Financial Globalization: Manna or Menace? The Case of Mexican Banking

While international capital markets have been developing for some time, direct foreign entry into the domestic banking sector of many countries has occurred only recently. Similarly, while consolidation of the financial services industry is not new, it is now beginning to transcend national borders in a more substantial way. These changes have occurred as a growing number of countries have considerably loosened long-standing restrictions on the foreign ownership of banks, thereby allowing financial globalization to advance on an unprecedented scale.

Most significant policy changes have their advocates and opponents, and the recent liberalization allowing global banking services is no exception. Advocates say global banking promotes improved practices and financial stability. But opponents claim foreign banks may lack commitment to the host country or be inordinately competitive with domestic banks, resulting in risk too great for domestic bank supervisors to control.[1] As global banking grows, the debate continues.

The situation in Mexico may shed light on this debate. The globalization of Mexican banking began in early 1994 with the North American Free Trade Agreement (NAFTA), which represented a significant step away from the country's history of a closed banking system. The peso devaluation of December 1994 subsequently put Mexico's banks on the brink of failure. Since then, however, Mexico has made numerous moves to stabilize both its economy and financial system, including further liberalization of foreign banking restrictions.

This process of deregulation, coupled with technological and economic factors propelling a general trend toward globalization, recently culminated in the foreign acquisition of the three largest Mexican banks, all within less than 18 months. As a result, Mexico is the largest economy in the world where such an overwhelming majority of commercial bank assets —almost 80 percent—are controlled by foreign financial institutions. As such, Mexico provides a fertile testing ground for assessing the merits of the arguments for and against financial globalization. While this new chapter in Mexico's modern history is only just beginning, the early evidence strongly favors an open policy toward global banking.

A Little History

Prior to NAFTA, individual foreign banks could hold no more than a 5 percent stake in a Mexican bank, and total foreign ownership in any single bank was limited to 30 percent. The only exception was granted to a U.S. institution, Citigroup, whose presence dates back to 1929, when it opened a branch bank in Mexico. This branch was allowed to continue operating, albeit under substantial regulatory restrictions.

NAFTA opened the Mexican banking system to foreign banks by permitting entry through the establishment of newly chartered subsidiaries. In 1994, Citigroup converted its branch into a separate legal subsidiary, and Banco Santander Central Hispano (BSCH) of Spain established a presence in Mexico. In 1995, 13 other U.S., European and Japanese banks entered the Mexican market through the establishment of new charters. Most of these banks formed a holding company, or *grupo financiero*, which held their banking interests in addition to other financial subsidiaries, such as leasing companies and broker–dealers.

Near the end of 1994, the Mexican peso was devalued, highlighting the growing strain in the banking system, which was damaged severely in the economic crisis that ensued. To attract much-needed capital, the Mexican Congress passed financial reform permitting foreign investors to acquire all or part of most existing banks. Still, foreign acquisition of the three largest banks was effectively prohibited. These reforms led to the acquisition of medium-sized commercial banks (between $5 billion and $10 billion) by Banco Bilbao Vizcaya Argentaria (BBVA) of Spain in 1996 and BSCH in 1997.[2] In addition, Citigroup expanded through the acquisition of Banca Confia, a medium-sized bank, in 1998. Each acquisition involved some form of financial assistance from the Mexican government. The government, meanwhile, took management control of 14 additional troubled banks.

By year-end 1998, Mexico already had more foreign than domestic banks. However, foreign banks controlled only 20 percent of banking system assets.[3] BBVA, BSCH and Citigroup controlled 7, 6 and 5 percent of total commercial bank assets, respectively. None of the other foreign banks had a market share greater than 1 percent.

Legislation removed all remaining market-share limitations on foreign ownership in December 1998 and created a deposit insurance and asset-resolution agency, Instituto para la Protección al Ahorro Bancario (IPAB), with stronger and well-defined powers, unlike its predecessor.[4] Subject to overview by the Mexican Congress, IPAB immediately began resolving government-intervened banks through the auction of bank assets and, in some cases, entire banks, to domestic and foreign buyers.

Catalysts for Globalization

In addition to deregulation, other forces in Mexico and around the world have propelled the country toward greater integration with the international community.

The economic fundamentals Mexico currently enjoys, especially in comparison with those of many other developing markets, have further increased the banking system's attractiveness to foreign suitors. In addition to comprehensive financial system reform and modernization, Mexico has implemented and maintained strict monetary and fiscal discipline. Mexico has successfully hit inflation targets in recent years and anticipates an inflation rate of about 3 percent by 2003, compared with 52 percent in 1995. The president and Congress have exhibited a commitment to reining in public spending, as evidenced by a shrinking budget deficit, and the political system itself has proven to be stable.

Common currencies, economic communities and trading blocs are eliminating obstacles to global expansion, a primary example being the European Community and the euro, which have facilitated merger activity among European banks. In this regard, while Mexico has a local currency, almost one-third of its bank assets and liabilities are denominated in U.S. dollars, and the Mexican peso has been relatively stable in recent years. Moreover, trade with the United States has flourished under NAFTA.

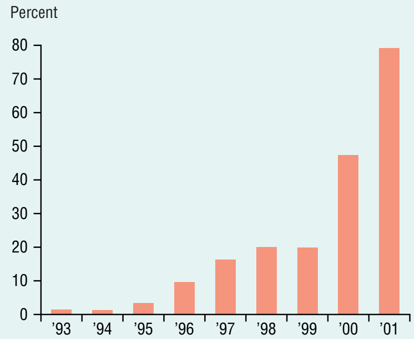
Additionally, technological innovations have changed bank products and revolutionized delivery systems. Advances in telecommunications and the Internet have especially benefited global expansion by enabling financial transactions and managerial control to easily traverse geographic boundaries. Such developments have reduced the information barrier traditionally associated with the distance between an organization's head office and its subsidiaries.

Large-Scale Foreign Entry

Spurred by these developments, a rapid-fire sequence occurred in which foreign banks acquired Mexico's three largest banks in less than a year and a half.[5] In May 1999 IPAB took control of Grupo Financiero Serfín, and in May 2000 this financial group was auctioned to BSCH. Immediately following this transaction, BBVA acquired a controlling interest in Mexico's second-largest financial group, Grupo Financiero Bancomer. The transaction was consummated in August 2000, dramatically increasing BBVA's stake in Mexico and making the newly formed Grupo Financiero BBVA Bancomer the country's largest banking group. This acquisition was the first significant foreign acquisition completed without financial assistance from the Mexican government. In the second quarter of 2001, Citigroup announced it would buy Grupo Financiero Banacci Accival (Banacci), which owns Banco Nacional de México (Banamex). The transaction was completed in September 2001.

Chart 1

Market Share of Foreign-Owned Banks in Mexico



SOURCE: Comisión Nacional Bancaria y de Valores.

Reflecting these acquisitions, the Mexican commercial banking system currently consists of 11 domestic and 19 foreign organizations.[6] The foreign banks include nine U.S. institutions, two Spanish banks, six other European banks, one Canadian bank and one Japanese bank. Foreign banks now hold nearly 79 percent of total commercial bank assets (*Chart 1*). Together, BBVA, Citigroup and BSCH hold 66 percent of these assets.

Mexico is not alone in these developments. Latin American banks in general have often been targets for foreign acquisition in recent years. As shown in Table 1, foreign banks now maintain a substantial presence in most Latin American countries. However, Mexico stands out in terms of the extent of foreign banking, especially given the large size of its economy.

Benefits for Mexico

Insufficient time has elapsed to comprehensively assess any differences in overall banking system performance resulting from foreign institutions' prominence in the Mexican banking system. Nevertheless, the trends have been positive. Each of the acquired banks has reported success in cutting costs, resulting in improved earnings and increased pressure on domestic banks to rationalize their own operations in order to remain competitive. As the cost synergies associated with recent acquisitions are fully realized, further operating-expense reductions are expected. More important, the capital adequacy of the three largest banks has improved, in some cases through capital injections provided by the new foreign parent companies.

In broader terms, the institutional changes since Mexico opened its bank-

Table 1

Foreign Bank Presence in Latin America

	2000 GDP (billions of U.S. dollars)	Foreign Bank Market Share (percent)
Brazil	1,194	24.0
Mexico	875	78.8
Argentina	403	54.7
Colombia	291	24.1
Chile	219	47.0
Venezuela	205	49.7
Peru	133	67.9
Ecuador	59	8.7
Dominican Republic	53	7.0
Uruguay	33	39.2
Bolivia	27	7.1
Panama	23	54.7
El Salvador	20	13.0
Jamaica	10	59.0

NOTES: The Mexican market share is as of June 30, 2001, and reflects the pro forma Citigroup–Banamex combination. All other market shares are as of year-end 2000, but the Jamaican market share reflects the pro forma foreign acquisition of the country's third-largest commercial bank in 2001.

SOURCES: GDP data are from the International Monetary Fund; market share data were compiled by various Federal Reserve Banks, through public information available from central banks and other supervisory agencies in individual countries.

ing sector to direct foreign entry correspond to the benefits claimed by the proponents of global banking in terms of improved practices and financial stability. A full analysis of the benefits of financial globalization must consider this process as a whole, rather than narrowly focus on the behavior of the foreign banks. In conjunction with the opening of its banking sector, the Mexican government has concentrated on stabilization, modernization, transparency and a drive toward internationally comparable standards and objectives.

A look at some related industry developments clearly shows that Mexico's financial system has been much improved and strengthened. The supervisory authorities have implemented a new bank monitoring and rating system, and accounting principles have continued to evolve closer to international standards. Furthermore, supervisors have moved quickly to promulgate new risk-management policies and processes for credit administration. For example, asset–liability management policies have been improved to better assess value at risk and mitigate liquidity and interest rate mismatches. While markets have generally stabilized over the past few years, the effects of these improvements in asset–liability management are reflected in less volatile market-related gains and losses. Moreover, the corporate community and governing authorities have enhanced the disclosure of financial information and established new corporate governance laws that strengthen the accountability of bank directors and increase the rights of minority shareholders.

These are the types of advances globalization advocates have contended would result from international banks' direct entry into a domestic market. A strong foreign presence brings world-class banking practices, heightened competitiveness, and the need for institutional and policy arrangements fully supportive of modern financial services. This process of change in Mexico undoubtedly began even before the onset of direct foreign ownership, as international players had already been competing with domestic institutions to serve Mexico's largest and most sought-after corporate borrowers.

Globalization Concerns Misguided

The path of progress has admittedly been a rough one for Mexico, as evidenced by the 1994 peso devaluation. But from a longer term perspective, even the peso crisis and its associated banking problems proved to be positive in that they helped spur the improvements and modernization subsequently undertaken by governing authorities and Mexican banks.

Opponents often emphasize the perceived weaknesses of an open financial system by referring to examples, such as Mexico's, of financial liberalization followed by financial crisis. But this ignores the underlying institutional and policy problems that typically have accompanied financial crises. A more thorough assessment would consider the possibility that adverse financial developments in the context of a deregulated environment might reflect deeper problems, rather than being the direct result of financial liberalization itself.

In Mexico's case, the 1994 peso crisis highlighted, among other things, the need to pursue the types of improvements to the financial infrastructure that Mexico has since successfully undertaken. Only through these efforts have domestic banking practices, the supervisory process, information quality and corporate governance been made commensurate with the demands of the global marketplace.

A Positive Direction

Mexico has established a strong foundation for economic growth and prosperity. Accompanying the banking sector's openness to foreign ownership and competition has been a large-scale modernization of regulatory practices and accounting standards, together with significantly increased disclosure and corporate governance requirements. In addition to opening its banking sector, Mexico has signed 10 free trade agreements in recent years, encompassing 35 countries that account for more than half of the world's GDP.

More time must elapse before the full effect of these changes on financial and economic performance can be assessed. Nevertheless, developments point firmly in a positive direction, especially in terms of the banking system's capital adequacy. Reflecting Mexico's financial success, the peso has remained fairly stable over the past three years, whereas the currencies of many other major Latin American countries have depreciated.

Within less than 18 months, Mexico's three largest banks were bought by foreign institutions. Cause for concern? We think not. Rather, Mexico's policy of openness is likely to result in continuing economic benefits far greater than what was widely expected only a few years ago.

—Robert V. Bubel
Edward C. Skelton

Bubel and Skelton are international financial analysts in the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.

Notes

1 An excellent discussion of these opposing views and related points can be found in the remarks by Robert W. Ferguson, Jr., before the International Banking Conference, Federal Financial Institutions Examination Council, Arlington, Va., July 20, 1998. See www.federalreserve.gov, under the section titled "Testimony and Speeches."

2 At the time, BBVA was known as Banco Vizcaya Bilbao and BSCH was known as Banco Santander.

3 The government does not report the assets of intervened banks, and therefore these assets are not included in the total. If the assets of intervened banks were counted, the market share calculated for foreign banks would be somewhat lower.

4 Entry is still permitted only through a separate, Mexican-chartered subsidiary. No branches or agencies of foreign banks can be established in Mexico.

5 In addition, during 2000, a Canadian bank acquired a medium-sized Mexican bank it had managed for the government since 1995.

6 The government currently controls 11 intervened banks, including one small bank that was intervened in 2001. Resolution of the largest intervened banks has been arranged through agreements with local banks. The remaining intervened banks are essentially shells, as the most valuable assets and deposits have already been sold. Recently, IPAB announced that the licenses for seven of these banks will be formally revoked and the banks fully liquidated.