becoming increasingly insufficient due to the relatively high level of past-due loans that had not been adequately provisioned. Moreover, some commercial banks were operating with serious problems, which were not readily noticeable from the information disclosed to financial authorities.\textsuperscript{76} In such a fragile state, the banking system was ill-prepared for the macroeconomic and political events that unfolded in 1994.


Sadly, Mexico suffered a series of unfortunate political and economic shocks in 1994 that forced investors to reconsider their investments and also endangered the sustainability of

\textsuperscript{73} See id. at 2656.

\textsuperscript{74} "[T]he Mexican trade balance deteriorated from an export surplus of $8.4 billion in 1987, to a deficit of $-.7 billion in 1989, and reached $-20 billion in 1992 and a $-18.5 billion deficit in 1994. At the same time, Mexico's current account balance declined from a $4.0 billion surplus in 1987 to a $-4.0 billion deficit in 1989, getting much worse with a $22.8 billion deficit in 1992, and a $-28.8 billion deficit in 1994. As a share of Mexican GDP, the current account deficit was 1 percent of GDP in 1987, -9% of GDP in 1989, -4.1% in 1992, and -5.2% in 1994." William A. Lovett, \textit{Lessons From the Recent Peso Crisis in Mexico}, \textit{4 TUL. J. INT'L & COMP. L.} 143, 152 (1996).

\textsuperscript{75} See Ayer, \textit{supra} note 18, at 5.

\textsuperscript{76} See Mancera, \textit{supra} note 22, at 231.
Mexico's spending policies. The first event was an armed uprising of Indian rebels that broke out on January 1, 1994 in the Chiapas region. The uprising was timed to coincide with the effective date of the NAFTA treaty and was a significant blow to Mexico's image as a stable and mostly conflict free modernizing country seeking to join the developed world. Then on March 23, 1994, Mexico's image was again tarnished by the assassination of presidential candidate Louis Donaldo Colosio. On the day after the assassination, the Mexican Stock Exchange fell by twenty-two points. Additionally, Mexico experienced large losses in foreign exchange reserves due to investors' increasing fears of political turmoil in Mexico.

Mexico responded by raising interest rates only slightly, allowing the peso to rise to the ceiling of its exchange rate band, and offering higher interest rates on cetes to attract foreign investment and offset further losses in foreign reserves. During this period, Mexican authorities also began to shift the composition of the country's short-term internal public debt from cetes to dollar-indexed securities, called "tesabonos," thereby transferring the exchange rate risk from investors to the government.

By the middle of 1994, Mexico was entering into another expansionary stage and there was an evident need for measures to reduce the current account deficit. But with Zedillo trailing in the polls only three months before the presidential election, the government ruled out a substantial devaluation in the peso as too disruptive. Indeed, the government exacerbated the problem by pumping credit into the economy through government development bank lending. Finally, the government ruled out any significant increases in interest rates because it was fearful that higher interest rates could severely impact a banking system that had already been weakened by the growing volume of past-due loans.

The government's failure to respond adequately to the current account deficit was based in part on the assumption that once the August presidential elections had concluded successfully, the stabilization of the political situation would calm the markets, causing capital inflows to resume and allowing the government a greater opportunity to engineer a smoother adjustment. Contrary to the government's assumption, however, conditions did not improve after the election. Instead, political stability was put into question once again in September 1994 when the ruling party's secretary general, Jose Francisco Ruiz Massieu, was assassinated in Mexico City. In November, foreign investors began reducing their exposure in Mexico causing reserves to decline by approximately $5 billion. By December, foreign reserves had reached dangerously low levels. The Chiapas rebellion intensified and immediate pressure hit the Mexican Bolsa and the peso.


78. By April 22, barely a month after the assassination, foreign reserves had declined by $10.8 billion. Id. at 52.

79. Although this action did not violate the commitment to exchange rate stability, it allowed for a significant depreciation in the value of the peso. By April 22, the peso was nearly 8% lower against the dollar than it was in mid-February. Id. at 58.

80. By the last week of April, there was nearly a sevenfold increase in tesabonos offered and a 57% reduction in cetes. The issuance of tesabonos created approximately $30 billion in short-term, dollar-linked liabilities. See Mexico: Country Overview, in Trends in Developing Economics 1996, (World Bank 1996); see also Chun, supra note 25, at 2657.

81. The peso had already depreciated 10% since March. See Lovett, supra note 74, at 154.

82. See Ayer, supra note 18, at 5.
To alleviate the pressure on the peso, Mexico announced a fifteen percent devaluation of the peso on December 20, 1994. In the absence of any parallel policy to manage possible large withdrawals, investors continued to reduce their exposure, causing international reserves to fall to $10.5 billion. The following day, after further capital flight of $4 billion, the Mexican Finance Minister reluctantly announced that its foreign reserves were insufficient to cover the adjusted exchange rate, and the peso was allowed to freely float.

Events after the devaluation did not lead international investors to conclude that Mexico was stable, either. To the contrary, investors' skepticism regarding Mexico's financial future grew in light of the Mexican Government's apparent unwillingness to raise interest rates to market levels. Perception became reality as investors, concerned that Mexico would not be able to finance its short-term tesabonos debt, refused to roll over their maturing tesabonos. Because its reserves had fallen to such a low level, the government was no longer able to meet the redemption demands of all the bondholders. These events pushed an already weak banking system toward insolvency.

C. THE EFFECTS OF THE PESO DEVALUATION ON THE BANKING SYSTEM.

The direct impact of the December 1994 devaluation on Mexico's commercial banks was softened somewhat since the Banco de Mexico had previously imposed a ceiling on the amount of foreign currency denominated liabilities that banks could incur. This measure was based in part on the consideration that the Banco de Mexico had a limited ability to act as lender of last resort with respect to foreign currency liabilities, and it assisted in preventing the run on banks' external obligations in early 1995 from being worse than it was.

Unfortunately, the indirect impact of the devaluation on the banking sector was substantial. Inflation and interest rates skyrocketed, economic activity fell sharply, and banks began to suffer a liquidity shortfall. Without sufficient liquidity, banks were unable to roll over certificates of deposit that were coming due, resulting in even higher interest rates. The higher interest rates resulted in a decline in the value of the banks' assets, as those assets were mainly investments in fixed income securities. In the first quarter of 1995, interest rates on home mortgages, consumer credit, and commercial credit rose to over eighty percent per annum. Furthermore, the December devaluation of the peso and the further deprecations in subsequent months, along with

83. Mexico's Finance Minister, Guillermo Ortiz, later admitted that the sudden, sharp devaluation in the peso "was less than impeccably executed." See Guillermo Ortiz, Comment, Banking Soundness and Monetary Policy, INT'L MONETARY FUND (1997) at 217.
84. See Chun, supra note 25, at 2658.
85. Sixteen billion dollars worth of tesabonos were due to mature in early 1995 and payment obligations on tesabonos for the entire year exceeded reserves by $23 billion. Id. at 2659.
86. This ceiling limited commercial banks' foreign currency obligations to 20% of total liabilities and prohibited the banks' net short or long foreign currency from exceeding 15% of net capital. See Ayer, supra note 18, at 7.
87. Nevertheless, commercial banks sustained foreign currency losses totaling more than 10% of equity (NP$ 4.6 billion) in the system. Some banks tried to recoup their losses immediately following the peso devaluation by converting net short positions into net long positions. Id.
88. However, in the second quarter after the devaluation, interest rate growth subsided and nominal rates declined to approximately 35%. Id.
the higher interest and inflation rates, the over-indebtedness of households and companies, and economic recession, made it much more difficult for debtors to make their debt service payments. This brought about further increases in banks' past-due portfolios and significant declines in their capitalization ratios.

IV. The U.S./IMF Rescue Package.

A few days after the devaluation, the governments of Mexico and the United States realized that the source of the instability was the Mexican debt profile. Mexico took action by seeking a financial assistance package from the United States to help stave off the liquidity crisis. "Although Mexico had sufficient incoming oil revenue to honor the random repayment demands of its bondholders, it did not have sufficient resources at hand to redeem all of the maturing bonds from the panicking multitude of bondholders." This prompted the arrangement of an $18 billion rescue package, announced on January 2, 1995.

Authorities presumed at the time that such a large assistance package would calm the market since it covered the outstanding tesabonos held by foreign investors coming due in 1995. However, the rescue package was too small to cover the bank certificates of deposit and other short-term obligations coming due in 1995. Through simple arithmetic calculations, investors estimated that, assuming no investors were willing to roll-over their investments, the $50 billion in public and private short-term debt obligations coming due in 1995 was far greater than the resources available.

By the end of the first week of January, it became clear to the Mexican Secretary of Finance that the situation was much more grave than first anticipated. News that some of the Mexican banks were unable to renew their certificates of deposit held by foreigners triggered another wave of flight from the peso. The peso continued to slide. Investors panicked, not only those in the Mexican stock market and debt instruments, but also investors in similar instruments issued by borrowers from countries in the same part of the world or perceived to be in similar circumstances. Thus began the so-called "tequila effect."

The tequila effect was induced by two types of factors. First, as perceived risks rose and expected returns fell, individual investors were persuaded to divest. Second, institutional holders, such as mutual funds faced with actual or threatened redemptions, were led to liquify their holdings not only of Mexican paper but also of the paper of other coun-

89. The inflation rate between December 1994 and December 1995 was 51.97%. See The Mexican Economy 1996, supra note 64, Part I.
90. Id.
91. See Lustig, supra note 16, at 53.
92. See Chun, supra note 25, at 2659.
93. Id. Mexican authorities assumed (or rather hoped) that a large portion of the certificates of deposit would be rolled over. This assumption, however, was not shared by investors. See Lustig, supra note 16, at 54.
94. International reserves in the Bank of Mexico were approximately $6 billion and the rescue package was $18 billion. Thus, the rescue package plus the international reserves would have barely covered half of Mexico's $50 billion in financial obligations for 1995. See Lustig, supra note 16, at 54.
tries, especially if they could do so while limiting their capital losses. The very real possibility of widespread contagion prompted President Clinton to announce on January 11, 1995, that the United States was committed to helping Mexico through what he considered a short-term crisis.

Clinton could not allow the Mexican economy to fail since he had invested a considerable share of political capital in Mexico's fate with his strong endorsement of NAFTA. A collapse of the Mexican economy would have transformed the passage of NAFTA from a stunning, positive achievement into a political embarrassment. Moreover, if Mexico were to fail, protectionism might resurface. This development would pose a severe setback for the Latin American countries that had struggled to grow out of their debt under the Brady Initiative, and for the United States, which had a vested economic interest in the health of these economies.

In an attempt to bridge the immediate crisis and prevent a total economic collapse of the Mexican economy, Clinton announced on January 12, 1995, a proposal to extend a new and larger rescue package of $40 billion to Mexico in loan guarantees. The package was slated for quick congressional approval, with endorsements from congressional leaders from both parties, the Federal Reserve, and Wall Street. However, the bailout quickly drew controversy. Opposition grew rapidly as populist Democrats, alarmed at the prospect of further U.S. job losses and shrinking U.S. exports after the peso devaluation, and isolationist Republicans, unsympathetic to NAFTA and Mexico, attached numerous conditions to the approval of the bailout. Others questioned details and demanded a more complete accounting for the bailout and stronger guarantees for repayment. Approval of a bill that would be acceptable to both the U.S. Congress and the Mexican Government became increasingly unlikely. Investors reacted to this development with another wave of capital flight.

Still determined to prevent the collapse of the Mexican economy, Clinton announced on February 1, 1995, that he would use executive authority to provide Mexico with a new emergency bailout loan deal including $20 billion in U.S. Treasury emergency stabilization funds (ESF), $17.8 billion in IMF assistance, $10 billion from the Bank of International Settlements, $1 billion from Canada, $1 billion in currency swaps from Argentina, Brazil, Chile, and Colombia, and $3 billion in new loans from commercial banks for a total of...

97. Perhaps more importantly, registered American voters who had investments in Mexican stocks and bonds would suffer a potential loss estimated at about $8-10 billion. See Chun, supra note 25, at 2660.
98. See Lustig, supra note 16, at 56.
99. See Lovett, supra note 74, at 155.
100. The conditions eventually covered the entire range of bilateral issues: migration, relations with Cuba, extradition practices, narcotics trafficking, among others. Id.; see also Lustig, supra note 16, at 56.
102. Congressional approval is not required for U.S. Treasury emergency stabilization funds. See Lovett, supra note 74, at 155.
approximately $53 billion. The announcement of the new rescue package halted the peso's nose-dive. However, the markets remained unstable until the Mexican Government announced a new economic program on March 9, 1995, which contained more realistic and plausible targets.

The new package received sharp criticism as well. At the IMF, parties opposed to the loan argued that IMF funds were being used to bail out risk-taking American mutual and pension fund managers and some were shocked by the size of the IMF contribution. The IMF contribution was nearly seven times larger than Mexico's quota and three-and-a-half times more than the IMF had ever lent in its history. Opponents further cautioned that excessive lending would create moral hazard and establish lending precedents that the IMF could not meet in the future.

The criticism in the U.S. Congress was even louder. Members of Congress were outraged that the Clinton Administration had circumvented congressional approval for such a large financial rescue package. Some representatives argued that the true purpose of the aid was to rescue wealthy Wall Street investors. Others questioned the wisdom of bailing out Mexico, a country with a "long and painful past of undisciplined financial mismanagement." Nevertheless, if Mexico had not obtained international financial support, the depreciation of the peso would likely have been greater, and so would have been the effect on interest rates, inflation, and the decline in real wages. Moreover, the damage to Mexico's financial system would have been of greater proportion and the contraction in economic activity would have been deeper and more protracted.

103. Of the total rescue package, $7.8 billion from the IMF standby was made immediately available. The distribution of the remaining funds was conditioned on Mexico's adherence to certain economic conditions and targets. See Lustig, supra note 16, at 58-59.

104. See George Graham et al., Bitter Legacy of Battle to Bail Out Mexico, FIN. TIMES, Feb. 16, 1995, at 4; see also Chun, supra note 25, at 2662.

105. Quotas are the contributions of IMF members to its General Resources Account. In 1995, access rules to the General Resources Account allowed a country to borrow 100% of its quota with cumulative limit of 300%. Mexico's quota was about $2.6 billion and thus, the IMF loan was nearly an unprecedented 700% times greater than Mexico's quota. See Daniel Bradlow, The International Monetary Fund: Overview of its Structure and Functions, in INTERNATIONAL BORROWING: NEGOTIATING AND STRUCTURING INTERNATIONAL DEBT TRANSACTIONS 399 (Daniel D. Bradlow ed., 2d ed. 1986).


109. In a speech given in the early part of 1998, President Zedillo applauded the financial assistance package arranged by the U.S. and multilateral institutions, stating that "it is no exaggeration to say that their swift and judicious actions averted the risk of a Mexican external default in 1995, with all its painful consequences for the world economy at large." See Remarks of President Ernesto Zedillo Ponce de Leon, President of Mexico, Plenary Session of the World Economic Forum, Davos, Switzerland (Jan. 31, 1998) <http://barracuda.iweb.com.mx/mib/s/1polit.html>.
The rescue package, although generous, was not without terms and conditions. The terms of the $20 billion U.S. package were formalized in the “U.S.-Mexico Framework Agreement for Mexican Economic Stabilization” (Framework Agreement) signed on February 21, 1995, which governs the U.S. loan and loan guarantees package for Mexico.110

Under the Framework Agreement, Mexico committed itself to comply with the IMF program and additional requirements set by the U.S. Treasury.111 In particular, the Mexican Government agreed to refrain from intervening in the foreign exchange market using international reserves, but rather to stabilize the peso using indirect fiscal and monetary policy. The Mexican Government further agreed to disclose information regularly on a number of variables and policy decisions in a systematic and transparent way and proceed with structural reforms.112 In connection with the Framework Agreement, the U.S. Treasury created the “Mexico Task Force,” whose purpose was to monitor Mexico’s economy and economic policy making.113

PART TWO
THE MEXICAN RESPONSE

In response to the financial crisis, the Mexican Government implemented several measures designed to alleviate the difficulties faced by financial intermediaries and help avoid systemic repercussions. These measures were aimed at achieving the goals of preserving the integrity of the real sector of the economy and strengthening the financial system. The different schemes to support the banking system and indebted bank clients were developed with the following principles in mind: (1) prevent systemic risk; (2) protect the legitimate interests of depositors and other bank creditors; (3) help debtors strained by the macroeconomic crisis; (4) resist pressures to bail out the stockholders of financial institutions; (5) avoid expansion of the central bank’s credit; (6) minimize the fiscal costs of the crisis management; (7) interfere as little as possible with the normal functioning of the markets; (8) minimize incentives which can lead to moral hazard problems; and (9) implement simple and transparent programs which foster confidence.114

110. The terms specify that disbursements can take place for one year and can be renewed once for six months. Since the use of the ESF money required an assured source of repayment, the Mexican Government agreed to deposit the proceeds of oil export sales by PEMEX into a special account at the Federal Reserve Bank of New York. The agreement was formalized in the “Oil Facility Agreement” found in Annex A of the Framework Agreement. See Lustig, supra note 16, at 59-61.

111. This agreement may be found in Annex C of the Framework Agreement entitled, “Economic Policy Memorandum.” Id. at 61.

112. Id.


I. Short-term Initiatives.

A. The Macroeconomic Austerity Program.

Almost immediately after the devaluation, the Mexican Government began the implementation of another painful austerity plan. On January 3, 1995, the government announced a new emergency economic agreement designed to restore financial stability, strengthen public finances, assist the banking sector, regain confidence, and reinforce the foundations for long-term sustainable growth.\(^{115}\)

The plan was not successful in preventing foreign investors from continuing to withdraw their funds from Mexico.\(^{116}\) This prompted the government to announce a new economic plan on March 9, 1995 of monetary, fiscal, banking, and social measures. The plan contained stringent economic policy adjustments consistent with agreements reached with the United States and the IMF. The main objectives of the new plan were to contain inflation and reduce the current account deficit. In contrast to previous plans, the new plan was not accompanied by a Pacto between the Mexican Government, business, and labor.\(^{117}\)

The plan consisted of several elements dealing with monetary, exchange rate, fiscal, and social policies. In order to stabilize the exchange market, the plan entailed a twenty percent reduction in the domestic money supply in real terms through higher interest rates and increased financial regulation.\(^{118}\) The floating exchange rate policy, adopted by necessity in December 1994, was maintained. The government ruled out any measures to limit currency convertibility because of the negative effect it would have had on Mexico’s attempts to access the capital markets in the future.\(^{119}\)

Mexico adopted several new fiscal policy measures in accordance with IMF guidelines. These measures included: (1) an increase in the value-added tax; (2) a reduction in budgetary outlays equal to 1.6 percent of GDP for fiscal year 1995; (3) an immediate tax increase on gasoline and diesel fuel, and an increase in electricity prices; and (4) an increase in the fiscal surplus of 2.1 percent of GDP.\(^{120}\)

Finally, Mexico made several changes to its social policies. Minimum wages were

\(^{115}\) See Mexico’s Financial Crisis, supra note 77, at 133.

\(^{116}\) Some of the economic projections incorporated into the program, such as maintaining a current account deficit of $14 billion and reducing the expected rate of GDP growth from 4% to 1.5 to 2% for 1995, were not viewed as credible by international investors. Id. at 133-34.

\(^{117}\) Although the government wanted to obtain the endorsement of the plan from the members of the old Pacto, its efforts to do so were unsuccessful because they disagreed with the austerity measures. Id. at 134.

\(^{118}\) According to the Federal Reserve, Mexico’s monetary program was intended to target a particular growth rate of net domestic assets, which, given flat net international reserves, would produce a particular growth rate of the nominal monetary base. The extent of real reduction in the monetary base would then depend on inflation. Id.

\(^{119}\) The mere hint that a country might impose exchange controls can preclude it from access to international capital markets because mutual fund managers cannot tolerate the possibility that they might be prevented from quickly dumping their holdings and shifting them elsewhere. See Cynthia Lichtenstein, The Mexican Crisis, Who Should Be a Country’s Lender of Last Resort? 18 Fordham Int’l L. J. 1769, 1775 (1995).

\(^{120}\) See Mexico’s Financial Crisis, supra note 77, at 135.
increased by ten percent in addition to a previously announced increase of seven percent.\textsuperscript{121} Other measures included an extension in health benefits for unemployed workers from two to six months and a rural employment program.\textsuperscript{122}

B. LIQUIDITY PROGRAMS.

1. Dollar Liquidity Facility.

In the immediate aftermath of the peso devaluation, Mexican banks encountered extreme difficulty in renewing their maturing dollar obligations. Mirroring the government's tesabono difficulties, commercial banks discovered that their CD depositors and other lenders were unwilling to roll over their investments. The Banco de Mexico responded in early January by establishing a special dollar liquidity facility whereby FOBAPROA provided short-term, twenty-eight-day dollar loans to enable banks to pay all foreign currency liabilities as they came due.\textsuperscript{123} The purpose of the dollar liquidity facility was to stop, and eventually reverse, the run on the external liabilities of commercial banks.

In order to encourage commercial banks to substitute the loans with private sector funding at the earliest possible time, FOBAPROA charged interest on the loans of up to twenty-five percent and required the loans to be secured by government securities, debt securities of Nacional Financiera, S.N.C. (the state development bank), or equity securities of the recipient bank.\textsuperscript{124} To further encourage the prompt repayment of these loans, it was established that early repayment of even a portion of the loans would reduce the interest charged on a portion of the outstanding balance.

2. Peso Liquidity Facility.

Mexican banks also found it difficult to maintain their peso funding. Banks' increasing need for pesos to buy dollars to retire maturing dollar-denominated CDs caused interbank peso lending rates to rise substantially. Smaller banks were put under additional pressure as their depositors transferred peso deposits to larger and presumably sounder institutions in a "flight to quality."

Acting as lender of last resort, the Banco de Mexico addressed the problem by providing short-term peso credit through special credit auctions. Credit was initially provided on an unsecured basis for banks that were experiencing a shortage of collateral. However, to ensure that liquidity provision did not become a means to delay recognition of insolvency, the Banco de Mexico began requiring banks after March 20, 1995, to post government securities, securities of National Financiera, and loans provided to prime borrowers as collateral.\textsuperscript{125} By

\textsuperscript{121} However, because the two increases were well below the projected inflation rate of 42%, real wages were projected to decline. \textit{Id.} at 136.

\textsuperscript{122} \textit{Id.}

\textsuperscript{123} Dollar financing under this program was extended to 17 commercial banks. At its peak in April 1995, the outstanding credit granted through the dollar liquidity facility had reached $3.9 billion. By September 1995, however, all dollar-denominated advances had been repaid as banks took advantage of renewed access to international financial markets. \textit{See The Mexican Economy 1996, supra note 64, IV(2)(c)(iii); see also Mancera, supra note 22, at 233.}

\textsuperscript{124} \textit{See Karaoglan & Lubrano, supra note 20, at 35.}

\textsuperscript{125} \textit{Id.}
March 31, 1995, outstanding balances stood at the equivalent of $3 billion, with most established banks participating in the auctions at some point. After the immediate crisis had subsided, banks were able to obtain peso liquidity from private money markets and no longer required the assistance of the Banco de Mexico for peso liquidity.

C. Temporary Capitalization Program (PROCAPTE).

The devaluation of the peso drastically increased the domestic currency value of bank loans denominated in foreign currency, causing the capital-asset ratios of many Mexican banks to fall below the accepted level. To remedy this situation, the government introduced the Temporary Capitalization Program (Programa de Capitalizacion Temporal or PROCAPTE) in February 1995 to assist the banks that had capitalization levels below the internationally accepted standard of eight percent of risk-weighted assets. This program was administered on a voluntary basis and was intended for use by viable banks that were facing short-term capital needs, rather than by problem banks requiring intervention.

Using resources obtained from the Banco de Mexico, FOBAPROA purchased subordinated convertible debentures from participating banks in amounts sufficient to raise the banks' ratio of net capital-to-risk-weighted assets to nine percent. To prevent unwarranted expansion of the Banco de Mexico's net domestic credit, the commercial banks were required to deposit the resources thus obtained in an account at the Banco de Mexico. Interest rates on the deposits were fixed to match the rates on the debentures to avoid negatively affecting the banks' income statements. While the debentures remained outstanding, participating banks were required to maintain a capital ratio of at least nine percent and were restricted from paying dividends or issuing new equity or subordinated debt.

Banks operating under PROCAPTE were kept under strict supervision by the CNBV. If a participating bank's capitalization ratio fell below 8.5 percent, FOBAPROA had discretion to approve additional subordinated convertible debentures to restore the bank's nine percent capitalization ratio. If a bank failed to repay the debt within five years, FOBAPROA could convert the debentures into equity capital of the bank, thereby becoming an owner of the bank. In addition to converting shares that were not repaid within five years, the convertibility feature could be invoked earlier if a participating bank's capital deteriorated to below 2 percent of its risk-weighted assets, or if the bank's capitalization, excluding the PROCAPTE obligations, varied more than 25 percent from the trend of average capitalization of all the banks participating in the program. If a bank's capitalization ratio improved to exceed nine percent, however, the bank was rewarded by attaining the right to redeem in advance all or part of the subordinated debentures held by FOBAPROA.

126. Id.
128. Although the program was voluntary, a bank which did not recapitalize faced suspension or revocation of its operating charter. See Mexico's Financial Crisis, supra note 77, at 144.
129. See Camdessus, supra note 7, at 221.
130. See Fluckiger, supra note 28, at 80.
131. Under no circumstances would the government retain any ownership interest in the banks. In keeping with its commitment to financial liberalization, the government was eager to demonstrate to the markets that it had no intention of renationalizing any banks, however weak. See Ayer, supra note 18, at 8.
132. See Karaoglan & Lubrano, supra note 20, at 38.
The program allowed banks a relatively long time to obtain fresh capital and pay their debts to FOBAPROA. At the same time, the program provided incentives to the banks to recapitalize as promptly as possible through the threat of dilution of interest or even total loss of investment presented by the mandatory conversion of the debentures after the five-year period. Indeed, faced with the mere possibility of having to rely on PROCAPTE’s resources, some banks made an immediate effort to obtain capital on their own. Moreover, many participating banks were anxious to leave the program as soon as possible due to the stigma that the market attached to these banks in the form of higher interbank rates for funds.

By the end of March 1995, six banks had entered into the PROCAPTE program, including Mexico’s third largest bank, Serfin. However, by June 1995, all participating banks except one had exited the program by injecting new capital from shareholders in return for the purchase of non-performing assets by FOBAPROA. The program had a positive effect on depositor confidence. The effect on future profitability, however, has been less than positive because of the high level of subordinated debt in the composition of the banks’ capital.

D. DEBTOR PROGRAMS.

According to literature published by the Banco de Mexico, all of the programs in support of debtors were designed with the following objectives in mind: (1) to foster responsible payment practices among debtors; (2) to carry incentives for banks to grant additional credit to certain sectors which the programs were designed to help and thereby contribute towards economic recovery in those sectors; (3) to limit financial support to small debtors and to limit the extent of support; (4) to structure the cost of the programs so that they be shared equally between banks and the Federal Government; and (5) to structure the program to have no monetary impact.

1. Debt Restructuring Program (UDI).

The rapid devaluation of the peso led to a substantial increase in inflation rate dur-
Mexico responded to this problem by introducing an inflation-indexed unit of account for financial transactions called the Unidad de Inversion (UDI) on April 1, 1995. Under the program, both new transactions and pre-existing loans can be denominated in UDIs.

The UDI is designed to be a constant value unit of account used to denominate credits. The value of the UDI is updated daily by the Banco de Mexico to reflect the behavior of the consumer price index. The value of credits denominated in UDIs remains constant in real terms with regard to both principal and interest so that the credits are protected against the accelerated amortization caused when high inflation eats away at the principal. Lenders are thus guaranteed a rate of return in excess of inflation while borrowers are shielded from interest rate volatility.

Under the program, the banks' loan portfolios are transferred to special purpose off balance sheet trusts, administered by the banks themselves, that restructure the loans and denominate them in UDIs. To carry out the restructuring, the trusts obtain loans from the government, also denominated in UDIs. In exchange for their loan portfolios, commercial banks receive long-term government bonds that pay interest only at maturity. Through the restructuring, commercial banks' peso-denominated liabilities are matched by assets in the same currency. The banks are required to keep the trusts adequately provisioned and to assume the credit risk of the loans in the UDI portfolio.

The government ends up with domestic currency-denominated liabilities (the bonds acquired by banks) and UDI-denominated assets (the loans to the trusts). Consequently, the government bears the risk that the interest rates charged on its UDI loans will be lower than the real interest rates it pays on the aforementioned bonds, while the commercial banks bear the credit risk.

Unfortunately, the complexity of the UDI program led to problems with its implementation. Both bank officials and borrowers had great difficulty understanding the economic effects of the new unit of account. Since banks were initially slow to make full use of the UDI program, the government was forced to intervene to facilitate the restructuring of a large number of viable loans and encourage their redenomination in UDIs. Although the program was a disappointment initially, borrowers and banks in non-mort-

140. During periods of high inflation, the value of a loan's principal remains constant in nominal terms but not real terms. In fact, inflation causes the real value of the principal to continuously deteriorate. Generally, the creditor charges a high rate of interest to compensate for the erosion of real value of the principal. Thus, except when highly negative real interest rates prevail (e.g., when the inflation rate is higher than the interest rate), the real amortization will be paid by debtors through interest payments. These higher interest payments, in turn, reduce the likelihood that a bank's loan portfolio will continue to perform. See Mancera, supra note 22, at 234; see also Karaoglan & Lubrano, supra note 20, at 41.


142. The UDI program further eases debt burdens by extending loan maturities. Participants are granted a variety of grace periods and terms permitting maturities of up to 12 years. See Ayer, supra note 18, at 12.

143. See Mancera, supra note 22, at 235.

144. Id.

145. The response, however, to the program from the mortgage lenders and borrowers was overwhelming. Mortgage borrowers generally had a greater understanding of the UDI program due to their previous experience with indexed instruments in connection with mortgage loans.
gage lending areas eventually caught on to the program's benefits. By the end of 1996, approximately $NP 167 billion of the loan portfolio had been restructured in UDIs to the benefit of approximately 375,000 debtors.146

2. Debtor Relief Program (ADE).

After the initial shock of the first few months of the crisis had passed, and once interest rate volatility began to subside, the government turned its attention toward relieving the debt burden of consumers created by high interest rates and the substantial decrease in economic activity. The government and the banks were equally anxious to encourage enterprises and consumers to reach agreement with lenders and return to servicing non-performing loans.147

In August 1995, the Mexican Government introduced the Agreement of Immediate Support of Bank Debtors (Acuerdo de Apoyo Inmediato a Deudores de la Banca or ADE) targeted at consumer, credit card, small business, agricultural, and mortgage loan debtors.148 The ADE was intended to assist debtors in remaining current on their loans, thereby reducing the systemic risk to the banking system stemming from widespread default. Within this framework, the government shared losses with banks, seeking to minimize fiscal costs and distribute them over time, while preventing further distortions in credit markets.149

Borrowers wishing to be eligible for the program were required to sign a letter of intent by October 31, 1995, to renegotiate their debts with creditors. The signing of the letter of intent obligated the lending bank to refrain from instituting legal proceedings against delinquent debtors until January 31, 1996, and to waive all accrued penalty interest.150 Interest rates payable by the borrower were capped for the year of the program's duration (September 1, 1995 to September 1, 1996) at 38.5 percent for credit card balances, thirty-four percent for consumer loans and twenty-five percent for commercial loans.151 The pro-

146. Market volatility during October and November 1995 required authorities to extend the UDI program in an effort to reduce the negative impact of interest rates on banks' fourth quarter results. The limit on the size of foreign currency loans available for restructuring was raised to $2 billion and the deadline for the commercial loan UDI restructuring program was extended. Additionally, authorities increased funding for the UDI mortgage program by 12,000 UDIs, which represents a 28.6% increase over the original amount. See Fluckiger, supra note 28, at 81; see also Mancera, supra note 22, at 235.

147. See Karaoglan & Lubrano, supra note 20, at 42.

148. The program was intended to preempt more extreme measures being promoted by certain borrower pressure groups and to foster responsible payment practices by providing viable borrowers with interest relief and a legal truce. Id.; see also The Mexican Economy 1996, supra note 64, IV(2)(c)(vii).

149. Importantly, the program has entailed no monetary expansion since the subsidy provided by the ADE program was financed through the issuance of bonds to the commercial banks rather than through the lending of funds. Furthermore, the ADE program has helped to improve the quality of commercial banks' loan portfolios, and has induced payment discipline and reductions in required provisions. See Karaoglan & Lubrano, supra note 20, at 42. See also Mancera, supra note 22, at 236.

150. See Fluckiger, supra note 28, at 81.

151. Mortgage loans restructured into UDIs were capped at UDI + 6.5%. See Karaoglan & Lubrano, supra note 20, at 42.
gram was intended to bridge the gap between what borrowers were willing to pay and what lenders were willing to accept.152

Participation in the ADE program was extensive. The program enabled seventy-five percent of borrowers from Mexican banks to completely refinance their debts.153 The cost of the interest rate subsidy was split evenly between the banks and the government and was much lower than had been initially anticipated.154

3. Other Debtor Programs.

Although the UDI and ADE programs helped tremendously by providing liquidity to banks and preventing a wave of defaults by borrowers, further assistance was necessary. To provide extra assistance in certain critical areas, the Mexican Government implemented a number of additional support programs.

Because existing bankruptcy laws and procedures were inadequate to enable a “work out” between insolvent shareholders and their creditors, the Mexican Government established the Coordinating Unit for Bank-Enterprise Agreements (Unidad Coordinadora para Creditos Corporativos or UCABE) in December 1995 to lay the foundation for the financial restructuring of large corporate debtors.155 Although the banks’ largest debtors (with loans totaling between $150 to $500 million) accounted for only eight to ten percent of total bank lending, the program nevertheless had a positive impact on reducing the overall debt burden.156 By year-end 1996, thirty-one loans were restructured by UCABE, for a total of $2.57 billion. Additionally, seven large firms resolved their payment-suspension situations with the help of UCABE.

The government launched a mortgage subsidy program (Programa de Beneficios Adicionales a los Deudores de Creditos para Vivienda) to ease mortgage borrowers’ heavy burden stemming from high interest rates and reduced purchasing power. As a result of the recession, property values fell, in many cases below the remaining balance on the mortgage loans. Under such circumstances, mortgage debtors lost the incentive to remain current on their payments. Defaults occurred even with mortgage loans restructured under the UDI program.

The program contains several key components designed to encourage mortgage debtors to avoid default. First, a thirty percent discount was made available on payments due in 1996, which will gradually decline to five percent in 2005 and applies only to the first 500,000 UDIs of the total loan.157 Second, the amount available to restructure mortgages in UDIs was increased by 43,000 million UDIs, to a total of 100,000 million UDIs.

152. The government planned to absorb up to 16 percentage points on the difference between the concessional interest rate, which varied depending upon the class of debtor and type of loan, and the market reference rate. If such limit had been surpassed, commercial banks would have borne half of the additional cost. Id. See also Mancera, supra note 22, at 237.

153. See Ayer, supra note 18, at 13.

154. The government reimbursed the full amount of the ADE subsidy, in cash rather than bonds, from November 1995 to January 1996 to alleviate liquidity and interest margin pressures stemming from market volatility.

155. See Ayer, supra note 18, at 13.

156. Id.

(about $22.3 billion as of mid-January 1997). Third, a scheme of minimum payments equivalent to rent was introduced to help mortgage debtors that, notwithstanding the benefit of the discount, were unable to service their loans.

The agricultural sector was particularly affected by the economic crisis. In July 1996, the government introduced the Agricultural, Livestock, and Fisheries Loan Support Program (Acuerdo para el Financiamiento del Sector Agropecuario y Pesquero or FINAPE), a loan restructuring mechanism designed to provide debt relief to Mexican farmers, fishermen, and ranchers. The mechanism provided discounts of up to forty percent, depending on the amount of the outstanding loan and the lending banks' willingness to forgive part of the loan. As with other support programs, the cost of the discounts were shared between the government and banks. But since the program also sought to promote flows of new financial capital to the agricultural sector, the cost borne by the government depended on the amount of new resources that banks injected into the sector.

Small and medium-sized firms also encountered difficulty in coping with the economic crisis. In August 1996, the government launched the Support Program for Small and Medium Sized Firms (Acuerdo de Apoyo Financiero y Fomento a la Micro, Pequeña y Mediana Empresa or FOPYME) to help alleviate the heavy financial burden faced by smaller, but viable, firms and to help them finance their current activities. Discounts under the program ranged from seventeen to thirty percent depending on the amount of the outstanding loan. To be eligible, loans were required to be under $NP 6 million and to have been contracted as of July 31, 1996. Banks promoted economic activity under the program by providing up to $NP 13 billion in new financing to creditworthy firms. Banks are committed to maintaining these lines of credit in real terms for at least three years.

II. Long-term Structural Reforms.

A. Relaxation of Foreign Investment Limitations Under NAFTA.

Under the 1993 amendments to the Law of Credit Institutions, foreign-controlled commercial banks were subjected to individual and aggregate market share limitations. No single foreign-controlled bank could represent more than 1.5 percent of the capital of the Mexican banking system and all foreign banks taken together were limited to eight percent of the market. NAFTA provided for gradual increases in the aggregate market share limitation until its elimination in the year 2000.

In an effort to encourage more capital investment into the financial system, the Mexican Government amended its financial sector legislation in February 1995 to permit

158. See Mancera, supra note 22, at 237.
159. Under this scheme, the debtor transfers title to the property as full payment of the loan but retains the right to repurchase it for up to 6 years. The government bears the cost of the discount by paying the banks in either cash or 5 year credits bearing an interest rate equal to that on 91-day cetes treasury bills. Id.
160. Id.
161. Id. at 238.
foreign individuals and foreign companies as a group to hold up to forty-nine percent of
the voting shares of a Mexican-controlled financial holding company, commercial bank, or
brokerage house.\(^{164}\) Under prior law, the limit on foreign holdings of shares of Mexican-
controlled commercial banks had been thirty percent.\(^{165}\)

Just as importantly, the financial sector legislation was amended to allow the Ministry
of Finance to waive the limits on market share in NAFTA on a case by case basis in certain
circumstances.\(^{166}\) To encourage well-capitalized foreign financial institutions to merge
with or take over existing Mexican banks, the amendments allowed foreign financial insti-
tutions to buy a controlling stake in existing Mexican commercial banks as long as the
resulting foreign-controlled bank had no more than 6% market share.\(^{167}\) The amend-
ments also raised the aggregate market share ceiling by restricting foreign-controlled banks
to twenty-five percent of the aggregate capital in the banking system. The new limits were
designed to allow mergers or takeovers of smaller institutions while placing the three
largest Mexican banks, Banamex, Bancomer, and Serfin, off limits.\(^{168}\)

B. BANK CONSOLIDATION AND RECAPITALIZATION.

1. Interventions and Restructuring.

In February 1995, the Law of Credit Institutions and the Law of Financial Groups
were amended to encourage the intervention and resolution of severely undercapitalized
banks. The amendments to the Law of Financial Groups provided that FOBAPROA could
give "preventative support" to the financial holding company to be channeled to its bank
subsidiary.\(^{169}\) Collateral for the support was provided by pledging the capital stock of the
financial holding company to FOBAPROA, giving it control over the bank in the event of
the bank's insolvency.\(^{170}\) The granting of such pledges conveyed to FOBAPROA the
authority to automatically exercise all corporate and ownership rights over the pledged
shares (including voting rights) without needing to execute the pledge. Through the exer-
cise of corporate and ownership rights, FOBAPROA could ensure that existing sharehold-
ers be made to share in the losses incurred by the financial institution.

In 1995, six financial institutions required intervention by the CNBV or required sup-
port through FOBAPROA: Banpais, Banco Obrero, Banco de Oriente, Banco del Centro,

\(^{164}\) Brokerage houses are not subject to market share limitations. See Karaoglan & Lubrano, supra
note 20, at 36.

\(^{165}\) Id.

\(^{166}\) Relaxation of the previous 1.5% individual market share limitation was crucial to permitting the
recapitalization of Probursa by Spain's Banco Bilbao Vizcaya. Id. at 36-37.

\(^{167}\) See Ayer, supra note 18, at 12; see also Mancera, supra note 22, at 235.

\(^{168}\) The 6% limit and the 25% aggregate cap on foreign-controlled banks were added to the amend-
ing legislation during Congressional consideration on the grounds that permitting foreign con-
tral of any of Mexico's three largest banks might compromise the domestic payments system. See
Mike Lubrano, Mexico Amends Financial Sector Legislation to Attract Greater Investment and

\(^{169}\) See Karaoglan & Lubrano, supra note 20, at 36-37.

\(^{170}\) Pledged shares must be valued at 75% of book value for purposes of calculating the number of
shares required as collateral for the preventative support provided by FOBAPROA. Id. at 37.
Banco Interestatal, and Banco Inverlat.\footnote{171} Furthermore, Banco Union and Banca Cremi, which had been the targets of intervention in 1994, received additional credit in February 1995 from FOBAPROA.\footnote{172}

In order to contain the costs to the government, the restructuring plan entailed an incentive framework designed to foster a favorable environment for private investors to recapitalize the banks through takeovers and mergers. In cases where mergers were not practical, the government simply liquidated the banks' assets.

2. Mergers/Acquisitions.

Since the outbreak of the crisis, the Mexican banking system has witnessed significant consolidation through a succession of financial mergers and acquisitions. For example, Spain's Banco Bilbao Vizcaya took over Mercantile Probursa in May 1995, as well as two other banks, Cremi and Banco de Oriente, in 1995 and 1996.\footnote{173} Additionally, Canada's Bank of Nova Scotia bought a controlling interest in Mexico's Banco Inverlat in 1995, while the Bank of Montreal bought a sixteen percent stake in Mexico's Bancomer in 1996.\footnote{174}

In October 1996, Spain's Banco Santander announced its intentions to acquire a seventy-five percent interest in Grupo Financiero Invermexico, which owned the fifth largest bank in Mexico, Banco Mexicano.\footnote{175} It marked the sixth purchase of a Mexican bank by a foreign investor since the crisis began.

More recently, in January 1998, London-based HSBC Holdings PLC agreed to purchase 19.9 percent of Banca Serfin as part of a recapitalization program.\footnote{176} In the same month, Banco Industrial signed an initial agreement with Far East National Bank, the U.S. subsidiary of Taiwanese financial group SinoPac, to sell a fifty-one percent stake. Finally, in May 1998, Mexican authorities formally agreed to allow Citibank de Mexico to purchase a majority stake in Confia Bank.\footnote{177} As a result of the consolidation of the banking system, the number of national commercial banks has dwindled from eighteen banks prior to the

\begin{itemize}
\item \footnote{171} See The Mexican Economy 1996, supra note 64, IV(2)(c)(v).
\item \footnote{172} As a result of the intervention, the existing shareholders of the two banks were eliminated as owners and replaced by FOBAPROA itself to dispose of the institutions as it saw fit. During the same period, the CNBV ordered an immediate management intervention of Grupo Financiero Banpais-Asemex after inspections revealed sharply increased past-due loans, a shortage of capital and irregular related-party transactions. However, the ownership of the bank remained under the control of the shareholders. Unfortunately, the disposal of banks and the restructuring of individual institutions has proceeded more slowly than desired, in part because of a shortage of capital from "fit and proper" sources. See Karaoglan & Lubrano, supra note 20, at 37; see also Ayer, supra note 18, at 9.
\item \footnote{174} See id.
\item \footnote{175} The transaction injected $425 million in new capital into Banco Mexicano, which will also sell about $2.36 billion in overdue loans to FOBAPROA. See Department of the Treasury, Monthly Report by the Secretary of the Treasury Pursuant to the Mexican Debt Disclosure Act of 1995, (last modified Nov. 20, 1996) <http://www.ustreas.gov/mexico/mex9610.html>.
\item \footnote{177} See Citibank Mexico Unit Buys Confia Bank, REUTERS NEWS SERVICE, (May 11, 1998).
\end{itemize}
devaluation to the present nine banks. And, of the remaining national commercial banks, only Banamex, Banorte, and Bancrecer remain 100 percent Mexican-owned.

Buyouts from well-capitalized foreign institutions such as these, provide a partial solution to the problems of low capitalization and bad loans that plagued Mexican banks since the crisis began. Bank mergers generally increase efficiencies and economies of scale, provide the banks with a larger core of savings, and provide banks a larger branch network in which to operate.

3. Loan Sale/Capitalization Program.

Although measures to provide temporary liquidity and capitalization to troubled banks helped avoid bank failures in the short-term, it was evident that long-term measures for bank restructuring and recapitalization were necessary in order to assure the prolonged soundness of the Mexican banking system. Thus, authorities have begun focusing their efforts on attracting fresh capital to the banking system.

An agreement between the Mexican Government and Banco Bilbao Vizcaya (BBV) for the recapitalization of Probursa provided an informal model for an ad hoc program to restructure and recapitalize other vulnerable Mexican banks. BBV agreed to increase its 20% stake in Grupo Financiero Probursa to seventy percent, with an aggregate investment of $350 million. In exchange for the new capital, FOBAPROA agreed to purchase approximately $780 million of Probursa's troubled loans, essentially cleansing the bank's balance sheet. FOBAPROA purchased the Probursa portfolio with ten-year bonds bearing interest at a rate equal to that on the twenty-eight-day cetes treasury notes. Pursuant to the agreement, Probursa is responsible for administering and collecting the loans on behalf of FOBAPROA.

In July 1995, a variation of the Probursa agreement was reached with Mexico's third largest bank, Banca Serfin, in which the bank's controlling Mexican shareholder group agreed to inject additional capital. Serfin was permitted to exit the PROCAPTE program by retiring the mandatory convertible subordinated debentures issued under that program and was able to increase its ratio of net capital to risk-weighted assets from ten percent at the end of March to eleven percent by the end of July. Several other banks,

179. According to CNBV statistics, at the end of June 1997, foreign capital represented 15.6% of the Mexican banking system. Id.
180. See Fluckiger, supra note 28, at 80.
181. Id. As a result of this agreement, Probursa's ratio of net capital to risk-weighted assets increased to 10.1% by the end of July 1995. See Karaoglan & Lubrano, supra note 20, at 40.
182. See Ayer, supra note 18, at 9.
183. FOBAPROA purchased loans from Serfin totaling more than NP$4.9 billion on the condition that Serfin's shareholders purchase N$1.24 billion in shares, N$930 million in convertible subordinated bonds, and N$600 million in non-convertible subordinated bonds. In addition to maintaining responsibility for the administration and collection of the loans, Serfin agreed to share 20% of any losses which the portfolio might have generated, thereby preserving its incentive to effectively manage the portfolio. See Karaoglan & Lubrano, supra note 20, at 40.
184. Id.
including Banco Atlantico,\textsuperscript{185} took advantage of the program as well.\textsuperscript{186}

Although each agreement was tailored to suit the particular needs of the banks, they all shared common characteristics. First, FOBAPROA purchased loans from the banks in return for a contribution of fresh capital by shareholders, generally at a 2:1 ratio. Second, loan loss provisions pertaining to the sold portfolio were negotiated between the banks and FOBAPROA. Third, banks continued to maintain responsibility for administering and collecting the loans sold. Fourth, banks retained between twenty to twenty-five percent of the risk on losses from the sold portfolio. Finally, loans were purchased with ten-year bonds paying the cetes rate for the amount of peso-denominated loans sold and the LIBOR rate for the amount of dollar-denominated loans sold, and all principal recovered from the sold portfolio was used to redeem the bonds.\textsuperscript{187}

4. \textit{Creation of the Asset Valuation and Sale Agency (VVA)}.

In March 1996, Mexico announced the creation of the Asset Valuation and Sale Agency (\textit{Valuacion y Venta de Activos} or VVA), an agency with functions similar to the U.S. Resolution Trust Corporation.\textsuperscript{188} It was charged with the duty of appraising and selling the assets that FOBAPROA acquired from the banks. The main objectives of the VVA were to: (1) maximize revenues from the sale of financial assets, real estate, and other property acquired by FOBAPROA; (2) sell assets through a transparent and open process as quickly as conditions permit; (3) design formulas to help restructure viable companies; and (4) promote the development of secondary markets for banks’ debt instruments and other financial and non-financial assets.\textsuperscript{189} Due to a shift in government strategy, however, the VVA was later dissolved. The responsibility for disposing of assets acquired from banks will now be shifted to the newly created Bank Savings Protection Institute.

C. \textbf{Establishment of Futures Markets}.

Derivatives and other financial innovations provide useful vehicles that enable investors to hedge several types of risks. The Banco de Mexico, realizing that futures markets are an efficient mechanism for managing and distributing risks and for determining prices and exchange rates, began actively facilitating their development.

In 1995, the Chicago Mercantile Exchange (CME) established a new division, the Growth and Emerging Markets Division, to provide risk management of emerging market currencies, equity, and interest rates, including those of Mexico. Today, in addition to currency forwards and options, the division offers products such as interest rate swaps and

\textsuperscript{185} Banco Atlantico agreed to sell 2 billion pesos to FOBAPROA in return for new capital injections from shareholders of 1 billion pesos. See Department of the Treasury, \textit{Monthly Report by the Secretary of the Treasury Pursuant to the Mexican Debt Disclosure Act of 1995}, (last modified Dec. 6, 1996) <http://www.ustreas.gov/mexico/mex9611.html>.

\textsuperscript{186} By the end of 1997, the banking sector had increased its capital by almost 158% over December 1994 levels. See \textit{The Mexican Economy 1997}, supra note 106, at III(2)(b)(ii).

\textsuperscript{187} See Karaoglan & Lubrano, supra note 20, at 40.


\textsuperscript{189} See \textit{The Mexican Economy 1997}, supra note 106, at III(2)(c)(i).
forward agreements, credit derivatives, and structured notes.¹⁹⁰

In November 1996, the CNBV inaugurated Mexico’s first futures market called the Mexican Derivatives and Futures Market (Mex-Der).¹⁹¹ The market offers products such as peso currency forwards and options, interest rate swaps, and IPC index contracts.¹⁹² The Ministry of Finance, Banco de Mexico, and CNBV are currently finalizing regulations to govern the new derivatives market.

A futures market provides an important mechanism for stabilizing over-the-counter markets; security is the primary benefit. According to Chris Campbell, director of Latin American Marketing at the CME, a futures exchange has never had a default.¹⁹³ Moreover, a futures exchange entices foreign investment because it provides a method to manage the types of risk which are common in emerging markets, namely currency risk and interest rate risk. Domestic futures markets also add a greater level of sophistication to an emerging market’s finance sector.

D. PENSION SYSTEM PRIVATIZATION.

Historically, Mexico has lacked strong internal financing and has continuously experienced a significant leakage of domestic savings to foreign investments. Indeed, the economy’s overall savings rate in 1994 fell to just sixteen percent of gross domestic product, which contributed to Mexico’s reliance on short-term foreign capital and to the subsequent financial crisis.¹⁹⁴

To rectify this situation, Mexico passed a new Social Security Act (Ley del Instituto Mexicano del Seguro Social) in late 1995 and the Retirement Savings Systems Act (Ley de los Sistemas de Ahorro para el Retiro) in April 1996 to privatize the nearly bankrupt government social security system.¹⁹⁵ All Mexican workers are required under the new laws to choose by the year 2001 which private pension fund administrator (called an AFORE) they wish to look after their pension contributions.¹⁹⁶

Regulations pursuant to the new law include a provision permitting U.S. and Canadian financial institutions to own equity in AFORES on a basis consistent with the


¹⁹¹. However, due to the amount of infrastructure required to set up a futures market, the Mex-Der did not become operational until 1998. See Mexico Derivatives Market Expected to Begin 1Q 1998, DOW JONES INT'L. NEWS SERV., Dec. 4, 1997 available in 1997 WL Dow Jones International News Service-Plus database.

¹⁹². Id.

¹⁹³. See Futures Market Picks Up Steam, SPECIAL REPORT, BUS. TIMES (Singapore), Mar. 1996.


¹⁹⁵. The government pension system, run by the notoriously inefficient IMSS, is already $6 billion in debt and is estimated to be completely bankrupt by 2006. Moreover, the previous pension system has been criticized as unfair because of the poor correlation between benefits and lifetime contributions. See Luis Cerda, The Mexican Pension Reform (visited Nov. 1, 1998) <http://www.shcp.gob.mx/english/docs/pension.html>.

¹⁹⁶. AFORES are financial institutions whose purpose is to professionally administer individual pension retirement accounts and to channel these funds into the corresponding sub-accounts in accordance with the social security laws, as well as to administer specialized retirement mutual funds, called “SEIFORES.” See The Mexican Economy 1997, supra note 106, at III(6)(a).
NAFTA and thus to participate fully in the management of the pension funds. Participation by other foreign institutions is limited to forty-nine percent of the AFORE capital. Additionally, no individual or corporation may control more than ten percent of the AFORE stock unless specifically authorized by the National Retirement Fund System Commission (CONSAR), the pension system regulatory agency.

The new system gives many Mexicans their first opportunity to participate in financial markets. Instead of having money taken out of their paychecks, employees will actively invest in their own retirement. Under the new system, workers' future pension benefits will be tied directly to their contributions, time spent working, and to their savings. Thus, at least in theory, a change of perception will be brought about by turning the worker into the sole owner of his contribution and of the capital that it generates. Currently, AFORES are restricted to investing in government and domestic corporate bonds within Mexico, but investment restrictions are expected to be liberalized within a year or two. Until then, the funds will be vulnerable to any major peso devaluations.

Pension privatization is being heralded as a cornerstone of President Ernesto Zedillo's efforts to deepen Mexico's financial markets, increase the domestic savings rate, and diminish reliance on foreign capital. As the pension system grows, the funds accumulated in individual accounts will broaden the opportunities for the development of the financial system and will significantly increase the supply of financial resources to the economy. This, in turn, will promote greater specialization of financial institutions as well as the creation of new financial instruments related to long-term investments. The long-term nature of retirement funds will facilitate channeling them to slow-yielding productive investments such as infrastructure projects.

While not the first pension system to be privatized in Latin America, Mexico's is by far the largest privatization and will draw the heaviest participation. Salomon Brothers estimates that the sector should control $24 billion of investments by the year 2000. Response to the program has been overwhelming, as more than eight million workers had already signed up for the program by mid-September 1997.


198. Additionally, in order to prevent any AFORE from obtaining a monopoly of the industry, no institutions may have a share of the market greater than 17% without authorization from CONSAR. See Cerda, supra note 195.


203. See Private Pension Funds, supra note 194.

204. Responsibility for the enormous response is due in part to an aggressive $135 million advertising campaign launched by owners of the AFORES hoping to acquire the largest share possible of the funds from the contributions equaling 8.5% of employees' gross wages. See Mexicans Rush to Switch Funds, supra note 199, at A1.
III. Regulatory and Supervisory Reforms.

A. Amended Loan Loss Reserve Requirements.

New guidelines were announced in March 1995 requiring Mexican banks to implement more stringent loan loss reserves. Under the guidelines, banks are required to maintain either reserves for non-performing loans of at least sixty percent of past due loans, or reserves equal to four percent of the total loan portfolio. Prior to the new guidelines, banks were required only to make quarterly provisions based on self-assessed risk rating categories. The new guidelines were prompted by the government's concern that the crisis, and its negative effect on the majority of Mexican borrowers, was preventing banks from properly provisioning for loans. As a result of the new guidelines, aggregate loan loss provisions increased substantially from N$ 24.5 billion at the end of 1994 to N$ 54.1 billion by the end of July 1995.

B. Stricter Bank Lending Standards.

Connected lending, insider dealing, and fraud were major contributors to the instability of the Mexican banking system before the crisis. To address these problems, the government instituted legislative reforms to prohibit self-lending or "autoprestamos," a practice in which a bank officer makes loans to himself or a corporation in which he has an equity interest. In the past, self-lending in Mexico was not considered an unethical practice, as long as bank officers complied with requirements to report all such loans to regulatory authorities. But with hundreds of millions in losses due to insider dealing at banks, savings and loans, and leasing firms, the Mexican Government reversed its former policy of giving bankers the benefit of the doubt regarding the legitimacy of their self-lending transactions.

C. Enhanced Supervision.

A number of steps have been taken to improve financial supervision. In May 1995, the Law of the National Banking and Securities Commission (Ley de la Comision Nacional Bancaria y de Valores or CNBV) went into effect. The key feature of the law is centralized supervision. The National Banking Commission and the Securities Commission were combined to form the CNBV and, importantly, the staff of the new commission was strengthened.

In 1997, the CNBV published an official agenda, entitled the Programa Institucional 1997-2000, which outlines four principle areas for improvement: (1) prudential regulation; 205. See Mexico's Financial Crisis, supra note 77, at 145.
206. See Karaoglan & Lubrano, supra note 20, at 38.
208. The reforms may cause significant problems for some Mexican industrial groups that bought into banks during the 1991-1992 privatization and do much of their lending to associated industrial groups. See id.
209. "Ley de la Comision Nacional Bancaria y de Valores," D.O., 1 de mayo de 1995 (Mex.).
(2) supervision; (3) market self-regulation; and (4) corrective actions.\textsuperscript{211} In order to address the new challenges presented by Mexico's transition to a universal banking system, the CNBV developed a consolidated “MACRO” supervision scheme to manage and coordinate on-site inspections and off-site monitoring of financial institutions and to assist in the evaluation of financial institutions' management of funds, capital adequacy, asset quality, profitability, and organization.\textsuperscript{212}

The MACRO scheme significantly changes the method of on-site inspections. Previously, inspectors were permanently stationed within the financial institution. The new scheme abolishes that practice in favor of using teams of inspectors stationed outside the financial institutions to carry out regular on-site inspections. On-site inspectors are responsible for monitoring the financial institutions' internal control systems for risk-management, paying particular attention to the institutions' operations, procedures, internal controls, management, and compliance with rules and regulations.\textsuperscript{213}

Off-site inspection has been strengthened through the development of the Financial Analysis System (SAF). The SAF is a computer database that electronically receives the financial information that institutions must provide to the CNBV, eliminating the need for physical delivery. The receipt of consistent and uniform financial information allows off-site inspectors to create individual, comparative, and sectoral analyses concerning the performance of financial institutions and thereby develop early warning mechanisms that make it possible to detect in a timely manner any atypical behavior, whether individual or systemic, that may pose risks to the financial position of an institution and to address those risks before they reach critical levels.\textsuperscript{214}

Additionally, the CNBV is considering a new system of internal and external audits to complement the supervision of financial institutions. Under the new system, external auditors must register with the CNBV and be evaluated regularly regarding their performance and opinions.\textsuperscript{215} External auditors will also be subject to sanctions for poor performance. Internal auditors must report directly to a financial institution's board of directors rather than the intermediate management of the institution. The CNBV will supervise internal auditors by examining the scope and regularity of audits, audit procedures, and the content of internal audit reports.\textsuperscript{216}

Lastly, to foster market confidence in Mexico's financial institutions, the Institutional Program calls for the public dissemination of quality financial information, in financial terms, so that markets may make their own evaluations regarding a Mexican institution's exposure to risk.

D. ADOPTION OF GAAP ACCOUNTING STANDARDS.

In an effort to improve the quality of information provided to markets by banks and to improve overall transparency of the financial system, the CNBV issued new regulations

\begin{itemize}
\item[212.] See id. at 15.
\item[213.] See id. at 16.
\item[214.] See id. at 18.
\item[215.] See id. at 20.
\item[216.] See id. at 19-20.
\end{itemize}
in December 1995 giving banks six months to implement accounting standards consistent
with the United States' generally accepted accounting principles (GAAP). By July 1996,
banks were required to report financial statements to the CNBV under both the old and
new principles. As of January 1, 1997, all financial statements must be reported under the
new standards exclusively.

Mexican institutions' financial statements prior to the adoption of GAAP differed con-
siderably from the United States' and other industrial nations'. The areas of divergence
included the valuation of fixed assets, the definition of non-performing assets, and the
treatment of interest income on loans. These and other differences in the accounting
practices between the two countries led to many complaints that the true nature of the
Mexican banks' asset quality during the months before the devaluation had been disguised.

Under the new accounting requirements, banks must include in their past-due loan
portfolios the total balances of delinquent loans, including past-due, due, and current bal-
ances. Once a loan has been classified as past-due, banks may not continue to apply
interest charges. Another important change under the new requirements is that practically
all securities portfolios will be valued at mark-to-market. The purpose of the new crite-
ron is to provide a clearer determination of the real value of financial institutions' invest-
ments and, consequently, of their equity.

Reporting financial statements using GAAP accounting standards makes it easier to
compare banks' accounts internationally and makes the accounts more credible in the eyes
of international money markets. Moreover, it is essential to proper credit analysis, the lack
of which contributed greatly to the loan defaults that have plagued banks since the crisis
began. The use of the new principles should also encourage market discipline to become
the basic means for maintaining a healthy financial system.

217. In an explanatory bulletin published at the end of 1995, CNBV President Eduardo Fernandez
outlined the reasons for the changes. "Considering the globalization of the financial markets and
the complexity which some Mexican banking operations have reached in the last years it's neces-
sary to reset the accounting standards, the valuation of assets and liabilities as well as the presen-
tation and publication of financial information of these institutions." See Switch to GAAP Seen To
Clarify Banks' Loan Losses, SPECIAL REPORT, BUS. TIMES (Singapore), Mar. 1996 [hereinafter
Switch to GAAP].

218. Specifically, using previous Mexican standards, only the missed payment of an installment loan is
classified as past due (after 30 days), while under U.S. GAAP, the loan itself is classified as past
due after 90 days. Additionally, in the United States, interest accrued on loans is discontinued
when it appears likely that the borrower will not be able to make payments. All unpaid interest
accrued is reversed. In Mexico, however, interest is allowed to continue to accrue on loans except
in cases where the entire balance of the underlying loan principal is past due. Unpaid interest
accrued does not have to be reversed. See Ayer, supra note 18, at 13; see also Fluckiger, supra note
28, at 79.

ed only the unpaid amortization of each loan. Thus, the transition to GAAP was particularly bur-
densome for many banks because it had the immediate effect of increasing the ratio of bad loans
to total loans in the banks' portfolios by approximately 24%. See Switch to GAAP, supra note 217.

220. Under a mark-to-market valuation, assets are valued at their current market price rather than
E. Participation in SDDS.

In March 1996, the Executive Board of the IMF approved an initiative to create the Special Data Dissemination Standard (SDDS). This standard seeks to improve the practices for the dissemination of information by countries participating in international capital markets.\(^2\) It was established by the IMF in response to lapses in the publication of economic and financial data prior to the Mexican crisis. Mexico accepted the IMF’s invitation to partake in this initiative and collaborate as a pilot country in the implementation of the first stage of the SDDS. In September 1996, Mexico and seventeen other countries inaugurated the Dissemination Standards Bulletin Board (DSBB).\(^2\)\(^2\)\(^2\)

The SDDS emphasizes four aspects: (1) the coverage, periodicity, and timeliness of data; (2) public access; (3) integrity of the data; and (4) the quality of data.\(^2\)\(^2\)\(^3\) The rationale behind the SDDS is that informed financial markets are likely to be less volatile, and that prompt, simultaneous release of government statistics, prepared according to adequate and harmonized standards, will be an antidote to runs by investors caused by leaks, rumors, and the decision to act on inside information before one’s competitor does.\(^2\)\(^2\)\(^4\)

F. Revised Capital Adequacy Valuations.

As of September 1996, banks are required to adjust their capital adequacy reports to reflect market risk (changes in share prices, interest rates, exchange rates, and inflation) as well as credit risk.\(^2\)\(^2\)\(^5\) This change will move Mexico closer to international regulatory standards, increasing transparency in the system.

G. Encouragement of Credit Bureau System.

In February 1995, the Mexican Government enacted new regulations designed to encourage the creation of credit bureaus covering areas such as credit card obligations, auto financing, and mortgages. Prior to the new regulations, only one credit bureau exist-

\(^{221}\) See id. III(8).

\(^{222}\) The group of subscribing countries included industrialized nations (the United States, the United Kingdom, Japan, Germany, Italy, France, and Holland), countries “in transition” (Croatia, Lithuania, Hungary, and the Slovak Republic), and “emerging” economies (Chile, Argentina, the Philippines, Singapore, Peru, Thailand, and Mexico). See id., n.33. By April 1997, more than 40 countries had subscribed to the SDDS. See id. Every subscribing country must post the main characteristics of each of 20 selected variables on the DSBB, including the methodology for computing the data, the procedures for publishing the information, the publishing institution, and the individual responsible for answering any question posed by users. See id. III(8). Moreover, the bulletin board must also include a schedule for the release of information indicating the dates on which the data will be published in the four subsequent months. See id.

\(^{223}\) In order to increase the public’s trust in the statistics published on the DSBB, equal access must be guaranteed to all users, and the clarity and objectivity of the information must be ensured. Basic statistical information must be published in the real, fiscal, financial, and external sectors. See id.


ed. This credit bureau, owned by a group of the largest Mexican banks, operated only on behalf of its owners, as banks historically have been unwilling to share credit information between each other. The lack of a common credit database made it extremely difficult for Mexican banks to access the information necessary to value new loans or to determine a potential borrower’s creditworthiness. The new regulations outline the procedures for collecting and disseminating consumer credit information as well as the procedures for applying to the Finance Ministry for operating licenses.


The Mexican Government is in the process of implementing significant structural changes to the financial regulatory agencies. On March 26, 1998, the President of Mexico presented to Congress a reform package, which included measures to grant the Banco de Mexico independence on exchange rate decisions, eliminate current limits on foreign ownership of domestic banks, simplify the shareholder structure of financial groups, create a limited deposit insurance system, transform the CNBV into a semi-autonomous agency, and convert all of FOBAPROA’s holdings into public debt.

The proposal to modify the shareholder structure of the controlling entities of financial groups, banks, and brokerage houses entails the issuance of a new, single series of O shares to be freely subscribed, thus allowing a broader participation in the institutions by foreign corporate entities and individuals. The legislation also called for the elimination of the current limitation that restricts foreign-controlled banks from acquiring a controlling interest in a bank whose net capital exceeds six percent of the aggregate capital in the banking system. The elimination of this restriction will make it possible for foreign institutions to acquire controlling interests in Mexico’s three largest banks.

Perhaps the most important initiative in the new legislation is the proposal to transform the CNBV into a semi-autonomous entity with increased regulatory and supervisory powers. Under the proposal, the CNBV will become dependent on the Banco de Mexico rather than the Ministry of Finance. Since the Banco de Mexico is an autonomous entity, the CNBV would gain similar autonomy. This reform would dramatically redistribute financial system supervisory powers from the Ministry of Finance to the Banco de Mexico. The Ministry of Finance will continue to exercise some influence over the CNBV, however, since one of six seats on the proposed Governing Board of the CNBV will be filled by the Secretary of Finance.

Another significant initiative under the new legislation is the creation of a deposit guarantee fund (FOGADE), which would provide deposit insurance of up to 500,000

226. "Decreto que Reforma la Ley del Banco de Mexico," 26 de marzo de 1998 (Mex.).
228. "CNBV Boletin de Prensa," 24 de marzo de 1998 (Mex.). Under the current structure, voting shares of commercial banks and brokerage firms are represented by Series “A” shares representing at least 51% of the capital stock and Series “B” shares representing the remainder. The ownership of Series “A” shares is reserved for Mexican individuals and companies that are majority owned and controlled by Mexicans. Both Mexican and foreign individuals and corporations may invest in Series “B” shares.
UDIs per person in each bank. The new deposit guarantee system would replace the current 100 percent implicit guarantee on deposits from FOBAPROA. Deposit protection would be gradually reduced so that the guarantee system would be in full force no later than 2008. By limiting guarantees on deposits, the government hopes to strengthen the financial system by reducing the moral hazard that may result from full deposit protection.

Moody's Investor Service, a credit rating agency, voiced its support for the legislation in a special comment, which stated that "the progress made by Mexican authorities during the past three years in terms of the quality of official oversight, if reinforced with energetic and rigorous implementation of the proposed March 1998 reforms, will move the industry toward a stable and more efficient banking system."229 The agency added that without the reforms, the Mexican banking system could continue to suffer periodic meltdowns.230

The most controversial measure of the legislation proved to be the proposal to eliminate FOBAPROA and to convert its assets into public debt in the form of government bonds.231 The proposal hit an immediate roadblock in the rebellious lower house of Congress which has been controlled by the combined opposition parties since 1997. Opposition leaders strongly criticized the proposal, accusing the government of seeking to force the common taxpayer to pay the price for lax banking supervision and the corrupt practices of bankers and wealthy businessmen. Opponents of the proposal also questioned whether the increase in public debt would hurt economic growth and hamper any efforts to boost the purchasing power of the peso, ease unemployment and underemployment, and reduce poverty.232 A tumultuous debate and political stalemate continued in the lower house for several months. During this period, the level of bad bank loans rose from approximately 552 billion pesos ($55 billion) on February 28, 1998 to over 640 billion pesos ($64 billion) by late November.233 Outraged leaders from both the pro-business National Action Party (PAN) and the leftist Democratic Revolutionary Party (PRD) called for the resignation of former Minister of Finance Guillermo Ortiz for his role in the FOBAPROA bank bailout.

Finally, Congress approved a compromise plan on December 12, 1998 which calls for the creation of a new Bank Savings Protection Institute to replace FOBAPROA.234 Under

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230. Moody's has long identified the issue of "moral hazard" that occurs when the government bailouts become conducive to excessive risk exposure. Measures that would burden even large depositors with bank risk will go far in addressing this problem. Moody's describes the new reform proposals as "the culmination of an almost four-year-long journey to reduce moral hazard through structural changes." See id.

231. FOBAPROA has been unable to dispose of much of the debt acquired from troubled banks and currently has $65 billion in non-performing assets, primarily in real estate and bad loans. Officials estimate that the government could recover approximately $24.5 billion from the sale of the bonds. See Mexico's Werner optimistic on financial reform, REUTERS NEWS SERV., May 15, 1998.


the compromise plan, FOBA\textsc{proa}'s liabilities will not be immediately assumed as public debt. Instead, the liabilities will be financed each year as a separate category in the federal budget. In addition, the plan calls for a team of auditors hired by Congress to perform detailed audits of the liabilities in early 1999 to determine which loans are tainted with fraud or other improprieties.\textsuperscript{235} Those loans that are found to be tainted by fraud will be returned to the banks that originally issued them.

\textbf{PART THREE}

\textbf{ASSESSMENT OF MEXICO'S REFORMS}

\textbf{I. Successes.}

In many respects, the support programs and legal reforms adopted by the Mexican Government conform to what are generally considered to be "best practices" for dealing with bank crises.\textsuperscript{236} In particular, Mexican authorities responded quickly in arranging the support and liquidity packages to stem the massive outflow of capital. Furthermore, regulators were able to successfully constrain the growth of impaired institutions without resorting to inflationary financing to resolve banks.

Additionally, Mexico has made significant progress in the areas identified by a special Working Party formed by the Group of Ten\textsuperscript{237} as "key indicators" of a robust financial system.\textsuperscript{238} For example, Mexico has considerably improved its accounting practices and disclosure techniques. The switch to GAAP was a particularly meaningful achievement as it will now enable markets to see a more realistic picture of the financial condition of Mexican banks. Participation in the SDDS program is also important because it gives markets the ability to monitor on a daily basis the condition of the Mexican financial system on an aggregate level, as well as monitor the activities of the Mexican financial regulatory authorities. One of the chief criticisms expressed by the markets after the crisis began was

\begin{itemize}
  \item \textsuperscript{235} \textit{Id.}
  \item \textsuperscript{236} For an in-depth discussion of "best practices" for dealing with bank crises, see Liliana Rojas-Suarez \& Steven R. Weisbrod, \textit{The Do's and Don'ts of Banking Crisis Management}, \textit{Banking Crises in Latin America} 121 (Ricardo Hausmann \& Liliana Rojas Suarez, eds., 1996).
  \item \textsuperscript{237} The Working Party was made up of representatives from the Group of Ten countries and of emerging market economies, including Mexico. In the course of the work, the working party consulted officials from the Basle Committee, the IMF, IOSCO, the World Bank, and other international organizations with expertise in financial matters.
  \item \textsuperscript{238} The key elements of a robust financial system outlined by the G-10 Working Party are: (1) a sound and well-developed legal and juridical framework; (2) comprehensive and well-defined accounting practices and disclosure techniques; (3) improved stakeholder oversight and institutional governance; (4) a market structure that favors free competition and promotes the efficient use of resources and the maximization of returns; (5) a financial regulatory and supervisory system designed to support and enhance market functioning, rather than displace it, by promoting the integrity of the market infrastructure and fostering the efficient operation of the financial system; and (6) a financial safety net designed to minimize moral hazard. \textit{See Group of Ten, supra} note 6, at 74-76.
\end{itemize}
that the Banco de Mexico's practice of providing information only on a quarterly basis disguised the true nature of its dwindling foreign reserves between quarterly reports.

Mexico has also made progress in creating a market structure that favors free competition and promotes the efficient use of resources. The relaxation of the limits on foreign ownership of Mexican financial institutions has heightened competition by reducing barriers to market entry. Moreover, foreign bank owners from developed financial systems have promoted the use of advanced and efficient market practices by their Mexican affiliates and this has had a positive effect on the Mexican financial system as a whole.

In addition to promoting disclosure and free competition, Mexico has made improvements in stakeholder oversight and institutional governance and has taken measures to strengthen its regulatory and supervisory system by giving it increased independence and authority to impose penalties on wrongdoers.

A. Positive Developments.

Several important developments since the first quarter of 1995 provide convincing evidence that Mexico's financial system has emerged from the crisis and is now beginning the process of transformation into a robust financial system. A particularly noteworthy development was that Mexico regained access to international capital markets in the second quarter of 1995, only five months after the December 1994 devaluation. This was in sharp contrast to the aftermath of the 1982 crisis, when Mexico needed almost seven years in order to tap capital markets again.239

According to a report by the Ministry of Finance, growth dynamics during 1997 confirmed that the economic recovery had been consolidated.240 Moreover, real GDP grew seven percent in 1997, the strongest performance since 1981.241 The report gave a very favorable outlook for 1998, predicting GDP growth at five percent in real terms, a current account deficit completely financed by foreign direct investment, and a continued commitment by the government to sound public finances.242

Financial and foreign exchange markets have been substantially more stable since 1995. Annual inflation maintained a clear downward trend, from 51.9 percent in 1995 to 27.7 percent in 1996, and then to 15.7 percent in 1997.243 The reduction in inflationary pressures

239. See The Mexican Economy 1996, supra note 64, Part I.
241. Furthermore, in contrast to 1981, last year's economic expansion was accompanied by a significant decrease in inflation and higher domestic savings. Significantly, domestic demand (consumption and investment) was featured as the main engine of economic activity. See Jose Angel Gurria Trevino, Address at the Economic Club of New York (visited Mar. 11, 1998) <http://www.shcp.gob.mx/english/docs/pr980312.html>.
242. See Mexico Quarterly Report, supra note 240. However, Mexico's economy is beginning to feel the negative effects from the current financial crisis in Asia. As a result, recent estimates of GDP growth for 1998 have been adjusted downward to 4.2%. See Mexico's Canacintra Revises down 1998 GDP estimate, REUTERS NEWS SERV., July 1, 1998.
since March 1995 has induced a downward trend in interest rates, which has been interrupt-
ed only by temporary setbacks. Whereas in mid-March 1995 the interbank twenty-eight-day
interest rate was 110 percent, a year later it had declined to forty-six percent, and at year-end
1997 it closed at 20.4 percent.\textsuperscript{244} Real interest rates (adjusted for inflation) moved in the
same direction. For example, in 1995, the average interbank twenty-eight-day rate was 11.6
percent, whereas in 1996 it declined to 9.4 percent, both in real terms.\textsuperscript{245}

The volatility of the peso-dollar exchange rate has been considerably reduced since
1995. In fact, based on a sample taken in 1996 of twelve major currencies under floatation
regimes vis-à-vis the U.S. dollar, the Mexican peso exchange rate was the second-least
volatile.\textsuperscript{246} Moreover, Banco de Mexico's international reserves have risen considerably
since the peso devaluation, reaching the level of $30.14 billion as of December 31, 1998,
slightly higher than the pre-crisis peak of $29.2 billion in February 1994.\textsuperscript{247}

Mexico has demonstrated its creditworthiness by repaying the funds lent to it by the
United States and the IMF in 1995 ahead of schedule. On January 17, 1997, Mexico pre-
paid the remaining outstanding balance of $3.5 billion owed to the United States under the
Financial Assistance Package granted to Mexico at the onset of the financial crisis.\textsuperscript{248} The
repayment ahead of schedule also saved the Mexican Government a significant amount of
money in interest.

Not only has Mexico paid off its external debt, it has made a meaningful reduction in
the debt incurred from the various financial support programs implemented since the cri-
sis began. By year-end 1997, nearly one-fifth of the cost of the financial support programs
(71.3 billion pesos in net present value) had already been covered.\textsuperscript{249}

Finally, the international financial community appears to have given the Banco de
Mexico its seal of approval.\textsuperscript{250} In its reunion of September 9, 1996, the Board of Governors
of the Bank for International Settlements (BIS)\textsuperscript{251} invited the Banco de Mexico and eight
other central banks to become BIS members. The selection of the new members was based

\textsuperscript{244.} See Mexico: January 1998, supra note 243.

\textsuperscript{245.} See The Mexican Economy 1997, supra note 106, at I(1).

\textsuperscript{246.} See id.

\textsuperscript{247.} See Banco de Mexico Net Assets Rise, Reserves Fall, Reuters News Serv., June 30, 1998.

\textsuperscript{248.} The original support committed by the U.S. Government totaled $20 billion. At its peak in July
1995, Mexico's outstanding balance owed to the United States reached $12.5 billion. By January
1996, however, Mexico had already repaid $2 billion of short-term liabilities, and in August 1996,
Mexico made an early payment of another $7 billion, leaving $3.5 billion remaining. See The


\textsuperscript{250.} S&P, an international financial credit rating agency, recently revised its outlook on Mexico from
"stable" to "positive," reflecting its favorable view of the unprecedented political liberalization, the
sustained economic expansion, the strengthening of balance-of-payment fundamentals, and the
recuperation of the banking system. See S&P Affirms Outlook on Mexico's Currency, Mexico Bus.

\textsuperscript{251.} The BIS is the world's oldest international financial institution. It is the only central banking
institutions at the international level that is owned and controlled by central banks. The BIS
carries out a number of highly specialized services for central banks, provides a forum for interna-
tional monetary cooperation, and functions as a center for monetary and economic research. The
Mexican Economy 1997, supra note 106, III(7).
on selective economic and financial criteria, as well as contributions to global economic and financial cooperation. The invitation extended to the Banco de Mexico recognizes Mexico’s economic and financial significance, the role the Banco de Mexico has played in promoting cooperation among central banks around the world, and the Banco de Mexico’s active participation in the BIS.

II. Remaining Deficiencies and Areas for Improvement.

Although developments since the first quarter of 1995 have been mostly positive, Mexico’s financial system still suffers from inadequacy in several areas. Until these inadequacies are addressed, the financial system will remain vulnerable to major economic shocks such as the December 1994 peso devaluation. In fact, some financial advisors continue to urge investors to use caution when considering investments in Mexico.252

One conspicuous deficiency in Mexico’s financial system is that it provides numerous incentives for moral hazard. The incentives for moral hazard are due, in part, to the way in which the intervention and recapitalization of troubled banks was carried out. First, the regulatory authorities failed to compel managers and shareholders to share enough of the losses. Moreover, instead of a single bailout, there were multiple bailouts. As a result, bank managers and shareholders may now be more inclined to incur excessive risk on the assumption that the government will consent to similar bailouts in the future.

Other aspects of the response to the crisis could induce moral hazard as well. For instance, the general extension of debtor aid programs, such as ADE, FINAPE, and FOPYME, could encourage some debtors, who would otherwise be willing and able to repay their debts, to refuse to pay their debt obligations until they receive such government assistance.

Another source of moral hazard arises from the lack of a proper Mexican deposit insurance system and from the government’s implicit 100 percent deposit coverage. Since the beginning of the crisis, the government has indicated that it will fully guarantee commercial banks’ obligations with the exception of subordinated debt, an implicit guarantee of all of the banks’ deposits.253 Such a sweeping implicit deposit guarantee scheme reduces bank managers’ and directors’ incentives to assure the efficient operation of the financial institution and to avoid excessive risk-taking. The recently enacted financial reform legislation, which will gradually impose limits on deposit insurance, is a considerable first step in addressing this source of moral hazard.

Mexico continues to suffer from a weak and inadequate bankruptcy system. An ideal robust financial system possesses a sound and well-developed legal and juridical framework, including a developed bankruptcy system. Well-defined bankruptcy laws make it possible to take possession of collateral, as well as to pursue other legal recourse, without undue delay. The bankruptcy laws in effect in 1995 (and still in effect today) were so cum-

252. As recently as May of 1998, Moody’s Investors Service cautioned that the Mexican banking system still suffers from extremely weak financial fundamentals. For example, Mexico has the lowest average bank financial strength rating (E+) of any major country in Latin America. Moreover, although it is not reflected on banks’ balance sheets, banks are still liable for contingent losses on approximately 25% of loans sold to FOBAPROA, which creates a significant exposure to credit risk. See Moody’s, supra note 229.

253. See Ayer, supra note 18, at 19.
bersome and inefficient that they afforded many debtors virtual immunity from collection efforts. A deficient bankruptcy system also hampers corporate restructurings and this has had a negative effect on the quality of Mexican bank portfolios since a significant percentage of the banks' debtors are corporations.

Although Mexico has made substantial improvement in the capacity and effectiveness of its regulatory and supervisory system, there still remains room for improvement. Above all, it is important that supervisors break free from the “rituals” of banking supervision, which for years have allowed formal compliance with regulations without addressing the crucial issues of bank solvency, profitability, and competition. Recent CNBV initiatives to eliminate the practice of permanently stationing on-site inspectors within the financial institutions should help to solve this problem.

Conflicts of interest stem from the government regulators' dual role as “watchdog” and supporter of financial institutions. Not only were regulators responsible for monitoring the banks and disciplining improper behavior, they were also responsible for orchestrating the bank rescue plan. During the financial crisis regulators focused on performing the role of supporter, organizing various bailouts and facilitating sales and mergers of institutions. Unfortunately, they somewhat disregarded their role as watchdog of the same financial institutions. The consequences of this failure have been made painfully evident by the discovery in early 1998 that a drug cartel was successful in purchasing a small Mexican bank in 1995, and also by the May 1998 sting operation conducted by U.S. law enforcement officers that uncovered widespread involvement by Mexican banks in money laundering schemes. These two revelations demonstrate the shortcomings of the previous supervisory practices and the need for the regulatory agencies to shift their focus more towards the role of watchdog.

254. In 1994, an initial draft of a bankruptcy reform program was proposed that would have lifted the effective immunity of debtors. Unfortunately, the legislation was never enacted. See id.

255. See Krivoy, supra note 4, at 176.

256. Mexican officials from the CNBV discovered in early 1998 that Mexican drug traffickers from the Juarez Cartel obtained a license from the Ministry of Finance in April 1995 to purchase a small domestic bank. The true owners of the bank were only uncovered after regulators detected fraud at the bank 19 months later. See Leslie Crawford, Mexico Drug Men 'Bought Bank,' FIN. TIMES (London) Mar. 17, 1998.

III. Conclusion.

The evidence suggests that Mexico has emerged from the crisis of 1995. Economic indicators from 1996 through 1998 show a generally positive trend in the economy in spite of the negative effects of plummeting oil prices and the financial crises in Asia, Russia, and Brazil. Nevertheless, Mexico's financial system has not yet risen to the level of robustness common in other OECD countries. On the contrary, the financial system is still weak and underperforming. Accordingly, to fully reap the benefits of the renewed growth in private capital inflows and financial integration with developed markets, the Mexican Government must continue to pursue an aggressive program of structural reforms in the banking sector to increase stability. Unless further improvements to the banking sector are made, the Mexican economy risks being dragged down by the persistent banking difficulties and will remain vulnerable to external economic shocks.