MEXICO

BANKING

SUMMARY

The implementation of the North American Free Trade Agreement (NAFTA) on January 1, 1994 and the financial crisis of 1994-95 radically altered the Mexican banking sector. Under NAFTA, foreign financial affiliates (basically wholly-owned Mexican subsidiaries of U.S. and Canadian banks, including the U.S. and Canadian banking subsidiaries of foreign-owned firms) were permitted to engage in the full range of banking activities subject to minor exceptions and market share restrictions. Initially, limitations may be placed on the maximum market share of U.S. and Canadian institutions, but these limitations will be phased out by the year 2000. NAFTA set an individual limit of 1.5 percent of the banking sector's aggregate capital and an aggregate limit of 8 percent. The individual limit will remain constant during NAFTA's transition period (January 1, 1994 to December 31, 1999) but the aggregate limit was scheduled to increase from 8 percent in 1994 to 15 percent by 2000. NAFTA also imposed a permanent limit on the size of NAFTA bank affiliates formed through mergers with or acquisitions of Mexican banks. Such institutions would be limited to the equivalent of 4 percent of the banking sector's capital.

As a result of the 1995 financial crisis, Mexican banks faced a dramatic increase in their overdue loans and a serious capital drain. In order to assist the banks, the Mexican government instituted a number of capitalization and debt-relief programs. As part of this package, the government passed financial reform legislation in March 1995 which liberalized foreign ownership and capital limit requirements for banks. This reform law lowered the amount of equity a NAFTA investor would need to hold for a bank to be considered a NAFTA affiliate from 99 percent to 51 percent.

In addition, the financial reform legislation permitted the Ministry of Finance and Public Credit to authorize on a case-by-case basis the acquisition by NAFTA-based banks of Mexican banks that exceed the 1.5 percent (transition) and 4 percent (permanent) market share limit. In those cases, the capital of the acquired bank may not exceed 6 percent of the banking sector's capital. The new limit is only applied to the capital of the acquired bank rather than the capital of the combined institution. The NAFTA individual and aggregate market limits still apply to the *de novo* establishment of financial institutions. Finally, the reforms raised the aggregate capital limit to 25 percent for NAFTA-based banks including the capital of acquired banks authorized by the Finance Ministry on a case-by-case basis. The NAFTA aggregate capital limits remain in place (but are not a binding constraint) for foreign affiliates that did not acquire Mexican banks on that basis.

The financial crisis also accelerated the consolidation of the Mexican banking sector. In 1992, Mexico had 20 banks. By 1994, the number had increased to 58 banks, of which 17 were foreign banks. The 1994-95 crisis produced a wave of mergers, interventions, and alliances with foreign banks. As of June 1, 1998, 38 banks (18 domestic banks, 20 foreign banks) were operating in

Mexico. The Mexican government is also winding up the affairs of 10 intervened domestic banks. Alliances have also flourished since the crisis. Foreign banks currently hold substantial investments in two of the top three Mexican banks.

The Mexican banking sector continues to be highly concentrated. As of December 1997, the top three banks held 56 percent of the sector's assets and capital. As of June 30, 1998, Mexican banks had seven agencies and three representative offices in the United States.

DESCRIPTION OF THE MARKET

The modern Mexican banking system was created in the 1920s with the creation of the National Banking Commission (1924), the passage of the Banking Law (1924), and the founding of the Bank of Mexico (1925). The Ministry of Finance is the primary regulator of the banking system. It issues licenses and sets general credit and fiscal policies. The Bank of Mexico implements Ministry of Finance policies, controls monetary policy, and operates the balance of payments system. The National Banking and Securities Commission (CNBV) is responsible for supervision and vigilance. The National Securities and National Banking Commissions were merged in April 1995.

Under recently proposed legislation, the CNBV would be transferred from the Ministry of Finance to the Bank of Mexico and given greater autonomy. The Bank of Mexico would increase its role in the drafting of financial regulations and gain control of foreign exchange policy. However, some political parties are pressing for a fully autonomous CNBV.

Commercial Banks

Mexico's commercial banks, with the exception of the local Citibank branch (now converted to a subsidiary) and Banco Obrero (a bank owned by the Mexican Labor Federation), were nationalized in 1982. The banks were sold to investors in 1991 and 1992 for 38.6 billion pesos (US$12.4 billion). The buyers of the banks paid a substantial premium for their acquisitions, on average over three times book value. Many of the buyers did not have substantial banking experience. The period of 1992-94 saw a rapid expansion of credit as banks fought for market share. Mortgage lending exploded and banks adopted very liberal lending policies. At the same time, the banks did very little to develop new deposit products.

The onset of the 1994-95 crisis produced a rapid deterioration in the banks' loan portfolios and a dramatic need for additional capital. The Mexican banking system's non-performing loans increased 143 percent from December 1994 to December 1995. By the end of 1996, the private sector had injected more than 63 billion pesos into the banking system. In addition, the Mexican government purchased billions of pesos worth of non-performing loans through FOBAPROA, the deposit insurance fund, intervened in several banks, and created a number of debtor assistance programs.

Commercial banks are required to contribute to FOBAPROA, a bank insurance fund managed by the Bank of Mexico. All banks make periodic contributions based on the level of their liabilities. The fund can inject capital into banks experiencing capital problems in exchange for partial or complete control of the bank. During the crisis, FOBAPROA purchased a large number of non-performing loans from the banking sector and assumed control of several intervened banks. As of February 1998, FOBAPROA had total gross liabilities of approximately US$65 billion and assets of approximately US$26 billion, for an estimated negative net worth of US$39 billion or 8.8 percent of GDP. Under recently proposed legislation, FOBAPROA would be split into a deposit insurance fund, FOGADE, and an asset recovery commission, COREBI. FOGADE will be funded by government allocations, bank contributions, and financing. The Ministry of Finance may set different fees for banks based on their perceived level of risk. Unlike FOBAPROA, FOGADE will not give unlimited protection to bank's obligations. COREBI will have a six-year life span and will be charged with selling FOBAPROA's assets.

According to CNBV's June 1998 statistical bulletin, the Mexican banking sector has assets of 1,114,415 millions of pesos (US$125.2 billion). This number, however, excludes the assets of intervened banks, banks in "special circumstances," and loans held by FOBAPROA, making it difficult to quantify the true state of the Mexican banking system.

The financial crisis accelerated the consolidation of the Mexican banking sector. The number of banks increased from 20 in 1992 to 58 in 1994, of which 17 were foreign banks. The 1994-95 crisis produced a wave of mergers, interventions, and alliances with foreign banks. As of June 1, 1998, 38 banks (18 domestic banks, 20 foreign banks) were operating in Mexico. The Mexican government is also winding up the affairs of 10 intervened domestic banks. The crisis also encouraged Mexican banks to enter into strategic alliances with foreign banks. For example, the Bank of Montreal holds a 16 percent stake in Bancomer, Mexico's largest bank. J.P. Morgan and HSBC Holdings together have a 28.5 percent stake in Serfin. Foreign banks also hold stakes in Bital and Inverlat.

Mexican commercial banks can issue three types of stock: A, B, and L. Series A shares must constitute 51 percent of a bank's voting shares and must be held by Mexican citizens, Mexican corporations, the Mexican government, development banks, FOBAPROA, or financial holding groups. Series B shares have unrestricted ownership with foreign investment of up to 49 percent. Series L shares have limited voting rights and unrestricted ownership of up to 40 percent of the common capital stock. Under recently proposed legislation, Series A and B shares would be merged into a new type of common capital stock, Series O, with no restrictions on foreign ownership.

The Mexican government and banking sector have increased the banking system's transparency and efficiency in recent years. In January 1997, the CNBV implemented new accounting practices for banks under a modified version of U.S. GAAP. The new accounting rules do not address troubled debt restructuring or require cash flow statements but do require banks to adopt inflation accounting.

Mexico is not a signatory to the Basle Capital Accord, although risk-based capital rules have been implemented on a modified basis. Financial and banking authorities have taken steps to improve bank inspection procedures in recent years and have received advice and training from international organizations. However, despite positive steps, deficiencies still remain. Beginning in 1997, banks were required to report "suspicious" transactions and were required to meet certain record-keeping and reporting requirements aimed at reducing money laundering. Although a credit bureau had been in place for many years, it has been recently revamped and modernized.

Development Banks

The Mexican banking system contains six government-owned development banks that lend to priority sectors, often through commercial banks. Development banks have been moving toward market-based financing and lending in recent years as opposed to subsidized lending. As of December 31, 1997, the development banking system held assets of 421.5 billion pesos (US$51.8 billion). Loans made up 84.9 percent of assets. As of December 31, 1997, overseas issues represented 10.9 percent of the banks' liabilities, local securities 29.4 percent, and interbank and international financial institution loans represented 53.7 percent.

Nacional Financiera (Nafinsa) is the dominant development bank, followed by Banobras and Bancomext. Nafinsa targets micro, small, and medium-sized businesses. It is often the government's agent for international financial transactions and promotes capital market development. Nafinsa also operates a neutral investment fund through which foreign investors may purchase an interest in Mexican Series A shares. The fund facilitates the expansion and liquidity of secondary markets and increases operating volumes. Nafinsa controls almost 49 percent of development bank assets and almost 50 percent of liabilities. Banobras, Mexico's infrastructure finance bank, holds almost 21 percent of the system's assets and 20 percent of its liabilities. Bancomext, the export finance bank, holds almost 19 percent of the assets and 18 percent of the liabilities.

U.S. PRESENCE IN THE MARKET

The Mexican banking sector continues to be highly concentrated. As of December 1997, the top three banks held approximately 60 percent of the sector's assets and capital. The 20 foreign banks currently operating in Mexico control 16.3 percent of the sector's assets and 15.6 percent of its capital. Ten U.S. owned banks are currently operating in Mexico. As of April 1998, there were 103 foreign bank representative offices, of which 21 represented U.S. banks. Mexican banks had seven agencies and three representative offices in the United States as of June 30, 1998.

In addition, institutions from OECD countries have used U.S. or Canadian subsidiaries to establish affiliates in Mexico via NAFTA. NAFTA's rule of origin is based on the country where the foreign financial institution is incorporated. The nationality of the institution's investment is immaterial.

These OECD member investors control a substantial portion of the market share of foreign banks in Mexico.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Under NAFTA, foreign financial affiliates (basically wholly-owned subsidiaries in Mexico owned by foreign banks domiciled in Canada or the United States, including the U.S. and Canadian banking subsidiaries of foreign-owned firms) were permitted to engage in the full range of banking activities subject to minor exceptions and market share restrictions. Individual and aggregate banking market share limits apply to U.S. and Canadian bank subsidiaries during a phase-in period. Between 1994 and 2000, an individual bank is limited to net capital of 1.5 percent of the total net capital of all Mexican and foreign commercial banks. Net capital is a measure that includes basic capital, essentially paid-in capital plus capital reserves adjusted by retained earnings and asset valuations, and complementary capital. It is estimated that total capitalization of the Mexican banking system is 98.5 billion pesos, or US$9.85 billion at an exchange rate of 10 pesos/US$. Thus, the 1.5 percent limit is US$148 million. Additionally, NAFTA set an aggregate net capital limit for U.S. and Canadian banks of 8 percent of net capital of the system in 1994 (US$1.22 billion equivalent as of May 1994), increasing in equal annual increments to 15 percent in 2000. These market share limits will disappear in the year 2000, but between 2000 and 2004 the Mexican government may unilaterally freeze new entries by NAFTA-based banks for a period of three years if the aggregate market share of the banks exceeds 25 percent of the banking sector's net capital. The Mexican government can only invoke this safeguard one time between January 1, 2000 and December 31, 2003. Second, a permanent safeguard allows Mexico to request consultations with the United States and Canada if the aggregate market share of NAFTA-based banks exceeds 25 percent of the sector's net capital, with a view to remedial action including a temporary freeze on the market share of the banks.

Under the NAFTA agreement, U.S. and Canadian, and other foreign banks through subsidiary banks established in the United States and Canada, were permitted to acquire Mexican banks as long as the combined capital of the acquired bank and a foreign subsidiary of the investor did not exceed the market share limit, or, after the transition period, 4 percent of the capital of the system. If the acquiring bank was already established in Mexico, both banks had to be merged and the 4 percent limit was applied to the merged institution. However, as a result of the 1994-95 financial crisis, Mexican banks faced a dramatic increase in their overdue loans and a serious capital drain. In order to assist the banks, the Mexican government instituted a number of capitalization and debt-relief programs. As part of this package, the government passed financial reform legislation in March 1995 permitting the Ministry of Finance and Public Credit to authorize on a case-by-case basis the acquisition by NAFTA-based banks of Mexican banks that exceed the 1.5 percent (transitional) and 4 percent (permanent) market share limits. The limit on those acquisitions and mergers was raised to 6 percent of the banking sector's capital. The new limit is only applied to the capital of the

acquired bank rather than the combined institution, and at the time of its implementation, signified that all but the three largest banks in Mexico could be controlled by NAFTA-based banks. The NAFTA individual and aggregate market limits still apply to the *de novo* establishment of financial institutions, but the aggregate capital limit including those specially-authorized acquisitions was raised, to 25 percent of banking system capital.

The 1995 financial reform law changed the NAFTA full ownership requirement from 99 percent ownership of the subsidiary's common stock to 51 percent ownership in order to encourage joint ventures between foreign banks and Mexican banks.

The Mexican government introduced a financial reform package before Congress in March 1998. The package deals with the FOBAPROA bank insurance fund controversy and various regulatory issues, including a lifting of the current 6 percent banking sector limit for foreign bank acquisitions of and mergers with Mexican banks. (The latter, if approved, would allow foreign banks to buy the three largest Mexican banks.) As of November 1998, it appears that the FOBAPROA portion of this package will be approved in some form this year. The rest of the regulatory reforms, including the lifting of the market capitalization restriction on foreign bank acquisitions and of mergers with Mexican banks, will not be addressed before 1999.

The implementation of NAFTA on January 1, 1994 committed Mexico to applying the principle of national treatment to U.S. and Canadian financial institutions. Since the implementation of NAFTA, North American owned bank subsidiaries have been able to offer the same services as Mexican financial institutions with several minor limited exceptions. Foreign financial institutions may only establish one institution of the same type in Mexico. In addition, they can only establish subsidiaries and not branches in Mexico. Mexican subsidiaries may not establish branches, subsidiaries, or agencies outside of Mexico. Finally, during the transition period, subsidiaries may only sell subordinated debentures to their foreign parent company.

Mexico has recently agreed to extend the benefits of NAFTA to OECD-based financial institutions. OECD-based financial institutions would be subject to NAFTA-style individual and aggregate market share limits during the NAFTA transition period. They would also be subject to the two NAFTA safeguards. As a result of the OECD agreement, overall aggregate market limits would be doubled, reaching 30 percent for commercial banks. Under the agreement, if, during the transition period, NAFTA-based institutions reached their aggregate market share limits, they would be entitled to draw on the OECD quota. The converse is not true.

Exchange Rates Used:

1992 end-of-period	3.11 pesos/US$
1997 end-of-period	8.14 pesos/US$
June 1998 period average	8.90 pesos/US$