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Report No. P-6616-ME

REPORT AND RECOMMENDATION

OF THE

PRESIDENT OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

IN AN AMOUNT EQUIVALENT TO US$1,000 MILLION

TO

NACIONAL FINANCIERA, S.N.C

WITH THE GUARANTEE OF

THE UNITED MEXICAN STATES

FOR A

FINANCIAL SECTOR RESTRUCTURING PROGRAM

MAY 24, 1995

CURRENCY EQUIVALENTS

Currency Unit	=	New Peso (NP)
US$1.00	=	5.885 New Pesos (May 22, 1995)[1]

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ABM	*Asociación de Banqueros Mexicanos* (Mexican Bankers Association)
BANOBRAS	*Banco Nacional de Obras y Servicios* (National Public Works Bank)
CD	Certificate of Deposit
CETES	Mexican Treasury Bills
CNB	*Comisión Nacional Bancaria* (National Banking Commission)
CNBV	*Comisión Nacional Bancaria y de Valores* (resulting from merger of CNB and CNV)
CNSF	*Comisión Nacional de Seguros y Fianzas* (National Insurance and Bonding Commission)
CNV	*Comisión Nacional de Valores* (National Securities Commission)
CONSAR	*Comisión Nacional del Sistema de Ahorro para el Retiro* (National Commission of the Retirement Savings System)
DVP	Delivery versus Payment
DFI	Direct Foreign Investment
ESF	Economic Stabilization Fund
FAMV	*Fondo de Apoyo al Mercado de Valores* (Securities Market Support Fund)
FOBAPROA	*Fondo Bancario de Protección al Ahorro* (Bank Fund for Savings Protection)
FONATUR	*Fondo Nacional de Turismo* (National Tourism Fund)
FOVISSSTE	*Fondo para la Vivienda de los Trabajadores del ISSSTE* (Government Workers' Housing Fund)
FSAL	Financial Sector Adjustment Loan (3085-ME)
FSRL	Financial Sector Restructuring Loan
FSRP	Financial Sector Restructuring Program
FTAL	Financial Technical Assistance Loan (3838-ME)
GAAP	Generally Accepted Accounting Principles
IDB	Inter-American Development Bank
IDP	Institutional Development Plans
IMSS	*Instituto Mexicano del Seguro Social* (Mexican Social Security Institute)
INDEVAL	*Institución para el Depósito de Valores* (Securities Depository Institute)
INFONAVIT	*Instituto del Fondo Nacional de la Vivienda de los Trabajadores* (National Workers' Housing Fund Institute)
ISSSTE	*Instituto de Seguridad y Servicios Sociales de los Trabajadores del Estado* (Institute of Security and Social Services for Government Workers)
NAFIN	*Nacional Financiera, S.N.C.*
NAFTA	North American Free Trade Agreement
PECE	*Pacto de Estabilización y Crecimiento Económico* (Economic Stabilization and Growth Pact)
PROCAPTE	*Programa de Capitalización Temporal* (Temporary Capitalization Program)
PROSSE	*Programa de Servicios Sociales Esenciales* (Program of Essential Social Services)
SAR	*Sistema de Ahorro para el Retiro* (Retirement Savings System)
SECOFI	*Secretaría de Comercio y Fomento Industrial* (Ministry of Commerce and Industrial Development)
SHCP	*Secretaría de Hacienda y Crédito Público* (Ministry of Finance and Public Credit)
SIC	*Sistema Internacional de Cotizaciones* (International Share Quotation System)
SOFOL	*Sociedad Financiera de Objeto Limitado* (Limited Purpose Bank)
SPEUA	*Sistema de Pagos Electrónicos de Uso Ampliado*
UDI	*Unidad de Inversión* (Investment Unit)
VAT	Value Added Tax

[1] Conversions in the text of this report are based on NP6 per US dollar.

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MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

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This report is based on the findings of joint IBRD/IDB missions that visited Mexico from March 6-10 and April 2-8, 1995. The IBRD team included: Sri-ram Aiyer (Director, LAT, Mission Leader); Surendra K. Agarwal (AF2DR); K.K. Framji (AF4CO); Roy Karaoglan (IFC); Thomas S. Glaessner (LA2PS); Mike Lubrano (LATPS); Daniel Crisafulli (LA2PS); and Miguel Navarro (LA2PS). Aristóbulo de Juan, Peter Jones and T. N. Dinh were consultants to the IBRD team; Jorge Serraino assisted in the processing of the report. The IDB team included: Hans U. Schulz; Kim Staking; Jorge Requena; Emilio Cueto; and Adolfo Diz (consultant). Messrs. Edilberto L. Segura and Robert M. Lacey are the IBRD Department Director and Division Chief, respectively, for this operation.

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MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM
LOAN AND PROGRAM SUMMARY

BORROWER: Nacional Financiera, S.N.C. (NAFIN)

GUARANTOR: United Mexican States

AMOUNT: US$1,000 million equivalent

TERMS: Repayment in 15 years, including 3 years of grace, at the standard variable rate

OBJECTIVES: The proposed loan would support the Government of Mexico's Financial Sector Restructuring Program (FSRP), which is designed to: (a) restore the solvency and soundness of Mexico's banking system, restructure banks, and improve confidence in the financial system; (b) reform the accounting standards and prudential regulations for banks, and strengthen supervision to prevent future recurrence of systemic problems; (c) improve discipline in the provision of liquidity by the Banco de Mexico (Central Bank); and (d) initiate reforms in development bank lending, accounting practices and regulation of financial groups, and the deposit protection system.

DESCRIPTION: The loan will support actions to: (a) improve discipline and manage systemic risks in the provision of liquidity support by the Central Bank and resources from development finance entities; (b) determine the health of the banking system, inclusive of diagnostic studies, with the assistance of independent auditors, of banks and financial groups intervened by the former National Banking Commission (CNB) and the newly merged National Banking and Securities Commission (CNBV), banks and financial groups that have come under the control of the bank support fund (FOBAPROA), and banks entering the temporary capitalization program (PROCAPTE); (c) restructure troubled banks with the assistance of investment banking advisers; (d) reform accounting standards and prudential regulations for banks; (e) strengthen bank supervision; (e) improve the regulatory framework to facilitate corporate work-outs and debt restructuring; (f) remove obstacles to securitization and secured lending; and (g) formulate a revised set of prudential regulations for brokerage houses, and a revised scheme for deposit protection.

BENEFITS: Immediate actions included under the program will help contain the losses of the banking system while enabling continued functioning of the credit and payments system which is essential for the real sectors. Successful implementation of the program will lead to increased confidence in the financial system, and restructuring of banks will restore their financial soundness and operating efficiency. The revision in accounting practices and disclosure requirements will improve the quality of information on banks, thereby enabling early recognition of future problems besides allowing market regulation. Improvements in prudential regulation and supervision and the legal/regulatory framework for lending will lead to a more efficient, sound and stable financial system. Together these actions will enable the financial system to mobilize increasing amounts of domestic and foreign capital.

RISKS: The principal risks are: (i) failure to maintain a satisfactory macroeconomic framework and the resulting continuation of high inflation and interest rates; (ii) political intervention in the implementation of policy and institutional reforms in the financial sector or in decisions on restructuring of banks; and (iii) shortage of technical capacity in government entities or poor coordination among them leading to delays in implementation. These risks are mitigated by the Government's strong support for the program. The loan contains safeguards to stop disbursement in the event of deteriorating macroeconomic conditions or unsatisfactory performance under the program. The implementation of diagnostic studies and establishment of a transparent framework and criteria for restructuring of banks will reduce the risks of political intervention. Provision of technical assistance under the recently approved Financial Technical Assistance Loan (FTAL) will help ensure timely availability of the additional skills required for implementation. To improve coordination among Government agencies, an ad hoc Financial Sector Working Group has been established with participation from the CNBV, the Central Bank and the Ministry of Finance and Public Credit.

POVERTY CATEGORY: Not Applicable.

COFINANCING: The Inter-American Development Bank is processing a parallel Sector Adjustment Loan in the amount of US$750 million with conditionality identical to this loan.

ESTIMATED DISBURSEMENT: The loan will be disbursed in two equal tranches. The first tranche will be disbursed upon loan effectiveness, and the second will be released upon compliance with tranche release conditions expected to occur about 9 months after effectiveness (March/April 1996). Retroactive financing up to an amount of US$200 million will be permitted for eligible imports made before the date of the loan agreement and after March 9, 1995.

IDENTIFICATION NO: MX-PA-40497

REPORT AND RECOMMENDATION
OF THE PRESIDENT OF THE
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
TO THE EXECUTIVE DIRECTORS
ON A PROPOSED LOAN TO NATIONAL FINANCIERA, S.N.C.
WITH THE GUARANTEE OF THE UNITED MEXICAN STATES
FOR A FINANCIAL SECTOR RESTRUCTURING PROGRAM

1.1 I submit for your approval the following report and recommendation on a proposed Sector Adjustment Loan to Nacional Financiera, S.N.C. with the guarantee of the United Mexican States for the equivalent of US$1,000 million in support of a program for restructuring of the financial sector. The loan would be at the Bank's standard variable interest rate with a maturity of 15 years, including three years of grace, and would be disbursed in two tranches of US$500 million each. The Inter-American Development Bank (IDB) is cofinancing the program with a Sector Adjustment Loan in an amount equivalent to US$750 million, to be disbursed in two tranches.

I. MACROECONOMIC CONTEXT

1.2 Facing near-depletion of its foreign exchange reserves, Mexico was compelled on December 20, 1994 to allow the peso to depreciate beyond the limits of the band that it had previously defended. A currency crisis has ensued and, as a result, the economy is contracting sharply this year. This section summarizes a more complete discussion of recent economic developments which appears in the **1995 Country Assistance Strategy** (Report No. 14518, May 22, 1995). Key economic indicators, and information on balance of payments and financing requirements, respectively, are given in Annexes III, IV and V.

A. Causes of the Crisis

1.3 The Mexican crisis was precipitated by a year-long series of domestic and external shocks. First, with 1994 a presidential election year and the economy in recession in the second half of 1993, the Government approved an expansionary budget for 1994. Then on January 1, 1994 the Chiapas revolt erupted, followed by several other political disturbances, including the assassination of the Presidential candidate of the ruling party, which increased uncertainty about the outcome of the August presidential election. On the external front, increases in U.S. interest rates beginning in February 1994 made U.S. assets relatively more attractive than before.

1.4 The negative reaction of investors to these shocks and the peso devaluation has been sharp, reflecting both the relative vulnerability of the economy when the shocks began and the macro policy response in 1994. Since 1987, Mexico had pursued a plausible but high-risk economic strategy, the main elements of which were: (i) the use of the exchange rate as a nominal anchor, which successfully reduced inflation to single-digit levels; and (ii) an aggressive program of structural reforms, designed to attract productivity-enhancing investment and thereby strengthen Mexican competitiveness. The risks were that this exchange rate policy would cause a real appreciation of the peso, and that the current account deficit would therefore grow and have to be financed by increasing foreign capital inflows. However, the Government believed firmly that increased investment and productivity gains would improve the economy's competitiveness sufficiently to bring the current account deficit back down to a sustainable level over time.

1.5 As expected, the real exchange rate did appreciate strongly, but sufficient increases in investment and productivity failed to materialize. Further, although important structural changes were made, other reforms proceeded too slowly to have the desired impact on productivity and competitiveness. Absent rapid productivity gains, the peso appreciation made it increasingly difficult for Mexico to compete internationally, and so the current account deficit ballooned from an average of 3 percent of GDP in 1989-90 to 7 percent in 1992-94, with no indication that a decline was beginning.

1.6 Although such large current account deficits would not be sustainable in the long-term, prior to 1994 Mexico was able to rely on surging private foreign capital inflows to finance them. Then in 1994, foreign capital inflows slowed -- responding to the shocks and to growing concern over the sustainability of Mexico's economic strategy -- and fell far short of the level needed to finance the current account deficit, so that reserves declined precipitously.

B. Government Response

1.7 Following the December devaluation, financial markets were unsettled by the Government's initial delays in announcing an economic program, and again by the limited scope of the program that was eventually announced on January 3, 1995. Recognizing the need for a more comprehensive economic program, the Government announced a revised program on March 9, which included strong fiscal and monetary adjustment, a program to deal with problem banks and prevent future banking problems, and a strengthening of the social safety net, with the program supported by a large international financial package.

C. Prospects

1.8 Although important risks remain, financial markets have begun to respond positively. Mexico's macroeconomic strengths -- a competitive real exchange rate, a balanced government budget, a manageable ratio of debt to GDP, a vigorous export sector, and the North American Free Trade Agreement (NAFTA) -- are permitting a delicate stabilization with a projected current account deficit of under 1 percent of GDP in 1995. Mexico's economic program is based, correctly, on the premise that the immediate problem is largely one of short-term cash-flow, and *not* of insolvency, and so its first objective is to restore stability by rebuilding international confidence. The program's international financial support package will enable the Government to convert its large portfolio of short-term debt to longer maturities. Moreover, the crisis has led the Government to accelerate structural reforms in the areas of infrastructure privatization, decentralization of public services, the legal and judicial systems, and the design of social programs.

1.9 The key risks for medium-term economic recovery are long-standing problems that have been exacerbated by the crisis: the fragility of the banking system, the slow pace of certain structural reforms, and the social pressures arising from rising unemployment and poverty. If not addressed adequately, any of these risks could erupt and so undermine economic recovery and investor confidence. The proposed PROSSE (*Programa de Servicios Sociales Esenciales* -- Program of Essential Social Services) aims to improve the social safety net and so ease social tensions, while the Bank's policy dialogue with Mexico is intended to assist Mexico's program of structural reform. Finally, strengthening the banking system is precisely the objective of this loan. Assuming that each of these risks can be contained (as discussed in the Country Assistance

Strategy), economic growth is expected to resume and the risks will gradually diminish.

II. THE FINANCIAL SECTOR

A. Background

2.1 **Structure and Size.** Mexico's financial sector comprises 34 commercial banks, 7 development banks and several trust funds operating at the second tier level, over 340 credit unions, 28 securities brokerage houses that are members of the Mexican Stock Exchange, 44 insurance and re-insurance companies, 19 bonding companies, 28 warehousing companies, 60 leasing companies, 58 factoring companies, 45 foreign exchange houses and a number of other non-bank institutions.

2.2 As of December 1994, total assets and total deposits of the banking system were NP857 billion and NP414 billion, respectively. Total outstanding loans amounted to NP594 billion. At the end of 1994, the three largest commercial banks accounted for 70% of commercial bank assets, received 72% of commercial bank deposits and operated 65% of commercial bank branches. Annex VI contains aggregate data on Mexico's commercial banks and on their performance.

B. Recent History (Nationalization, Consolidation and Re-privatization)

2.3 **Commercial Banks.** In September 1982, Mexico nationalized 58 of its 60 private commercial banks.[2] Thereafter, the banking sector went through a major consolidation and restructuring process: 9 institutions were closed or liquidated, 20 regional institutions were merged with mid-size banks, and by 1986 only 18 commercial banking institutions remained (6 national banks, 5 regional and 7 multi-regional banks). In addition, the non-bank financial holdings of the commercial banks were returned to private ownership. The nationalization of banks granted the Government a monopoly on the provision of banking and credit services. Coupled with administrative actions to merge and downsize development banks and trust funds, this led to a fall in commercial bank credit extended to the private sector from 40 percent of total bank credit in 1980-81 to only about 25 percent in 1986. During the 1985-1987 period, the Government used commercial banks to finance the public sector deficit.

2.4 From 1988 to 1992, as Mexico's public finances began to improve and the Government's demand for funds decreased, the Government introduced a wide range of financial reforms culminating in the re-privatization of commercial banks in 1991-1992.

2.5 To establish a clear legal and regulatory framework for the provision of banking and non-banking financial services by the private sector, a new Credit Institutions Law was adopted in 1990. The Financial Groups Law was also enacted in 1990, allowing for the establishment of a conglomerate banking regime permitting separate commercial banking, brokerage and other financial service companies to be controlled by a single holding company. (Annex VII describes the key laws governing Mexico's financial sector.) At the same time, several measures were taken to deregulate important areas of the Mexican financial system: (i) liberalization of deposit

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[2] The two exceptions were Banco Obrero, controlled by Mexican labor unions, and Citibank, the only foreign bank then allowed to operate branches in Mexico.

and lending interest rates; (ii) elimination of reserve requirements; (iii) elimination of the liquidity coefficient; and (iv) elimination of regulations requiring commercial banks to hold long-term government paper until maturity.

2.6 On June 28, 1990, the Constitution was amended to remove banking from the list of activities reserved for the state, thus allowing for the re-privatization of the commercial banks. By July 1992 controlling shares of the 18 institutions previously owned by the Government had been auctioned for US$12.5 billion equivalent. Eleven commercial banks were acquired by securities brokerage houses and the rest were bought by industrial groups or individuals. Currently, 13 of these banks are subsidiaries of financial groups.[3] Non-bank financial services also benefitted from liberalization policies. Regulation of insurance premiums and policies was simplified, as were the rules governing mutual funds. Following the market crash of October 1987 (in the U.S. and Mexico), the laws governing Mexican capital markets were modified with the aim of reducing transaction costs, boosting transparency, and providing stronger penalties against insider trading. Reforms were enacted to liberalize pricing, permit product innovation, and rationalize taxation policies for the entire financial sector.

2.7 **Development Banking**. As of December 1994, assets of the development finance entities (DFEs) were about NP369 billion equivalent, with outstanding credits of NP294.2 billion equivalent. The sector is composed of seven development banks (NAFIN, BANCOMEXT, BANCOMINT, BANRURAL, BANOBRAS, FINASA and BANJERCITO) and several trust funds operating at the second-tier level (including FIRA, FONAVIT, FONATUR, FOVI and FIDEC). These banks and funds are assigned to sectors, with substantial overlap.[4] While the institutions depend on the Ministry of Finance and Public Credit (SHCP) and are subject to regulation by the National Banking and Securities Commission (CNBV), the trust funds are under the auspices of the Central Bank.

2.8 In recent years, the public development banks have aggressively shifted their operations from the first-tier to the second-tier level. The outstanding financial resources for the consolidated development finance sector (including trust funds) to private financial institutions grew from NP21.8 billion at the end of 1990 to roughly NP123.9 billion by 1994. Of this total, NP107.6 billion was held by commercial banks.[5] This compares with the total capitalization of the commercial banking sector of NP44.7 billion, and does not include liquidity provided through interbank and other short term operations, portfolio finance investments or loan guarantee programs. During the recent crisis, some DFEs increased their provision of liquidity to commercial banks, operating daily volumes of several hundred million dollars.

C. Sector Policy Since Privatization

2.9 **Financial Conglomerate Model**. With the enactment of the Financial Groups Law in

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[3] Excluding two banks, Union and Cremi, which were intervened in September 1994.

[4] Besides acting as a fiscal agent for international loans of the Federal government, NAFIN provides first and second-tier financial services to small and medium sized companies in industry, commerce and services. BANCOMEXT promotes external trade; BANCOMINT - domestic commerce; FIRA and BANRURAL - agriculture; FOVI - housing; FIDEC - commerce; and FONATUR - tourism.

[5] Equivalent to approximately 16% of total commercial bank credit outstanding to the non-financial private sector.

1990, Mexico adopted the financial conglomerate model followed in one form or another by numerous European countries, including Germany, Spain and the U.K. Under the Financial Groups Law, commercial banking, securities brokerage, investment banking, leasing, factoring, foreign exchange, mutual fund management and insurance activities may be conducted by separate subsidiaries of a common holding company. In addition, a number of non-bank financial services, such as leasing, factoring, and trading in debt instruments, may be carried out directly by the commercial bank subsidiary of a financial group. This model was adopted to make Mexico's financial system more efficient and competitive, permitting financial groups to exploit economies of scale and scope, enter new markets and cross-market services. The NAFTA chapter on financial services and the Financial Groups Law both provide for the possibility of foreign-controlled financial groups with the same basic conglomerate banking structure as domestic financial groups.

2.10 As noted above, the adoption of the conglomerate banking model resulted in substantial concentration in the financial services markets. The purchase of privatized banks by groups with substantial holdings in other financial services industries (particularly brokerage and insurance) clearly raised competition concerns for the Government. The Government has sought to mitigate the negative effects of this concentration by permitting limited foreign competition, by deregulation and by fostering greater exchange of information among financial service providers (for example, through the encouragement of credit information bureaus).

2.11 **Foreign Participation and Competition**. The Credit Institutions Law, the Capital Markets Law and the Financial Groups Law provide for a special category of foreign-controlled financial holding companies, commercial banks and brokerage houses, where provided for by treaty (e.g., NAFTA). Foreign-controlled commercial banks are ordinarily subject to individual and aggregate market share limitations. Initially, no single foreign-controlled bank may represent more than 1.5% of the capital of the banking system and all foreign banks taken together may have no more than 8%. The aggregate ceiling will gradually increase to 15% by 1999. After January 1, 2000, the market share limits will no longer apply. However, the treaty provides that Mexico may take certain safeguard actions to prevent a surge of competition from foreign-controlled financial entities.

2.12 The Government expected that gradually increased competition in financial services from foreign-controlled entities would provide incentives for Mexican-controlled commercial banks to become more efficient, adopt new techniques and technologies and gradually reduce intermediation costs. Even after privatization in 1992, bank intermediation spreads in Mexico remained extremely high, averaging 8% through 1993, declining to about 6% in 1994 following conclusion of NAFTA. The charters for the first foreign-controlled financial institutions and holding companies were approved beginning in August 1994. Thus, the direct effects of foreign competition on the Mexican financial services industry were not yet apparent before the December 1994 devaluation.

2.13 On February 15, 1995, in the aftermath of the devaluation, Mexican laws were modified to permit foreign individuals and companies as a group to hold up to 49% of the voting shares of a Mexican-controlled financial holding company, commercial bank or brokerage firm. More importantly, as an incentive for foreign financial institutions to come to the rescue of undercapitalized Mexican banks, the amendments now permit foreign financial institutions to purchase a controlling interest in a Mexican commercial bank with a market share of up to 6%, four times higher than the initial NAFTA limitations (Annex VII). Thus far, only Spain's Banco Bilbao Vizcaya has expressed interest in taking advantage of the amendment, and is currently negotiating to increase its substantial minority stake in the Probursa - Mercantil financial group to majority control.

2.14 **Improved Regulation**. Since the privatization of the commercial banks, the Government has taken several important steps to further modernize the framework for regulation of the financial sector. In June 1993, the Constitution was amended and legislation went into effect to grant the Central Bank far greater autonomy with more clearly defined functions (e.g., in the conduct of monetary policy and regulation and supervision of the payments system and foreign exchange market). In July 1994, legislation was enacted creating the National Commission for the Retirement Savings System (CONSAR), with responsibility for supervising Mexico's retirement savings system.

2.15 Refinements were also made to the principal legislation governing the financial sector. Amendments to the Credit Institutions Law and the Financial Groups Law effected in July 1993 broke down some of the divisions between the services that could be provided by different entities in a financial group, permitting a greater variety of services (including leasing and factoring) to be offered by commercial banks. The laws governing the operation of insurance companies, bonding companies and auxiliary credit institutions (e.g., warehouses) were modified in the same month to clarify the capital adequacy requirements for such entities. In July 1993 and in the following year revisions were made to the Capital Markets Law to encourage greater competition (liberalization of brokerage firm operations abroad and introduction of a system for quotation of securities originally issued abroad).

2.16 The authorities with jurisdiction over the financial sector (the Central Bank, SHCP and the Commissions) have also issued important new regulations over the past few years in such areas as regulatory treatment of newly-introduced financial instruments (including exchange coverage contracts), marketing of financial services (including mutual funds) and securities trading practices of banks and brokerage firms. The authorities have also taken limited steps to encourage greater competition to minimize the negative effects of Mexico's highly concentrated market for financial services. In February 1995, new regulations were issued by SHCP to foster the development of credit information bureaus (which maintain data on credit transactions). The goal is to require the sharing of information on individual and corporate credit transactions, formerly treated as proprietary by financial institutions.

2.17 **Merger of Commissions**. The Mexican financial system is regulated and supervised by the SHCP, the Central Bank, the National Banking and Securities Commission (CNBV, created out of the merger of the National Banking Commission (CNB) and the National Securities Commission (CNV)), the National Insurance and Bonding Commission (CNSF) and CONSAR. The primary regulators for commercial and development banks are the Central Bank and the CNB, with the latter taking primary responsibility for supervision of banks and enforcement of applicable laws and regulations. Following the recent merger of the CNB and CNV, (para. 2.20), the merged body (CNBV) is now responsible for supervising virtually all financial holding companies as well as banks and brokerage firms. This should permit more efficient and effective supervision of financial groups.

2.18 Effective supervision requires comprehensive inspection procedures covering all aspects of bank operations, skilled and experienced supervisory staff, and an institutional development strategy. The adoption of the financial conglomerate model and the privatization of the commercial banks took place before a strengthened supervisory infrastructure could be put in place. In particular, CNB staff were inexperienced in the types of deregulated activities in which banks were now permitted to engage. It was also recognized by the Government that consolidated supervision of financial groups as a whole needed to be strengthened. In April 1994, the CNB was substantially reorganized and an institutional development plan was initiated to rationalize responsibility for on-site and off-site supervision and to modernize the training of inspectors and other staff. Implementation of the institutional development plan also involved the hiring of a substantial number of new staff at the management level. The Financial Sector Technical Assistance Loan (Loan No. 3838-ME) signed in March 1995 is to assist the Banking and Securities, and Insurance and Bonding Commissions to modernize regulations and supervisory techniques and improve permanent training programs for their staffs.

2.19 The CNB had a staff of about 110 full time on-site examiners for commercial banks at the time of its merger with the CNV (para. 2.20). Additional examiners are employed in the Commission's off-site and special supervision departments. Since the reorganization of the CNB in April 1994, on-site examiners typically work in teams of approximately 25 and conduct annual examinations of each of the 18 principal commercial banks. The examination staff of the CNB has been receiving intensive training under the direction of a Field Office Supervisor of the U.S. Federal Deposit Insurance Corporation (FDIC) seconded to the CNB since October 1994 under the FTAL. In light of the increased demands being made on the examination staff, the FTAL will support additional training in on-site and off-site supervision for CNBV staff from the U.S. FDIC, Office of the Comptroller of the Currency (OCC) and the Federal Reserve System.

2.20 In early December 1994, for the purpose of improving the effectiveness of the supervisory authorities, the Government announced that the CNB and the CNV would be merged. The merger became effective on May 1, 1995. The President of the CNB was appointed President of the CNBV, the new body resulting from the merger. The merger is expected to facilitate consolidated supervision of financial groups and to better employ human and technological resources in financial sector supervision.

D. Problems of the Banking System Before the Crisis

2.21 **Rapid Growth**. Prior to the peso devaluation, and in the aftermath of the re-privatization of the banks during 1991/92, the Mexican commercial banking system had gained in depth and had recorded significant growth. Between 1991 and 1994, aggregate assets of commercial banks (including intervened banks, see para. 2.48) 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 NP735 billion, equivalent to 58.8% of GDP, as compared to a ratio of 42.5% in 1991. By the end of 1994, aggregate bank assets reached the record level of NP857 billion. However, as a result of the steep devaluation of the peso in December, aggregate bank assets decreased by 25% in U.S. dollar terms, from the equivalent of US$215 billion at the end of September 1994 to about US$161 billion by year-end.

2.22 The growth rate of the banks' loan portfolios was even higher than that of assets. During the three-year period 1991-94, aggregate gross loans (excluding discounted 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%. This is equivalent to at least eight times the rate of growth of real GDP during the same period.

2.23 **High Ratio of Loans to Deposits**. Although deposit mobilization also improved significantly during the period under review, with the ratio of average deposits to GDP increasing from 21.4% in 1991 to 31.3% in 1994, the rate of growth of the loan portfolios outstripped that of deposits. Consequently, the ratio of loans to deposits increased steadily from 94.1% at the end of 1991 to 113.8% by 1993, and still further to 124.0% by 1994. This resulted in an increasing reliance on interbank funding, the bulk of which consisted of lines of credit from foreign banks. In fact, the aggregate amount of interbank borrowings increased from the equivalent of NP34 billion at the end of 1991 (of which NP23 billion were denominated in foreign currency) to NP124 billion at the end of 1994, of which the equivalent of NP92 billion (US$17.3 billion) were denominated in foreign currency. These figures imply that the ratio of aggregate interbank borrowings to aggregate shareholders' equity increased from 155% in 1991 to 278% by 1994.

2.24 **Deterioration in Loan Portfolio Quality**. The rapid rate of growth of loan portfolios, coupled with the banks' generally lax monitoring guidelines and procedures, and with the ineffective supervision undertaken by the CNB (until mid- 1994), resulted in a noticeable deterioration in loan portfolio quality. Whereas at the end of 1991, aggregate past due loans (including both principal and interest) of commercial banks (excluding Union and Cremi), accounted for 4.09% of gross loans (including discounted loans), by the end of 1993 the ratio stood at 7.25%. During the first half of 1994, the ratio increased further to 8.30% before decreasing to 7.33% by year-end (see Table 2.1 on the following page), largely due to a 27% increase in gross loans during the second half of the year. At the same time, the ratio of non-performing credits (defined as the 3 lowest of the 5 credit categories)[6] to gross credits (which include loans plus off-balance sheet exposures) increased steadily from 5.20% at the end of 1991, to 6.65% by 1992, to 8.15% by 1993, and finally to 8.80% by 1994.

2.25 The above two indicators of loan quality understate the extent of the deterioration of the loan portfolios. The ratio of past due loans to gross loans reflects the amount of arrears, rather than the amount of outstanding loans affected by arrears, which is usually significantly larger, especially for installment loans. The ratio of non-performing credits to gross credit risks is also understated to the extent that, in practice, banks tend to upwardly adjust the overall classification of their major debtors, in order to reduce the amount of loan loss provisions to be made. Secondly, rollovers or rescheduled loans, which should be presumed problem loans in most cases, are classified as performing loans or loans with minimal risk. Because of these shortcomings, published classifications do not accurately represent the true risk profiles of the banks' loan portfolios.

2.26 **Inadequacy of Loan Loss Provisions**. Mexican banks generally have not allocated sufficient provisions to cover their actual and potential loan losses (see Table 2.1 on the following page).

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[6] The five categories are: minimal risk (A); low risk (B); moderate risk (C); high risk (D) and loss (E), with the latter three categories considered as the non-performing component of the portfolio.

Table 2.1: Deterioration in Loan Portfolio Quality and Inadequacy of Loan Loss Provisions of Commercial Banks[1], 1991-94
(in million of NP and percentages, as of year-end)

	1991	1992	1993	1994
Gross loans[2]	240,153	336,907	421,126	594,205
Past due loans	9,828	18,757	30,527	43.544
Loan loss provisions	4,994	9,072	13,045	20,849
Equity	21,336	28,802	37,383	44,667
Ratios (%)				
Past due/Gross loans	4.09	5.57	7.25	7.33
Non-Performing credits/Gross credit risks[3]	5.20	6.65	8.15	8.80
Provisions/Gross loans	2.08	2.69	3.10	3.51
Provisions/Past due	50.81	48.37	42.73	47.88
Open loan exposure[4]/Equity	22.66	33.62	46.77	50.81
Open loan exposure/Adjusted stockholders' equity[5]	40.86	53.97	71.47	73.91
Net capital/Risk-weighted assets	7.73	9.01	9.94	9.60

1 Aggregates exclude two banks, Cremi and Union, which were intervened in September 1994.
2 Including discounted loans.
3 Gross credit risks include gross loans and off-balance sheet risks (i.e., discounted loans, guarantees and irrevocable letters of credit). Non-performing credits comprise loans classified in categories C, D, and E. Figures of gross and non-performing credit risks actually relate to the preceding quarter.
4 Open loan exposure is defined as the difference between past due loans and loan loss provisions.
5 Defined as stockholders' equity less revaluation surplus.
Source: CNB

Although aggregate loan loss provisions increased from NP5.0 billion at the end of 1991 to more than NP13.0 billion by 1993, the ratio of provisions to past due loans actually decreased from 50.8% to 42.7% during the two-year interval. The coverage decreased further to 40.7% by the end of September 1994, before rebounding to 47.9% by year-end, primarily in response to the adverse effects of the peso crisis.

2.27 One important indicator of the adequacy of a bank's portfolio provisions is the ratio of its open loan exposure (i.e., the difference between the level of past due loans and that of provisions) to its stockholders' equity. As shown in Table 2.1, the ratio for the commercial banking system as a whole (excluding Cremi and Union) more than doubled during the period under review from 22.7% at the end of 1991 to 50.8% by 1994. And if the banks' equity is adjusted downward by excluding the revaluation surpluses, the ratio of open loan exposure to equity increases significantly, from 40.9% at the end of 1991 to 73.9% by 1994. These ratios imply that even prior to the peso crisis, the level of the Mexican banks' provisions was inadequate. However, an accurate estimate of the shortfall in the banks' provisions cannot be derived without obtaining additional information relating to the true risk profile of the banks' loan portfolios, the aging of arrears, and the amount of loans affected by arrears (para. 2.25).

2.28 **Overstated Capital Adequacy Ratios and Profitability**. Notwithstanding the shortfall in the banks' provisions, the banks' capital adequacy ratios improved during the period 1991-1994, in response to the phased raising of the minimum required ratio of net capital to risk-weighted assets, from 6% at the end of 1991 to 7% by the end of 1992, and then to 8% by the end of 1993. As shown in Table 2.1 above, the average ratio increased from 7.73% at the end of 1991 to 9.94% by 1993, and still further to 10.27% by the end of September 1994, before decreasing to 9.60% by year-end, due to the losses incurred during December in the wake of the peso devaluation.

2.29 Financial statements of Mexican banks are prepared in accordance with CNBV guidelines which are based on Mexican Generally Accepted Accounting Principles ("Mexican GAAP"). These differ in a number of important respects from U.S. GAAP, including the definition and treatment of non-performing loans, of provisions and of the accrual of interest income on loans (Annex VIII). The main shortcoming of the Mexican banks' financial statements is the overstatement of bank profits, and hence of stockholders' equity. In addition to underprovisioning (paras. 2.26 and 2.27), two other factors distorted the banks' profitability ratios, namely, the accrual of interest on past due loans and the creation of loan loss provisions through a charge on capital reserves without passing through the income statement, which together resulted in overstating profits by some 40% during 1993-1994. It is estimated that during the two-year period 1992-1993, the amount of provisions created through capital charges totalled at least NP2.8 billion, which is equivalent to about 35% of the additional net provisions made by the banking system during the period, and to more than 18% of the net profits (including undistributed earnings from subsidiaries) generated by the system.

2.30 During 1993 and 1994, the amount of past due interest outstanding of the whole banking system (including all intervened banks) increased by about NP9.3 billion, to reach NP14.2 billion, which is equivalent to 25.7% of the system's past due loans. (Table 2.2 below.) This increase in past due interest accounted for 13.5% of the system's net interest income during the same period. Consequently, the banks' reported figures on net interest income are overstated. However, since banks are required to make provisions on their past due interest, presumably averaging about 48% of amounts past due, the extent of the overstatement of net operating income is reduced. Nevertheless, it is estimated that the banks' overstatement of net operating income during 1993 and 1994 was of the order of NP4.8 billion, equivalent to almost 40% of the system's aggregate net profit.

Table 2.2: Evolution of Past Due Interests of Commercial Banks, 1992-94
(in million of NP, as of end year/month)

	Dec 1992	June 1993	Dec 1993	June 1994	Dec 1994
Past due principal	14,729	21,434	24,362	31,044	40,888
Past due interest	4,862	6,836	8,320	10,581	14,156[2]
Past due loans[1]	19,591	28,270	32,682	41,625	55,044[2]

[1] These figures are higher than those indicated in Table 2.1, since they include Cremi and Union.
[2] Partly estimated.
Source: Derived from data published by CNB and the Dirección de Investigación Económica, Banco de Mexico.

2.31 **Supervision**. The institutional development plan initiated by the then CNB in mid-1994 (para. 2.18) was only just being implemented by its new management when the devaluation occurred. Thus, important deficiencies in banking supervision remained, although some improvements have been achieved since. Although the basic framework for implementing new policies and procedures for bank inspections is in place, there is not yet an adequate number of sufficiently trained and experienced inspectors to be fully effective. In particular, the CNBV's capacity to assess the level of risk in individual bank portfolios and the quality of banks' risk management needs to be improved. Since the devaluation, the former CNB and the recently merged CNBV's focus has been principally on asset quality and it has received technical assistance from the World Bank, foreign bank supervisors and others to improve its staff's capacity in this area. However, in the longer term, staff will need to improve their skills in treasury management (interest rate and foreign exchange rate risks), securities activities (market risk and market practices) and international financial activities. Improvement of the overall supervision of financial groups should also be a priority. The CNBV does not yet conduct formal consolidated supervision of financial groups or apply a capital adequacy rule for holding companies. These important regulatory and supervisory tools remain to be adopted.

E. Impact of the Devaluation on the Banking System

2.32 The banking system was severely shaken by the peso crisis following the December 1994 devaluation. The two immediate adverse effects were the foreign exchange losses incurred by several banks on account of their open short positions, and the impairment in the value of the banks' investments (consisting mainly of fixed-income securities) resulting from the sharp rise in interest rates which followed the collapse of the peso. In addition to these losses, banks are facing, on the one hand, significant liquidity pressures which substantially increase their funding costs and, on the other, an accelerated deterioration in the quality of their loan portfolios, the extent of which will depend on the duration of the excessively high interest rates currently prevailing.

2.33 **Exchange Losses**. Mexican banks are subject to two fairly restrictive limits on the relative size of their foreign currency-denominated liabilities and their net open foreign currency exposure. Under prevailing regulatory guidelines, banks are required to limit their foreign currency liabilities to no more than 20% of total liabilities, and their net open short or long foreign currency positions to 15% of their net capital. Despite these restrictions, and despite the fact that some banks recouped part of their losses by converting their net short positions into net long positions shortly after the devaluation, but before the further collapse of the peso, the net foreign currency losses incurred by the banking system were not negligible. Published financial statements indicate that at least eight banks (including the three largest) recorded significant fourth quarter losses. For the system as a whole, fourth quarter foreign exchange losses totalled about NP4.6 billion, equivalent to more than 10% of equity. No additional foreign exchange losses are anticipated in 1995, unless banks speculate on currency markets, since data published by the Central Bank indicates that at the end of 1994, the commercial banking system had an aggregate net long position of US$911 million.

2.34 **Interest Rate Exposure**. The banks' aggregate investment portfolio increased by about 84% in 1994 to reach the level of NP85.9 billion at year-end. The bulk of these investments consisted of fixed-income securities (NP55.8 billion), whose market value has been impaired by the significant hike in interest rates. In the aftermath of the peso devaluation, the CNB issued in January 1995 a new regulation requiring banks to value their securities at market prices and to disclose their unrealized gains or losses on their financial assets and liabilities in their off-balance sheet accounts as of end-1994. Published financial statements indicate that only Banamex realized losses on its securities portfolio, totalling NP869 million, equivalent to 7.9% of its equity at year-end. Most of the other banks showed unrealized gains, since the valuation method adopted by CNB (which differs from U.S.GAAP) takes into account both financial assets and financial liabilities. Thus the banking system, excluding Banamex, showed an aggregate unrealized gain of NP209 million, equivalent to 0.6% of equity. Including Banamex, the losses (both realized and unrealized) amounted to NP660 million, equivalent to 1.5% of the system's equity at year-end.

2.35 **Liquidity Problems**. At the end of 1994, aggregate deposits with the commercial banks (excluding Union and Cremi) totalled NP413.9 billion, of which 18.3% was denominated in foreign currency and 73.6% consisted of time deposits. The latter comprised promissory notes (NP164.6 billion), fixed deposits (NP89.2 billion), bank bonds (NP38.0 billion), and subordinated obligations (NP13.0 billion). About 15.6% of time deposits, or the equivalent of NP65.4 billion, were raised by the 13 banks that operated branches (28 in total) outside Mexico. The bulk of these time deposits consisted of U.S. dollar-denominated CDs, which reportedly amounted to about US$8 billion.

2.36 As a result of the peso crisis, the banks have come under heavy liquidity pressure, as they are finding it extremely difficult to roll-over maturing CDs. In fact, during the first three months of 1995, aggregate foreign currency-denominated deposits with the commercial banks (including Union and Cremi), decreased by 23% or by more than US$3.5 billion, to stand at end-March 1995 at US$11.8 billion, which is equivalent to 15.8% of total deposits.

2.37 The pressure on the banks was for awhile compounded by the Government's difficulty in dealing with the Tesobono problem. The liquidity assistance provided by FOBAPROA to the commercial banks (para. 3.5), which amounted to US$3.3 billion during the first quarter of 1995, has significantly improved the banks' liquidity position. However, the liquidity crunch will have significant adverse effects on the banks' average cost of funds and, hence, on their profitability during the first half of 1995.

2.38 **Loan Portfolio Quality**. As a result of the rapid rate of growth of their loan portfolios during a period of relatively slow economic activity in the country, Mexican banks were already saddled with high levels of non-performing loans when the peso crisis ensued (para. 2.24). The banks' concern with the rapidly deteriorating quality of their loan portfolios is reflected in the additional loan loss provisions made. In fact, aggregate new loan loss provisions made during the fourth quarter of 1994 amounted to more than NP5.3 billion, as compared to NP5.5 billion for the first three quarters combined. As a result of these heavy charges, coming on top of the foreign exchange losses, the impairment in the value of the securities portfolio, and the unrealized losses from the banks' subsidiaries, the banking system (excluding Cremi and Union) recorded during the fourth quarter of 1994 an aggregate loss before tax of NP3.5 billion, which is equivalent to 43% of their profit (before tax) during the first three quarters of the year, and to 7.9% of the equity at year-end.

2.39 Since most loans are repriced monthly, the prevailing high interest rates have quickly diminished borrowers' ability to service their debts. As part of the Government's revised economic program, monetary policy was tightened substantially, causing nominal interest rates on peso-denominated Treasury bills to rise to an average of 70 percent for the first four months of the year. Yet in real terms, these interest rates are low, since the rate of inflation in the four months of 1995 was equivalent to 84 percent on an annualized basis. Since mid-April, interest rates on short-term Government obligations have declined from a peak of more than 80% to a current rate under 60%. It has been projected that the economic program will steadily restore confidence and reduce inflation to less than half of current levels by the end of the year, so that nominal interest rates should fall by a similar magnitude. Should inflation remain stubbornly high or confidence resume only very slowly, high nominal interest rates would continue to exert a negative impact on bank loan portfolios.

2.40 The accelerated deterioration in the quality of the loan portfolios of 19 major commercial banks is illustrated in Table 2.3 below. In fact, the ratio of past due loans to gross loans (including discounted loans) of the group (which excludes Cremi and Union), increased from 7.4% at end-1994 to 8.4% by the end of January 1995, and further to 9.3% by the end of February 1995. If Cremi and Union, whose combined gross loans at the end of February 1995 stood at NP35.8 billion, of which 41.6% was past due, are included in the group, the ratio of past due loans to gross loans increases to 11.1%. Although banks increased substantially their loan loss provisions during the first two months of 1995 by an aggregate amount of NP7.9 billion, the ratio of provisions to past due loans remained inadequate at the end of February 1995: it stood at 50.5% for the group of 19, and at 45.7% if Cremi and Union are included. The increasing inadequacy of the banks' loan loss provisions is demonstrated by the jump in the group's ratio of open loan exposure to equity, from 53.4% at the end of 1994 to 74.3% by the end of February 1995.

Table 2.3: Accelerated Deterioration in Loan Portfolio Quality of Selected Commercial Banks[1]
(in million of NP and percentages)

	End Dec 1994	End Jan 1995	End Feb 1995
Gross loans[2]	587,012	602,533	611,834
Past due loans	43,491	50,477	56,924[4]
Loan loss provisions	20,813	22,466	28,735
Equity	42,436	42,578	37,926[5]
Ratios (%)			
Past due/Gross loans	7.41	8.38	9.30[6]
Provisions/Gross loans	3.55	3.73	4.70
Provisions/Past due	47.86	44.51	50.48[7]
Open loan exposure[3]/Equity	53.44	65.79	74.33
Net capital/Risk-weighted assets	9.40	8.66	7.75

[1] Aggregates relate to the largest 19 banks (excluding Cremi and Union, which were intervened in September 1994), accounting at the end of 1994 for 95.0% of the system's equity and for 98.8% of the system's gross loans (excluding Cremi and Union).
[2] Including discounted loans.
[3] Open loan exposure is defined as the difference between past due loans and loan loss provisions.
[4] With Cremi and Union, past due loans amounted to NP71,818 million new pesos.
[5] Partly estimated.
[6] Ratio increases to 11.09% if Cremi and Union are included.
[7] Ratio decreases to 45.70% if Cremi and Union are included.
Source: CNB

2.41 **Eroding Capitalization**. The significant new loan provisions taken and the increased funding costs have impacted negatively on the banks' capital position. During the first two months of 1995, the aggregate equity of the group of 19 banks decreased by NP4.5 billion or by 10.6%. Consequently, the group's average ratio of net capital to risk-weighted assets decreased during the interval from 9.40% to 7.75%. In fact, at the end of February 1995, 9 out of the 19 banks had ratios below 8%, as compared to only 3 at the end of 1994. The latest statistical data show that the banks' aggregate past due loans (including Cremi and Union), increased to around NP80 billion by the end of March 1995. This highlights the system's need for additional capital, which is supported by the Government's recent actions. The scarcity of capital would become considerably more acute if the prevailing high lending rates were to continue for a relatively long period of time, and the recession deepen.

2.42 **Estimates of Potential Bank Portfolio Losses and Fiscal Impact**. Estimating the overall cost of bank restructuring (including cleaning-up non-performing portfolios and recapitalizing banks) is important for the design of appropriate fiscal policy and for ensuring the preparedness of the authorities in responding to the financing requirements of bank restructuring. Any such estimate, however, is likely to be extremely tentative for several reasons. First, it is difficult to quantify potential losses of individual banks prior to completion of detailed portfolio audits, which are scheduled to start shortly. Second, it is difficult to estimate the extent to which such losses might be subsequently recovered (through loan collections and/or sale of assets), since these recoveries would depend on the macroeconomic outlook as well as the effectiveness of the recovery efforts to be pursued by the authorities and the banks. Third, it is equally problematic to estimate the magnitude of capital injection which could be expected from the private sector (existing and/or prospective shareholders) as the bank restructuring program unfolds, and which would correspondingly reduce the ultimate losses. Fourth and finally, in the present dynamic Mexican context, the condition of banks and firms is likely to change rapidly, and some losses will reveal themselves only over time. For these reasons, the loss estimate given below will need to be updated from time to time to reflect changing circumstances, and to take account of up-to-date information as it becomes available, in particular the results of diagnostic audits.

2.43 The loss estimate presented in Table 2.4 on the following page is based on available actual data as of end-March 1995 (i.e., gross loans outstanding, reported past due loans, actual provisions), supplemented by a number of adjustments (to take account of under-reporting and assets classification guidelines, etc.) and assumptions (e.g., 20% increase in gross loans, varying percentage increases in past due loans between March and September 1995). The basis for adjustments and underlying assumptions are explained in the footnotes to the Table. The data shows that, as of end-March 1995, the likely shortfall in portfolio provisions for the banking system (after some necessary adjustments), would range from NP24 billion to NP48 billion, with the median estimate at around NP36 billion (US$6 billion equivalent). Projections of the potential shortfall in provisions for the situation as of end-September 1995, based on varying assumptions of deterioration of the portfolio for planning purposes, show that this could increase from NP38 billion to NP96 billion, with the median estimate at NP65 billion (US$11 billion equivalent).

2.44 The Government will seek to mitigate the fiscal as well as the monetary impact of banking system losses through the application of appropriate financial modalities in carrying out the bank restructuring program (e.g., in cleaning up portfolio losses and recapitalizing banks).

Table 2.4: Potential Loan Portfolio Losses of Commercial Banks
(in billion of NP)

	Low Scenario	Intermediate Scenario	High Scenario
End March 1995			
Gross loans (1)	666.0	666.0	666.0
Reported past dues (1)	80.0	80.0	80.0
Actual Provisions (2)	48.0	48.0	48.0
Adjusted past dues (3)	120.0	140.0	160.0
Shortfall in Provisions	24.0	36.0	48.0
Percentage of Gross loans	3.6	5.4	7.2
End September 1995			
Projected Gross loans (4)	800.0	800.0	800.0
Assumed Increase in Past dues (%)	20.0	35.0	50.0
Projected past dues	144.0	189.0	240.0
Required Provisions	86.4	113.4	144.0
Potential Shortfall in Provisions (5)	38.4	65.2	96.0
Percentage of Gross loans	4.8	8.2	12.0

1 Including Cremi and Union. Gross loans include discounted loans, partly estimated.
2 As required by prevailing prudential regulations (60% of past due loans).
3 Taking into account loans affected by arrears (rather than the amount of the arrears), revised loan classification guidelines, and rollovers.
4 Assumed to be 20% over end-March level.
5 Assuming, conservatively, that no additional provisions will be made during March-September 1995.

These modalities are discussed in the "Operating Guidelines for Bank Restructuring" (Attachment II of Annex I) and in paras. 3.19 - 3.21. It is envisaged in particular that, while paying attention to the liquidity needs of restructured banks, the Government would minimize cash injection and instead issue bonds with maturities spread over several years. The median estimate of banking system losses of NP65 billion (approx. US$11 billion) would correspond to 4.0% of projected 1995 GDP while the high scenario loss estimate of NP96 billion (US$16 billion) would amount to 5.9% of GDP. The magnitude of banking system losses in relation to GDP for some other countries which have faced similar problems to Mexico are as follows: Ghana 6%, Hungary 10%, Finland 8%, Sweden 4.5%, and Norway 4%. If spread out over ten years, the annual burden of the high scenario losses for Mexico, including principal and interest (at 10% p.a. real), would be manageable as it would represent 0.9% of projected 1995 GDP.

F. Recent Government Measures

2.45 **Strengthened Supervision**. After the CNB was reorganized in mid-1994, it began to perform its duties of regulating and supervising banks with increased vigor. Thus, even before the December 1994 devaluation and the ensuing financial crisis, the CNB had intervened in two banks along with the financial group controlling such banks. A third financial group was intervened in February 1995 following inspection of its commercial bank by the CNB. (para. 2.50)

2.46 **Role of FOBAPROA**. Many of the Government's programs for providing support to the banking sector are channelled through FOBAPROA, the support fund for banks administered by the Central Bank. As described in Annex IX, FOBAPROA's role goes beyond simple deposit insurance. The fund has broad powers to extend credit to banks to permit them to meet their obligations to depositors and other liability holders. Since the December 1994 devaluation, FOBAPROA has maintained a dollar liquidity window for commercial banks (para. 3.5) and is the entity through which the Government administers the PROCAPTE scheme (paras. 3.12 - 3.13).

2.47 Credits granted by FOBAPROA to assist a bank in meeting its obligations to the public are referred to as "preventive support." FOBAPROA's operations are funded through annual and special contributions from commercial banks and from lending extended to FOBAPROA by the Central Bank. In return for preventive support (other than through PROCAPTE), FOBAPROA may require a pledge of the shares of the bank receiving such support, or of its financial holding company. FOBAPROA is also empowered to exercise the voting rights of shares that have been pledged to it. If amounts extended as preventive support are not repaid or if serious undercapitalization or irregularities are uncovered in a bank, FOBAPROA may vote the shares it has received in pledge, take majority control of the bank or financial group, replace management, write down the bank's capital in accordance with the results of a full audit and sell the bank.

2.48 **Interventions**. In June 1994, as a result of the discovery of irregular transactions in the course of regular bank inspections, the CNB ordered the administrative intervention of Banca Cremi and Banco Union, both commercial bank subsidiaries of the Grupo Financiero Cremi-Union. On September 6, 1994, after discovering numerous additional irregularities and evidence of fraud involving related party transactions affecting the soundness and solvency of these banks, the CNB removed the management of both banks and appointed a management intervenor for the group and its subsidiaries.[7] Since the appointment of the intervenor, losses of NP4,750 million from bad loans, fraud and the effects of the devaluation have been recognized and an additional NP2,350 million of capital were injected by FOBAPROA. The board of directors of the CNB approved the creation of an intervention committee to assist in resolving the intervened subsidiaries of Grupo Financiero Cremi-Union. The committee's goals include reassuring depositors and creditors that the intervened banks, with the support of FOBAPROA, will continue to comply with their obligations.

2.49 On February 16, 1995, immediately upon the effectiveness of the amendments to the Credit Institutions Law and Financial Groups Law clarifying FOBAPROA's power to vote the shares of financial institutions pledged as collateral for preventive support, this was done to

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[7] The CNB take-over of Cremi-Union was the first such intervention since the privatization of the banking system. Earlier in 1994, the CNB and FOBAPROA negotiated an arrangement with Banco Obrero (a bank owned by Mexican labor unions, which was never nationalized) under which FOBAPROA made a capital infusion of NP 300 million in exchange for a majority interest. Inspections of Banco Obrero had exposed insufficient capitalization and certain past management deficiencies.

effect a reduction of capital of each of the banks to zero and to issue to FOBAPROA new shares of capital stock in exchange for its preventive support. Thus, the original shareholders of the financial group and its subsidiary banks lost their entire equity in these entities and FOBAPROA became their sole shareholder.

2.50 In February 1995, the CNB ordered an immediate management intervention of Grupo Financiero Banpais - Asemex after inspections turned up sharply increased past due loans, a shortage of capital and irregular related party transactions. An intervenor and an intervention committee were appointed. The real condition of the financial group's bank (Banpais) and its other subsidiaries is currently being determined. Although this process is not yet complete, losses of approximately NP4,000 million are expected to be recognized.

III. THE GOVERNMENT'S FINANCIAL SECTOR RESTRUCTURING PROGRAM

A. Actions Already Taken by the Government

3.1 During the first quarter of 1995, the Mexican authorities overseeing the banking system (the Central Bank, CNB, and SHCP) initiated a number of actions to mitigate the negative impact of the peso crisis on the banking system. These included provision of liquidity, intensive inspections of banks resulting in increased provisions, and a temporary recapitalization scheme for banks. Since that time, in discussions with the Bank, these actions have been coordinated into an integrated program, and additional safeguards and policy reform measures identified to restructure the financial sector. The technical assistance necessary to enhance the authorities' capacity to manage and implement this far reaching program has also been reviewed. The Government has now put into effect a number of holding actions to reduce Central Bank credit risk in liquidity provision, and systemic risk in the payments process, and to contain losses and minimize risky behavior by troubled banks. The latter include: (i) prohibition of dividend payments by PROCAPTE banks; (ii) strict enforcement of the 8% capital adequacy rule; (iii) increased provisions; (iv) separate reporting of rollovers; and (v) limits on new lending and large exposures. The Government will keep these holding actions in effect throughout implementation of the program. In addition, the CNB will use moral suasion to restrict dividend payments by other banks in 1995. The CNB has also prepared an inventory of additional operating restrictions to be required of banks by the supervisory authorities, depending on the particular circumstances of individual banks (e.g., discontinuation of lending to adversely classified borrowers, limitation on new lending, establishment of internal control mechanisms, sale of non-core assets). These holding actions are shown in Box II of the Matrix of Policy Actions (Annex II) and in an annex to the Operating Guidelines for Bank Restructuring (attached to Annex I hereto).

3.2 The actions outlined above are being carried out during a time when the Government is also engaged in a major effort to build up the institutional capacity of financial sector authorities, particularly the CNBV. As noted earlier, in April 1994, the CNB was substantially reorganized and an institutional development plan was initiated to rationalize responsibility for on-site and off-site supervision and to modernize the training of inspectors and other staff. Implementation of the institutional development plan has also involved the hiring of a significant number of new staff at the management level. The CNB has recently been merged with the CNV (para. 2.20), so as to enable the consolidated supervision of financial groups including banking institutions and to achieve greater efficiency and coordination. The FTAL (Loan No. 3838-ME), signed in March 1995, is to assist CNBV and the Insurance and Bonding Commissions to modernize regulations and supervisory techniques and improve permanent training programs for their staffs.

B. Principles Guiding the Government's Program

3.3 The Government's program is guided by several important principles:

(a) the need to ensure the continued functioning of the credit and payments system while taking strong measures to contain losses;

(b) taking decisions on recapitalization of selected banks after determining their financial condition;

(c) putting in place a transitional program for recapitalization of banks to avoid further instability and allow time for shareholders to infuse additional capital;

(d) requiring diagnostic studies for intervened and PROCAPTE banks for clear recognition and sharing of losses;

(e) formulating and adopting a comprehensive set of guidelines ("Operating Guidelines"), setting out the basic principles and methodology for bank restructuring, including the treatment of bad assets;

(f) promoting credibility and market confidence through transparency in the procedures followed;

(g) restructuring loans of potentially viable borrowers in the real sectors facing short term liquidity problems; and

(h) reforming and modernizing the policy and institutional framework to enable the mobilization of increasing amounts of domestic and foreign capital, while putting the system on a sound footing to prevent future recurrence of similar problems.

3.4 The Government's program to restructure the financial sector is embodied in the attached Letter of Financial Sector Development Policy (Annex I), and described in the following paragraphs. The Letter of Financial Sector Development Policy is supplemented by three substantive technical papers: a Policy Matrix; the Operating Guidelines for Bank Restructuring; and a Statement on Development Finance Entities.

C. Maintaining Operations and Containing Losses

3.5 **Provision of Liquidity to Banks.** In the aftermath of the December 1994 devaluation, a number of Mexican commercial banks experienced extreme difficulty in renewing their maturing dollar obligations. The Government responded by establishing in early January 1995 a special window (as part of FOBAPROA) to provide short-term dollar liquidity at interest rates of up to 25%, secured by acceptable collateral. The total outstanding balances drawn by 10 of the commercial banks were about US$3.3 billion by March 31, 1995. After the December 1994 devaluation, the Central Bank began providing peso liquidity on an unsecured basis through special credit auctions as some banks were experiencing a shortage of eligible collateral. Outstanding balances stood at the equivalent of US$3.0 billion by March 31, 1995 and 15 banks had participated in such auctions.

3.6 In order to ensure that liquidity provision does not become a means to delay revelation of insolvency, since March 20, 1995 the Central Bank requires banks to post Government securities, NAFIN securities, and loans provided to prime borrowers as collateral in peso credit auctions. This provision will remain in place throughout the implementation of the program, and liquidity support from the Central Bank will take account of solvency considerations. The Government has also agreed to undertake studies to reform development bank lending to serve as a basis for the preparation of action plans for implementation (para. 3.32).

3.7 **The Payments System and Daylight Overdrafts**. The volume of intra-day credit or daylight overdrafts extended to commercial banks by the Central Bank immediately after the devaluation was unlimited. Thus, during the day its credit risk grew as the liquidity crisis worsened and some banks maintained daylight overdrafts greater than several times their capital. An organized system of risk safeguards was not in place to prevent the failure of one bank (e.g., with large peso daylight overdrafts) from causing a potential systemic problem. To improve operation of the payments system while implementing explicit safeguards to reduce its credit risk, a Circular issued on March 3, 1995 requires pricing of Central Bank intra-day credit on a real time basis, pledging of collateral by banks that maintain large and frequent daylight overdrafts with the Central Bank, and debit caps for the portion of daylight overdrafts not subject to collateralization. Finally, the Central Bank has indicated that commercial banks will be required to hold special non-interest earning clearing balances if daylight overdrafts are deemed to be too frequent. These actions will limit both credit risk and systemic risk. They will make solvency problems at commercial banks more apparent, triggering early decisions on continued intra-day or longer-term liquidity support.

3.8 To limit the risk of contagion through interbank transactions, the Central Bank issued a circular in March 1995 establishing the *Sistema de Pagos Electrónicos de Uso Ampliado* (SPEUA), a special clearing house for settlements of large value payments between Mexican commercial banks or between them and their foreign correspondents.[8] The system for netting of payments over this system (i.e., multilateral netting), combined with the imposition of bilateral credit limits, will substantially reduce the risks of contagion within Mexico's financial system. The Central Bank will also eliminate FOBAPROA coverage of settlements through SPEUA by March 1996. This will reduce the risk that participants in SPEUA do not implement proper risk safeguards because of the government's (FOBAPROA) guarantee of all bank liabilities (paras. 2.46 and 3.26). These measures, taken together, substantially minimize the systemic risk arising from inter bank transactions.

3.9 **Intensified Inspection**. In order to quickly assess the health of the banking system, beginning January 1995, the CNB initiated a program of intensified on-site inspection of

[8] The hardware and software of SPEUA are provided by the Central Bank while the risk safeguards are implemented by the commercial banks participating in the transfer of large value payments over the system.

commercial banks based on the CAMEL[9] system focussed on asset quality and provisions. These are being done on a targeted basis, beginning with the more vulnerable banks. This has revealed the precarious financial situation of some banks, whose capital would drop below the 8% required under the regulations if they were to set aside adequate provisions. Under the program, the CNBV expects to complete on-site inspections of all but four privatized banks by September 30, 1995, and the remaining four by December 31, 1995. The CNBV will continue to conduct such on-site inspections annually. Satisfactory progress in the completion of annual on-site inspections of banks is a requirement for the release of the Second Tranche.

3.10 **Monitoring Rollovers/Reschedulings/Large Exposure**. In order to prevent troubled loans from being automatically rescheduled with interest being capitalized and enabling banks to avoid provisions on them, on January 11, 1995, the CNB required all banks to separately identify roll-over loans for monitoring. In addition, the CNB required banks to maintain or reduce large exposures to return to compliance with applicable prudential regulations.

3.11 **Increased Provisions**. On February 22, 1995, the CNB required all banks to increase the level of provisions to the higher of: (a) 4% of the loan portfolio; or (b) 60% of past due loans; or (c) provisions required from quarterly loan classification. This led all banks to raise provisions, but in doing so, several banks fell short of the requirement for 8% capitalization.

3.12 **Temporary Recapitalization Program (PROCAPTE)**. On February 24, 1995, the Government introduced a program for temporary recapitalization (PROCAPTE, administered through FOBAPROA), for those banks which are unable to mobilize additional equity capital from existing shareholders to meet the 8% requirement. The principal characteristics of the PROCAPTE scheme are set out in Annex X. The program involves the issuance of subordinated convertible debentures up to an amount sufficient to raise each participating bank's net capital to 9% of its risk-weighted assets. The proceeds from the issuance are deposited in a special account in Banco de Mexico that carries an interest rate equal to that paid on the debentures. Whenever in the future a participatory bank's capitalization ratio falls below 8.5%, FOBAPROA will subscribe for an additional amount of subordinated convertible debentures sufficient to restore the bank's 9% level. If, however, a bank's capitalization ratio exceeds 9%, the bank has the option to redeem (partially or in full) the subordinated debentures held by FOBAPROA. FOBAPROA is required to convert the subordinated debentures outstanding at the end of five years into equity. However, the convertibility feature could be invoked earlier by FOBAPROA if a participating bank's equity capital falls below 2% of its risk-weighted assets, or if bank's capitalization (excluding the PROCAPTE obligations) varies more than 25% from the trend of average capitalization of all the banks participating in the program. Following discussions with the Bank, it has been agreed that FOBAPROA will, in any event, exercise the conversion and take over the ownership of any bank whose capital falls below zero percent.

3.13 Six of the nine banks that had deficient capitalization ratios at the end of February (i.e., Serfin, Comermex, Internacional, Centro, Confia and Oriente), joined the scheme at the end of

[9] Capital adequacy; Asset quality; Management; Earnings; and Liquidity, asset and liability management.

March[10]. The combined equity of these six banks, which amounted to NP10.2 billion at the end of 1994 (equivalent to 22.8% of the system's total equity), decreased by almost NP3.0 billion during the first two months of 1995. Consequently, the group's average capitalization ratio declined from 8.13% to 5.82% (Table 3.1). During March, four of the six banks managed to raise only a small amount of capital privately, totalling NP443 million. As shown in Table 3.2, the PROCAPTE obligations issued totalled NP6.5 billion, thereby enabling the banks to raise their average capitalization ratios to 9.60%.

Table 3.1: Ratio of Capital to Risk-Weighted Assets of PROCAPTE banks
(in percentages)

Bank	End December 1994	End February 1995	End March 1995
Serfin	7.99	4.84	9.77
Comermex	7.95	6.86	9.70
Internacional	8.40	6.74	9.37
Centro	8.08	7.91	9.60
Confia	8.55	6.60	9.06
Oriente	9.14	-0.79	9.00
Group of six	8.13	5.82	9.60

Table 3.2: Increase in Equity of PROCAPTE banks during March 1995
(in million of NP)

Bank	New capital injection	Convertible debt	PROCAPTE obligations	Increase in equity
Serfin	240	--	3,200	3,440
Comermex	30	--	1,400	1,430
Internacional	--	--	700	700
Centro	--	--	452	452
Confia	28	35	425	488
Oriente	--	110	311	421
Total	298	145	6,488	6,931

3.14 **Debt Restructuring - UDI Scheme**. The doubling of the NP-dollar exchange rate, the fourfold rise in interest rates, and the onset of recession are making it difficult for corporate borrowers in the non-export sector and many other debtors (e.g., consumers, home owners, state and municipal governments) to service bank loans. To minimize the risk of bankruptcy of firms that are viable in the long-run, the Government is: (a) reviewing means to reduce legal, tax, and

[10] Of the remaining three banks, one (Banpais) had already been intervened in February 1995, another (Mexicano) raised enough capital through a share capital increase and issuance of subordinated debt to improve its capitalization ratio above the 8% level, and a third (Probursa) was granted an additional month to meet the minimum capital adequacy requirement since negotiations with a foreign financial institution regarding a substantial capital injection had reached an advanced stage.

regulatory impediments to voluntary debt restructurings; and (b) actively promoting debt restructurings, given the acute nature of the crisis. The Government has introduced a number of Support Programs (*Programas de Apoyo*) to permit the restructuring of loans on the balance sheets of commercial banks and some development banks up to an aggregate ceiling of NP 170 billion (or about US$ 28 billion) including loans for: (a) industry; (b) housing; (c) states and municipalities; and (d) certain development banks loans. (Annex XI.) These programs use the *Unidad de Inversion* (UDI), a real unit of account. The Central Bank periodically adjusts the UDI's NP value based on an index of national consumer prices. Short-term NP-denominated, nominal interest rate loans would be converted into long-term UDI-denominated loans that have constant real interest rates, whose use is aimed at eliminating the inflation-uncertainty component of floating peso interest rates. The Government will lend funds to the banks to finance the restructured loans at a real rate of 4 percent (UDIs+4%) and borrow from the banks at market determined nominal interest rates based on the 28 day CETES rate. Thus, if the ex-post real CETES interest rate is higher than 4 percent (as is likely, particularly in the short-term), there will be a subsidy which will translate into a fiscal cost.

3.15 The Government has analyzed the potential fiscal cost of the UDI scheme, taking into account its inflationary impact. Additionally, the Central Bank has issued a circular to banks setting out basic criteria, modalities and procedures for the UDI scheme. It has been agreed that beginning January 1, 1996, CNBV will review the classification of assets in the UDI trusts as they evolve, and re-classify them every quarter, and require banks to build necessary provisions immediately. The CNBV will also, before March 31, 1996, (i) analyze the initial implementation experience of the UDI scheme and associated fiscal costs, and formulate changes, as appropriate; (ii) review the results with the Bank; and (iii) implement the revised scheme.

3.16 **Legal/Regulatory Framework for Corporate Workouts.** Containing the real impact of financial distress requires preventing closure of illiquid but ultimately solvent enterprises as well as efficient winding up of insolvent businesses. Unfortunately, the Mexican legal/regulatory framework is not conducive to corporate restructuring. Bank regulatory provisions limit the options available for restructuring. Legal, notarial, re-registration and other costs associated with restructuring can also be quite high. Bankruptcy reorganization procedures are outdated, time-consuming, costly and seldom lead to efficient workouts. There is also a general lack of confidence in how well the court system is equipped in terms of skills and processing capacity to handle what may turn out to be a large number of defaults.

3.17 The Mexican Bankers Association (ABM) has established a committee to develop initiatives for removing legal/regulatory obstacles to corporate restructuring. These include means of more rapidly and cheaply notarizing restructured loan and security agreements, facilitating registration of amended mortgages and initiating pre-default consultations among creditors. The ABM is also developing an arbitration procedure for resolving disputes among creditors in corporate restructurings. The Government recognizes that legal and regulatory changes are desirable to facilitate re-organization of troubled enterprises. The Ministry of Commerce has already begun work on improving the bankruptcy code. Accordingly, the Government will conduct a study of the obstacles to voluntary corporate debt restructuring (including recognition, execution and enforcement of out-of-court workouts and arbitration awards), review the findings with the Bank before December 31, 1995 and agree with the Bank on a plan of action by March 31, 1996 for removing unnecessary impediments to voluntary debt restructuring, through appropriate changes in regulations and/or the legal framework.

3.18 **Diagnostic Studies of Banks**. The inspections by the CNBV provide better information than was available hitherto on a bank's financial condition including capital adequacy under present Mexican accounting standards. However, the CNBV's inspection capacity is limited and its staff lacks experience in some technical areas (para. 2.31). In order to obtain accurate and consistent financial information, uniform accounting standards, consistent with U.S. GAAP, for loan classification and provisions need to be applied. Availability of such information is also essential for banks to be able to mobilize equity capital from the financial markets. Therefore, under the program, the CNBV has agreed to recruit an independent auditing firm under terms of reference acceptable to the Bank to assist the CNBV in conducting detailed diagnostic studies of intervened and PROCAPTE banks, and initiate the diagnostic study of at least one intervened bank before Effectiveness. The CNBV will complete the diagnostic studies and review results with the Bank: (a) by September 30, 1995 for two intervened banks; and (b) by December 31, 1995 for all intervened banks and PROCAPTE banks as of May 31, 1995. The CNBV has also agreed to initiate diagnostic studies of banks (not in the PROCAPTE/FOBAPROA programs as of May 31, 1995) within 90 days of their joining PROCAPTE or being intervened by CNBV or coming under the control of FOBAPROA, to complete such studies within a maximum of four months from the starting date, and to review the results with the Bank. Reviews of the results of the completed diagnostic studies with the Bank are requirements for the release of the Second Tranche.

3.19 **Bank Restructuring**. The initiation of detailed diagnostic audits for selected banks (para. 3.18) constitutes only the first step in formulating and implementing a comprehensive bank restructuring program. The Government recognizes the need to put such program on a sound, methodical and transparent basis. For that purpose, and following discussions with the Bank, it has formulated and approved a framework document entitled "Operating Guidelines for Bank Restructuring" (attached to the Letter of Financial Sector Development Policy, Annex I). The document (and the three technical papers annexed to it) sets out the main objectives, methodology and criteria for the restructuring of troubled banks. The four principal objectives of the restructuring framework are:

- to minimize the overall fiscal cost while adequately meeting the financial requirements of the restructured banks;
- to ensure an attractive environment for both domestic and international investors to participate in the capitalization of banks;
- to limit (financially and over time) the role of the public sector in the bank recapitalization process; and
- to promote the consolidation of the banking system through selective mergers or liquidations.

3.20 Experience demonstrates that for the rehabilitation of troubled banks to be successful, three goals should be pursued: first, losses should be covered in full, both in terms of stocks and of income flows; second, management responsible for the losses should be changed; and third, ownership structure should be changed. Experience also shows that successful bank restructuring usually entails: (a) on a system-wide basis, some consolidation through selective mergers or liquidations; and (b) at the level of individual banks, significant reduction in operating expenses through staff retrenchment and rationalization of the branch network.

3.21 The bank restructuring program should therefore encompass: (a) the closure and liquidation of those banks identified as fundamentally non-viable; (b) the merger of banks in order to improve their financial condition and operating efficiency; and (c) the organizational/managerial restructuring and recapitalization of troubled but potentially viable banks. In all these cases, two of the most important issues facing the authorities are the method of financing losses (including loss allocation between the Government and other parties) and the treatment of non-performing loans. To render a bank more attractive to prospective investors the non-performing loans would likely have to be removed from the bank's balance sheet. In the case of the Mexican banks that have already been intervened or those that would be intervened in the future, FOBAPROA could purchase these loans at book value (i.e., gross value less provisions already taken), thereby itself taking the loss. These assets should then be recovered or sold as quickly as possible, through auctions, securitization or any other appropriate market mechanism. The assets could either be lodged with the new bank or alternatively in a special trust fund (*fideicomiso*) for recovery or liquidation. A performance-based commission could be envisaged as an incentive for the recovery institution. An alternative method could be the creation of a "bridge bank" for every intervened bank. The "bridge bank" would take over the sound portion of the bank's portfolio, and then be sold as a clean bank, while the bad assets, contingencies and litigation liabilities are left in the bad bank for liquidation. The financial modalities/instruments to be used by the Government/FOBAPROA for cleaning up the banks' losses and their recapitalization should consist of an appropriate mix of cash and non-cash (offsetting of cross assets/liabilities; issuance of medium-term bonds), which would take into account the fiscal implications for the Government as well as the liquidity needs of the restructured banks. These modalities for financing the bank restructuring program and for the treatment of non-performing assets are described in the technical papers of the "Operating Guidelines" (Annex I - Attachement II).

3.22 The Operating Guidelines for Bank Restructuring (with its technical papers) have been approved by the Government prior to Board Presentation. Recruitment of investment banks and/or specialized consultants to assist in preparing specific restructuring plans for individual banks will be a condition of Effectiveness. The Government will submit and review with the Bank, restructuring plans including implementation strategies, approved by CNBV, SHCP and FOBAPROA, by September 30, 1995 for two banks under FOBAPROA control, and for any remaining banks within three months of the date of FOBAPROA taking control. Submission of the restructuring plans prepared in accordance with the Operating Guidelines, including implementation strategies, and approved by CNBV, SHCP and FOBAPROA, for all banks under FOBAPROA control, for review with the Bank, and continued satisfactory implementation of these plans are conditions of Second Tranche release.

D. Policy and Institutional Reforms

3.23 **Revision of Accounting Standards and Disclosure**. Financial statements of Mexican banks are prepared in accordance with CNBV guidelines, which differ significantly from U.S. GAAP. The principal differences are in the treatment of interest income on loans (and on rescheduled debts), and repurchase agreements, valuation of fixed assets, disclosure requirements, and the definition of non-performing assets. The accounting procedures used are thus not internationally comparable. In November 1994, CNB began preparation of draft guidelines reconciling Mexican and U.S. GAAP, with assistance from the Bank and in consultation with the U.S. Federal Reserve, FDIC and the corresponding bodies in Canada. The draft guidelines are now being discussed with the Mexican Institute of Public Accountants and Auditors after which they are to be reviewed with the Mexican Bankers Association. The Government recognizes the need to adopt uniform accounting principles for banks consistent with U.S. GAAP for use by auditors. It also plans to revise the accounting standards for financial groups. Therefore, under the program, the CNBV will formulate uniform accounting principles (including consolidation of financial statements), consistent with internationally accepted principles (U.S. GAAP) and acceptable to the Bank, and consistent across all transactions and activities, for financial statements and regulatory reports of banks by Effectiveness; and it will issue the revised standards to banks by September 30, 1995, requiring them to use the new accounting standards beginning January 1, 1996 for completion no later than year end-1996 accounts. Implementation will also be a condition for Second Tranche release. The CNBV will require auditors to strictly follow the guidelines for conducting audits issued under Circular 1222 of November 14, 1994 for banks, and under Circular 10-165 of January 4, 1993 for brokerage firms, and monitor auditors' performance, beginning with the audits of 1994 accounts. The CNBV will: (a) formulate, by September 30, 1995, draft acceptable uniform accounting principles, consistent with internationally accepted principles (U.S. GAAP) and consistent across all transactions and activities, for financial statements and regulatory reports non-bank financial institutions that are affiliates of financial groups with bank affiliates; and (b) issue these by December 1, 1995. The issuance of revised acceptable accounting standards for non-bank financial institutions is a condition of Second Tranche release. The CNBV has agreed to strengthen disclosure by banks to supervisory authorities requiring banks to submit new regulatory reports and special reports, and review progress with the Bank by September 30, 1995. The CNBV will also continue the ongoing efforts to improve disclosure to the public, and review progress with the Bank by September 30, 1995. In addition, the CNBV will complete by March 31, 1996, a study of ways to improve real estate appraisal standards, and to identify an institution that can undertake the regulation of appraisers.

3.24 **Reform of Prudential Regulations**. Prevailing prudential and supervisory regulations applicable to Mexican banks and financial groups need strengthening. Prudential regulations do not apply to financial groups, and conglomerates are not required to publish consolidated financial data, and submit consolidated regulatory reports; this has often led to regulatory and supervisory "arbitrage." The recent crisis has also highlighted weaknesses in such areas as asset classification, valuation standards for trading portfolios, troubled debt restructuring guidelines, capital adequacy standards for different entities within financial groups and on a consolidated basis for the entire group. Similarly, over the medium term regulations relating to large exposures on a group-wide basis, to consolidation of financial statements and reporting are also in need of substantial revision. There will be a need to formulate enforceable trading practice regulations in such areas as insider dealing, front running, dumping of securities (i.e., sale of securities by brokers to mutual and pension funds managed by such brokers or their affiliates), best execution of securities trades, and conflicts of interest. The new regulations should be conceived in a manner that promotes self-monitoring of financial groups by market participants or self-regulatory organizations such as the Mexican Stock Exchange. Finally, it is important to harmonize these standards to the degree possible with those adopted in other NAFTA countries and internationally.

3.25 To remedy the existing deficiencies in prudential regulations, the CNBV will issue supplemental internal instructions prior to Second Tranche release, acceptable to the Bank, for inspection of banks (including development banks), covering, inter alia, asset classification and provisioning, exclusion of *de facto* treasury stock (stock owned or financed directly or indirectly by related entities, or covered by repurchase agreements) for purposes of capital adequacy standards, composition of Tier I capital, large exposures and concentration, and related party lending. The CNBV will also, prior to Second Tranche release: (a) review with the Bank the need for the issuance of new prudential regulations for banks and issue such new regulations to the extent necessary; and (b) issue new prudential regulations with respect to capital adequacy standards for brokerage firms.

3.26 **Deposit Protection Scheme**. A savings protection scheme should primarily protect small, uninformed savers and accumulate reserves commensurate with potential risk. The present Mexican scheme leaves significant uncertainty regarding both the role and scope of the liabilities covered by FOBAPROA (the commercial bank support fund) and FAMV (the support fund for brokerage firms). While FOBAPROA is not a formal deposit insurance scheme and although there is no enforceable legal obligation of FOBAPROA or FAMV to support bank and brokerage firm liabilities beyond the funds' accumulated reserves, the Government has clearly indicated that the funds will support all bank and brokerage firm liabilities except subordinated debt (Annex IX). This sweeping support clearly reduces incentives for large creditors and depositors to monitor the performance of banks and brokerage houses. Moreover, the accumulated funds in FOBAPROA and FAMV clearly will not cover the losses of the current crisis. This means that fiscal expenditures will ultimately support the liabilities of failing banks and brokerage firms to the extent that depositors and other creditors are protected. Thus, over the medium term, Mexico needs to overhaul its current savings protection policy.

3.27 While the system needs to be changed in the medium term, the Government is rightly reluctant to do this in the midst of a crisis. Past experience in some other countries showed that reversing earlier pronouncements might instigate panic and capital flight, damaging economic recovery and financial development. Available data show that, in fact, deposits in Mexico's commercial banks rose by over 10% between end December 1994 and end March 1995. Peso deposits rose by 12% (from NP375.2 billion to NP422.8 billion), far exceeding 1.6% decline in foreign currency deposits (from NP 81.7 billion to NP80.4 billion equivalent) in the same period. Thus, during the remainder of 1995, the Government does not intend to change the coverage afforded to liability holders, although technical work towards reforms would begin.

3.28 The Government will complete by December 31, 1995, a study of liability coverage including a set of options for implementing an appropriate level of coverage for large liabilities of financial entities and their affiliates. The study will be reviewed with the Bank by March 31, 1996. The Government will adopt the revised protection scheme for phased implementation beginning January 1, 1997.

3.29 **Modernization of Legal/Regulatory Framework for Lending**. Although the overall framework for the financial sector was overhauled by the introduction of the Credit Institutions Law, the Capital Market Law and the Financial Groups Law and subsequent amendments, the Government recognizes that important shortcomings remain in the legal/regulatory framework for the business of mobilizing and allocating resources. Impediments to securitization restrict the amount of credit and other financing available to a number of sectors (in particular, housing finance). The lack of a comprehensive legal framework for lending secured by movable property distorts credit allocation and limits the availability of credit to small and medium enterprises. Unless remedied, these shortcomings will also importantly limit the scope for rapid improvement in the quality of credits originated by banks and the options available for restructuring and disposing of the assets of troubled banks. Details on the issues to be addressed to reform the framework for securitization and secured lending are in Annex XII. Under the program, the Government will conduct a study to identify remaining regulatory obstacles and legal impediments to asset securitization, and make the recommendations for removing such obstacles and impediments available to the Bank by December 31, 1995. Thereafter, CNBV and SHCP will initiate the process of removing such legal and regulatory obstacles. In the area of secured transactions, the Government will conduct a study to identify shortcomings of, and propose changes to, the legal/regulatory framework for secured lending and make recommendations available to the Bank by December 31, 1995. Thereafter, the Government will initiate the process of improving the legal/regulatory framework for secured transactions on the basis of such recommendations.

E. Development Banks

3.30 Each development finance entity (DFE) in Mexico utilizes its own eligibility criteria to determine access of private financial institutions to its funds. The criteria used, which are generally lax, differ across DFEs and even within different units of the same institution. Exposure limits are established by each operating unit for its respective operations, but the total financial obligations outstanding are not monitored in a centralized and consistent manner. This facilitates access in amounts that by far exceed the capital of certain commercial banks and might absorb substantial portions of a bank's liabilities. For example, BANPAIS and Mercantil - PROBURSA[11] had outstanding obligations with NAFIN and BANCOMEXT in excess of 200% of their capital at the end of 1994.

3.31 The pricing of financial products offered by DFEs is based on administered rates and does not reflect risk differentials or market funding costs. In domestic currency, intermediaries of different credit quality have access to public funds at uniform rates that are generally below the opportunity cost of private sector funds. In addition, the respective rates are based on a flat or negative yield curve, thus undermining the development of medium and long term private sector funding. The spread to be charged by the intermediary to the final borrower is generally fixed at the second tier level[12].

3.32 Overall, DFEs provide a rich variety of arbitrage opportunities to private financial intermediaries (FIs) through credit, liquidity and portfolio investment that have contributed to the lack of discipline and market clearance which partially accelerated the financial weakening of many private intermediaries during recent years. If unchecked, development finance could undermine the discipline of a rational resolution process. In addition, the fiscal impact of

[11] BANPAIS has been intervened recently and Mercantil-PROBURSA is currently negotiating the sale of the majority shareholdership with a European bank in a move to avoid entering into PROCAPTE.

[12] The credit unions generally do not operate a variety of financial products, which makes it much more difficult to charge a higher rate by adding fees on other products. Besides, they do not have significant private sources of funds and therefore cannot average out the interest rate charge on loans like commercial banks.

uncollectible assets with weak private FIs could become a sizeable fiscal burden in the near term. Arbitrage opportunities among sources of capital from DFEs therefore need to be reduced and demand driven selectivity fostered, based on the principles of consistency, transparency and efficiency. Also, lending and other financial exposure of the DFEs should be limited to private FIs that demonstrate solvency. Prior to Effectiveness, SHCP will present terms of reference, satisfactory to the Bank, for studies of: (a) the impact of establishing risk-based exposure limits for the liabilities of each FI to DFEs; (b) the establishment of eligibility criteria for FI participation in DFE second-tier operations (such study to include an analysis of the impact of establishing rating requirements from qualified private agencies); and (c) the current interest rate policy in domestic and foreign currency, including an evaluation of its incentive structure and impact on financial markets and final borrowers. SHCP, prior to release of the Second Tranche, will also review results of the above studies with the Bank, prepare an action plan and take the necessary official action to implement such action plan.

IV. BANK GROUP STRATEGY IN MEXICO'S FINANCIAL SECTOR

A. The Bank

4.1 The Country Assistance Strategy paper being distributed along with this document sets out in detail the Bank Group strategy in Mexico. It also covers IMF and IDB activities. Annex XIII provides the status of Bank Group operations in Mexico.

4.2 The World Bank supported Mexico's adjustment program during the FY 1986-1991 period with loans totalling almost US$ 11.4 billion. Half of this amount was committed under sector adjustment loans in trade, finance, agriculture, transport, industry, and for an interest reduction loan linked to Mexico's external debt reduction package with commercial banks. The FY89 Financial Sector Adjustment Loan (FSAL) supported important policy reforms to deregulate Mexico's financial system, which proved critical to the recovery that ensued. The FSAL supported the deregulation of interest rates on deposits, elimination of forced lending, and reduction of the role of special trust funds as intermediation channels for Government resources and elimination of reserve requirements on peso deposits. The FSAL also supported efforts to begin to modernize banking regulation and supervision. Since FY 92, annual lending has averaged US$1.4 billion, with no adjustment loans proposed until now. By FY 91, adjustment lending fell to 25 percent of total commitments; and the forms of operations shifted to poverty reduction, human resource development and environment, while maintaining a strong program in infrastructure.

4.3 The Country Economic Memorandum: Fostering Private Sector Development in the 1990s (Report No. 11823-ME, May 16, 1994), addressed the remaining constraints to financial sector development in Mexico. The Bank, jointly with the IMF, subsequently undertook a review of the Mexican financial system. The Bank continued to develop this diagnostic work through informal sector work during FY93 and FY94. In the second half of 1994, the Bank prepared policy options papers for the incoming administration that addressed the financial sector, contractual savings and commercial law reform.

4.4 The $23.6 million equivalent Financial Sector Technical Assistance Loan (FTAL No. 3838-ME), approved on January 24, 1995 and signed on March 9, 1995, was intended to meet three interrelated objectives: (a) to improve the safety and soundness of the financial system through improved prudential regulation and supervision, and through greater incentives for self-regulation of market participants; (b) to support the development of the pension system; and (c) to strengthen public investment evaluation and budgeting. The loan was a logical extension of previous efforts to emphasize transfer of specialized human capital and institution building to support the modernization of Mexico's regulatory framework and supervisory capacity. The loan is designed to support a flexible program addressing the emerging issues of concern in development of the Mexican financial sector. The FTAL is being restructured in order to provide the technical assistance required to accelerate support in areas of immediate need such as inspections and diagnostic studies of banks and to assist the Government in selecting advisors to prepare bank restructuring plans. However, to ensure the implementation of the essential elements of the original FTAL program, as well as address technical assistance needs for the development of financial markets in Mexico in the medium-term (e.g., completion of consolidated prudential regulation and supervision across all financial intermediaries, improvements in contractual savings schemes inclusive of the SAR accounts, and further development of the legal and regulatory framework for asset-backed securities (securitization) and capital markets more broadly), a supplemental loan is also planned for the restructured FTAL.

4.5 The onset of the current economic crisis required the Bank to intensify its analytical and diagnostic work on the causes of the problems and their evolution, drawing upon experience of similar system wide operations in other countries. The objective was to ensure that the acceptable actions are taken by the Mexican authorities to restore the safety and soundness of the banking system. In collaboration with the Mexican authorities, the Bank assisted in identifying measures additional to those already initiated and in accelerating the schedule in order that the problem is managed and its eventual costs contained. The main focus was on ensuring that long standing regulatory, legal and institutional impediments are removed, to permit the financial system to more efficiently mobilize and allocate resources. This proposed first operation is aimed at dealing with the immediate problems through speedy recognition of the problems and potential losses through intensified inspections and diagnostic studies, and disposal of troubled banks. Subject to satisfactory progress of the immediate program, a follow-on operation of $500 million is planned during this calendar year to address medium term policy and institutional issues facing the sector including development of contractual savings.

4.6 The proposed operation is designed as an adjustment loan with two tranches. The proceeds of the loan are intended to help the Government support the cost of restructuring its financial sector so as to overcome the current crisis, to enable the continued functioning of enterprises in the productive sectors, and to lay the basis for the development of a healthier financial system.

4.7 In the context of recent experience in financial sector operations in Mexico and other countries, the Bank has drawn several important lessons that have been taken into account in designing the reforms under the proposed loan. The main lessons of recent experience relevant to this operation are the following:

- Programs to restructure troubled financial institutions are successful only when designed to promote institution building, the strengthening of market forces, and improved oversight by reform-oriented governments.

- Restoration of macroeconomic stability and early progress in implementing reforms are critical for establishing investor and consumer confidence.

- Government ownership, project design, and quality at entry are enhanced when the Bank and the government have developed a close policy dialogue supported by strong economic and sector work.

- Conditions for tranche release should be clearly defined and easily monitored for compliance.

- Priorities for technical assistance should be carefully identified and supported with rigorous supervision.

B. The IFC

4.8 In recent years, IFC's operational strategy in Mexico has supported the private sector in adapting to the opening of the economy and in re-entering the international financial markets. Although greater emphasis is presently being given to second-tier companies, IFC's investments in Mexico have in the past been primarily directed at the large corporate firms and have mainly involved capacity expansions and modernization. Mexico's capital markets, tourism, food processing, general manufacturing, and, to a lesser extent, petrochemicals have benefitted most from IFC's recent operational activities. Operations in infrastructure have remained modest due to the slow progress achieved by the Government in resolving outstanding regulatory issues.

4.9 The special problems confronting Mexico today will give IFC a unique opportunity to increase the pace of its investments in that country. Besides the opportunity to build on the corporate restructuring experience that IFC acquired in Mexico in the mid-1980s, the recent events will provide the Corporation with renewed opportunities to diversify its local equity at a time when these had become largely limited to quasi-equity transactions among second-tier and unlisted companies. Based on the emerging needs of the local private sector, the anticipated portfolio growth will be primarily driven by new investments in the general manufacturing, capital markets, and infrastructure sectors. The Bank and IFC will closely collaborate through the proposed loan to identify banks and companies for financial assistance. IFC is similarly working with the Bank through the proposed Infrastructure Privatization Technical Assistance operation in exploring ways to support the privatization process and to arrange financing and securitization for new investment projects. The IFC's Foreign Investment Advisory Service (FIAS) is providing advice to SECOFI on strengthening Mexican producers of parts, components and intermediate goods in the post-NAFTA context.

4.10 In the *manufacturing sector*, IFC will continue to give priority to second-tier companies. However, the special circumstances facing Mexico will also dictate that it provides selective support to those larger industrial groups which it had helped graduate to the international financial markets in recent years and which now face unusual investment financing constraints. In *capital markets*, IFC will focus on providing liquidity to give stimulus to sectors such as SMEs, infrastructure, and housing at a critical time when the Government's response to current economic imbalances is likely to be recessionary. Additionally, it will seek to enhance the Mexican securities markets through underwriting facilities and institution-building activities. In the *infrastructure sector*, IFC will respond to the Government plans to accelerate privatization in power, satellite communications, ports, airports, railways and highways. To that effect, it will assist the local private sector in remedying some of the financing constraints which have thus far adversely affected the pace of infrastructure privatization in the country. However, IFC's success in diversifying its activities in this sector will depend heavily on Government steps to establish shortly the regulatory framework required to attract private investors into infrastructure services.

C. Coordination with the IMF

4.11 The Bank has been working closely with the IMF in monitoring the macroeconomic situation in Mexico and advising the Government in this area. Given the IMF's direct role in financing the stabilization program, their team has naturally led the dialogue on macroeconomic stabilization measures, exchange rate policy, and liability management issues. In fiscal policy, the IMF has concentrated on developing macro-level targets, while the Bank's sectoral background has enabled us to advise on sectoral policies. In the financial sector, the Bank has a lead role, due to our experience through our lending for banking sector reform in other coutries, and in preparing the FTAL. The IMF and the Bank will coordinate especially closely in implementing the Financial Sector Restructuring Loan, because of the inter-dependence of financial and macroeconomic stability. The impact of macroeconomic adjustment on social programs is of concern to both institutions, and the Bank is sharing with the IMF its analysis in this area during the course of the stabilization program. Finally, macroeconomic stability will depend critically on Mexico's ability to increase domestic savings and productivity. The Bank's planned analytical work in these areas will be shared with the IMF, so that it can feed into the evolving macroeconomic framework.

V. THE PROPOSED LOAN

A. Background

5.1 The proposed operation is a strong response to the current economic crisis, and would help ensure that acceptable actions are taken by the Mexican authorities to restore solvency and soundness of the banking system. The loan is also a critical element in the coordinated response of the World Bank, IMF, IDB, the US Treasury and other multilateral and bilateral lenders to assist Mexico in resolving its macroeconomic and financial sector crisis. The program design is an outcome of intensive discussions between the Bank and Mexico's financial authorities between January and April 1995. As noted earlier, it builds on significant actions initiated by the Government immediately following the crisis. Basic agreement on the strategic approach for program design was reached in early March 1995. The IDB staff also participated in discussions in Mexico City in March and April, and took the lead in the area of development banks and trust funds. The IDB is also preparing a separate project mainly to strengthen NAFIN's institutional capacity to carry out its many functions.

B. Tranching and Conditions

5.2 **Tranches.** The proposed Bank loan of US$1,000 million is to be disbursed in two equal tranches of US$500 million each. The first tranche will be available for disbursement upon loan effectiveness. The second tranche is expected to be released about nine months following effectiveness. The tranching is based on the: (a) substantial policy and institutional reform measures taken by the Government to arrest further deterioration and restore solvency to the system; (b) associated costs already incurred to date and the anticipated costs in the immediate future; (c) balance of payments and financing needs for the rest of this year; and (d) need to provide a clear signal of support to the markets.

5.3 The Government's Letter of Financial Sector Development Policy (Annex I) and the Matrix of Policy Actions (Annex II) describe the program, actions already taken, and future actions for restructuring of the financial sector. The actions taken prior to negotiations and Board presentation, and the main conditions of loan effectiveness and release of Second Tranche are summarized below.

5.4 Before negotiation of the loan and presentation to the Executive Directors, the Guarantor has:

(a) provided the Bank with a signed letter of Financial Sector Development Policy (para 3.4);

(b) submitted to the Bank the approved "Operating Guidelines" for bank restructuring (para. 3.19);

(c) created an inventory of operating restrictions for use by the supervisory authorities as necessary vis-a-vis selected banks depending on their individual condition (para. 3.1);

(d) analyzed the estimated fiscal costs of the UDI scheme (para. 3.15); and

(e) provided a statement on development finance entities (para. 3.4).

5.5 **Conditions of Effectiveness**. Before the effectiveness of the loan, in addition to ensuring continued implementation of the economic stabilization program described in the Letter of Financial Sector Development Policy, and progress in the execution of the FSRP, the Guarantor will have or caused to have taken the following actions, acceptable to the Bank:

(a) recruited an independent auditing firm to assist in the preparation of diagnostic studies of banks, and initiated the diagnostic study of at least one intervened bank (para. 3.18);

(b) recruited investment banks or specialized consultants or firms to assist in the preparation of restructuring plans of banks (para. 3.22);

(c) formulated uniform accounting principles (including consolidation of financial statements) consistent with internationally accepted principles (U.S. GAAP), and consistent across all transactions and activities for financial statements and regulatory reports of banks (para. 3.23); and

(d) furnished terms of reference for studies on: (i) the impact of establishing risk-based exposure limits for the liabilities of each FI with regard to the DFEs; (ii) the establishment of eligibility criteria for FI participation in DFE second tier financial operations and the impact of establishing rating requirements by qualified private agencies; and (iii) the interest rate policy in domestic and foreign currency, including an evaluation of its incentive structure and its impact on financial markets and final borrowers (para. 3.32).

5.6 **Conditions of Second Tranche Release**. Before release of the second tranche, in addition to ensuring continued implementation of the economic stabilization program described in the Letter of Financial Sector Development Policy, and progress in the execution of the FSRP, the Guarantor will have or caused to have taken the following actions, acceptable to the Bank:

(a) reviewed with the Bank the results of all completed diagnostic studies for PROCAPTE banks and intervened banks (para. 3.18);

(b) made satisfactory progress in executing CNBV's inspection program of banks and reviewed the results with the Bank (para. 3.9);

(c) submitted to the Bank for its review the restructuring plans of banks under FOBAPROA control (including implementation strategies), prepared in accordance with the Operating Guidelines and approved by CNBV, SHCP and FOBAPROA (para. 3.22);

(d) made satisfactory progress in the execution of the bank restructuring plans (para. 3.22);

(e) issued regulations for revised uniform accounting principles (including consolidation of financial statements) for banks, consistent with internationally accepted accounting principles, for application beginning January 1, 1996 and completion no later than for year-end 1996 accounts (para. 3.23);

(f) issued revised accounting principles (including consolidation of financial statements) for non-bank financial institutions that are affiliates of financial groups with bank affiliates, consistent with internationally accepted accounting principles (para. 3.23);

(g) issued supplemental internal instructions, for inspection of banks (including development banks) covering, inter alia, asset classification and provisioning, exclusion of de facto treasury stock (stock owned or financed directly or indirectly by related entities, or covered by repurchase agreements) for purposes of capital adequacy standards, composition of Tier 1 capital, large exposures and concentration, and related party lending (para. 3.25);

(h) reviewed with the Bank the need for the issuance of new prudential regulations for banks and issued such regulations to the extent necessary (para. 3.25);

(i) issued new prudential regulations with respect to capital adequacy standards for brokerage firms (para. 3.25); and

(j) (i) reviewed the results of the studies (para. 5.5(d)) with the Bank; (ii) prepared an action plan on the basis of such reviews; and (iii) taken all necessary official action for the implementation of such action plan on the basis of a phased implementation schedule (para. 3.32).

C. Implementation Arrangements

5.7 **Program Coordination**. To ensure adequate coordination of all Government agencies responsible for financial sector regulation, supervision and resolution of troubled banks and timely implementation of the program, an ad hoc Financial Sector Working Group has been established by the Government. The President of the CNBV serves as Chairperson of the Working Group, which includes officials of the SHCP, the Central Bank (including FOBAPROA), the CNSF, and the CONSAR. The Working Group would also serve as the primary counterpart for all communications with the Bank regarding program implementation and would provide periodic progress reports to the Bank.

5.8 **Technical Assistance.** The FTAL is being redesigned to support the now urgently needed technical assistance support for implementation of the FSRP (e.g., for diagnostic studies, additional assistance from FDIC and OCC to the CNBV inspection teams, and design of restructuring plans for troubled banks). A coordinated, timely and transparent process is being established for the selection of investment banking advisors that will assist the CNBV and FOBAPROA in bringing intervened or FOBAPROA owned banks quickly to the point of sale. Assistance from such advisors should also enable the Government to transfer ownership at less cost than through other means.

D. Procurement and Disbursement

5.9 No recent Country Procurement Assessment on Mexico is available. However, Mexico's procurement regulations (*Ley de Adquisiciones y Contrataciones*, December 1993), include a special provision authorizing the application of procurement procedures of international financial institutions in the procurement of goods, works and services financed by such organizations. Private sector procurement is generally conducted on the basis of competitive procedures. Loan proceeds would be used to finance the foreign exchange cost of general imports, with the exception of goods financed by other bilateral and multilateral agencies, luxury goods, military equipment and other goods specifically prohibited in a negative list defined under the Standard International Trade Classification or equivalent classification. Goods imported by public and private sector entities valued at US$10 million or more would be procured through simplified international competitive bidding procedures in accordance with Bank guidelines (January 1995), using Bank-issued standard bidding documents, and commonly traded commodities may be procured through other channels of competitive procurement acceptable to the Bank. Contracts for imports valued at less than US$10 million would be awarded by government entities following public sector procedures, and by other purchasers, in accordance with established commercial practice. For commodities under existing contracts, Bank retroactive financing would not exceed the average price per unit for such commodities as posted in the recognized international markets. All contracts above US$10 million will be subject to prior review by the Bank.

5.10 Disbursements would be made in two tranches. Nacional Financiera, S.N.C., the borrower and financial agent for the Loan, would be responsible for submitting withdrawal applications and would maintain separate records and accounts for all transactions under the Loan. Retroactive financing would be permitted for eligible imports as of March 9, 1995 up to a maximum of US$200 million equivalent. Retroactive financing is justified given the reform measures already undertaken by the Government. The aggregate value of expenditures for petroleum products and food-stuffs will not exceed US$50 million equivalent. The minimum contract size under the loan will be US$50,000 equivalent. Disbursements would be made against Statements of Expenditures (SOEs) for contracts below US$10 million. For contracts valued at US$10 million or more, disbursements would be made against full documentation. The minimum value for each SOE submitted would be US$10 million equivalent. Documentation for withdrawals under SOEs would be retained by NAFIN and made available for the required audit, and for review by the Bank during supervision. The loan closing date would be December 31, 1996.

E. Accounts and Audit

5.11 NAFIN will maintain separate records and account for all transactions under the Loan. An audit report by independent auditors acceptable to the Bank will be submitted to the Bank within four months after the last disbursement under each tranche. Audit reports would include a separate opinion from the auditor with respect to withdrawals made against SOEs.

F. Monitoring and Reporting

5.12 Monitoring of and reporting on the implementation of the overall program described in the letter of financial sector development policy will involve the follow-up of each of the program's multiple components. The assessment of the health of the banking system will require that relevant government agencies report on the findings of intensive inspections and diagnostic studies of individual banks. In cases where conditions relate to restructuring or sale of individual banks, monitoring will involve detailed reviews by the Bank of the restructuring plans for each institution. Monitoring of procedural changes and design of regulations will be undertaken through supervision and through periodic reports submitted to the Bank that indicate the status or represent drafts or final regulations.

5.13 Monitoring and reporting will be facilitated through the close coordination of activities and implementation agencies supported by the FTAL. Under the FTAL, technical assistance will be provided to assist the Government in implementation of the overall program. To ensure a timely response, the ad hoc Financial Sector Working Group will coordinate compliance with all reporting requirements. Within the Bank Group (and the IDB), monitoring of the overall program will require intensive supervision, which will be provided by an inter-disciplinary team comprising both suitable Bank Group staff (at the Regional and Central level, and IFC) and external experts with requisite experience in specific areas (bank restructuring, asset management, financial workouts). A significant part of the supervision work will be carried out from the field, through the assignment of suitable staff to the Resident Mission in Mexico City. One important objective of supervision should be to help achieve a degree of integration of the overall program, apart from monitoring its individual components.

G. Benefits and Risks

5.14 **Benefits**. Immediate actions included under the program will help contain the losses of the banking system while enabling continued functioning of the credit and payments system which is essential for the real sectors. Successful implementation of the program will lead to increased confidence in the financial system, and restructuring of banks will restore their soundness. The revision in accounting practices and disclosure requirements will improve the quality of information on banks, thereby enabling early recognition of future problems besides allowing market regulation. Improvements in prudential regulation and supervision and the legal/regulatory framework for lending will lead to a more efficient, sound and stable financial system. Together these actions will enable the financial system to mobilize increasing amounts of domestic and foreign capital.

5.15 **Risks**. The principal risks are: (i) failure to maintain a satisfactory macroeconomic framework and the resulting continuation of high inflation and interest rates; (ii) political intervention in the implementation of policy and institutional reforms in the financial sector or in decisions on restructuring of banks; and (iii) shortage of technical capacity in government entities or poor coordination among them leading to delays in implementation. These risks are mitigated by the strong support of the Government for the program. The loan contains safeguards to stop disbursement in the event of deteriorating macroeconomic conditions or unsatisfactory performance under the program. The Government's macroeconomic stabilization program is being supported by close collaboration with the IMF and an IMF Standby Agreement equivalent to 688 percent of quota. In the event of a significant setback in the results of this program (for example, if inflation or interest rates fail to decline in line with the trajectory envisaged in the program), the IMF would assist the Government in revising the program appropriately. The implementation of diagnostic studies and establishment of a transparent framework and criteria for restructuring of banks will reduce the risks of political intervention. Provision of technical assistance under the FTAL will help ensure timely availability of the additional skills required for implementation. To improve coordination among Government agencies, an ad hoc Financial Sector Working Group has been established with participation from the CNBV, the Central Bank and the SHCP.

5.16 **Social Impact**. In the short term there is likely to be some loss in employment in the privatized banks. However, as the restructuring program proceeds and the capital base of the banks improves, employment levels should stabilize. The employment losses come at a time of a downturn in economic activity in general and weak overall employment growth. The Government has taken measures to strengthen the social safety net, particularly with respect to support for the unemployed (1995 Country Assistance Strategy). The Government's Program of Essential Social Services is supported by a separate Bank loan (Report No. 14392-ME, May 22,1995).

5.17 **Environmental Impact**. There are no negative environmental impacts associated with this loan, which therefore, has an environmental rating of "C".

VI. RECOMMENDATION

6.1 I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank, and recommend that the Executive Directors approve it.

Richard H. Frank
President *ad interim*

Washington, D.C.
May 24, 1995

Attachments

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Government's Letter of Financial Sector Development Policy
(English Translation of Original Document in Spanish)

May 19, 1995
Particular Secretariat
Mexico, D.F., Mexico

MR. RICHARD H. FRANK
President *ad interim*
International Bank for Reconstruction
and Development
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In the last few years, Mexico has carried out far-reaching structural and macroeconomic reforms which will make it possible to set the basis for the achievement of a sustained economic development. However, in recent years the improvement in economic performance has been accompanied by a reduction of private domestic savings and a persistent increase in the current account deficit, even though public finances remained at a healthy level. Moreover, even though the growth in exports, particularly manufactured goods, has been extraordinary, imports increased dramatically, stimulated by abundant private capital flows, the increase in real income, commercial liberalization, and the appreciation of the real exchange rate.

At the beginning of 1994, the combination of adverse political events, increased interest rates in the U.S., and investor concerns over the sustainability of the exchange rate regime and the current account deficit began to generate pressures in the exchange and financial markets. In order to stem these pressures, the authorities raised interest rates, placed a greater amount of *Tesobonos* (Treasury bonds indexed to the exchange rate), implemented greater exchange rate flexibility within the floating band, and made use of international reserves. However, these measures calmed the markets only until early November. In the middle of that month, new pressures in the market and political events produced a substantial fall in international reserves that culminated in an exchange crisis and led to the floating of the Mexican peso after December 22.

The change in the exchange regime did not contribute to a restoration of confidence and foreign investors in the market began to sell their holdings in financial instruments denominated in pesos, as well *Tesobonos*. Also, in the context of this speculative attack against the peso, concerns arose over Mexico's capacity to repay maturing short-term foreign obligations. Under normal circumstances, such obligations would have been renewed, but given the uncertainty prevailing in the market, the Government found it difficult to place new securities at the same time as the maturity of the foreign currency liabilities of some commercial banks was approaching. At the end of December the new peso had devalued by 44 percent and the *CETES* interest rates reached a level in excess of 30 percent.

For this reason, on January 3 of this year, the Unity Agreement to Overcome the Economic Emergency (*Acuerdo de Unidad para Superar la Emergencia Económica*) was signed. Despite the announcement of this Agreement, the markets did not react as expected, which contributed to the continued devaluation of the exchange rate. For this reason, on March 9, 1995, the Government of Mexico announced the Action Program to Strengthen the Unity Agreement to Overcome the Economic Emergency (*Programa de Acción para Reforzar el Acuerdo de Unidad para Superar la Emergencia Económica* -- PARAUSEE). This agreement contains specific measures to strengthen the financial system.

In parallel, negotiations were conducted on a loan package with the international financial community to support the country's economic strategy. These culminated in obtaining an unprecedented financing for a total among of US$52 billion, of which the U.S. Treasury Department contributed US$20 billion, the International Monetary Fund US$17.8 billion through a contingent credit agreement (Stand-by), the Bank for International Settlements US$10 billion and the rest coming from other bilateral and multilateral sources.

I. IMPACT OF THE ECONOMIC CRISIS ON THE BANKING SYSTEM

Before the present economic crisis, the banking system already showed certain signs of weakness, among the most notable of which were the inadequacy of preventive reserves and the increase in non-performing loans, which became more acute with the economic crisis, further weakening the banking system. Accordingly, it was necessary for the Government to design a Program for Restructuring the Financial Sector (*Programa de Reestructuración para el Sector Financiero* -- PRSF), with the objective of maintaining its stability and the effective functioning of the payments system. It is the Government's desire that such program be partially financed with resources from the World Bank and Inter-American Development Bank.

The main short-term impacts of the economic crisis on the banking sector were the absence of liquidity in foreign currency and the deterioration of the quality of assets as a consequence of the increase in non-performing loans, as well as the decline in the value of securities held by the banks.

As for the liquidity crisis, mechanisms were established to assure the timely performance of the obligations of the banks, without permitting such mechanisms to be used to hide insolvency problems of credit institutions.

The uncertainty generated in the markets over the economic situation of our country made the refinancing of liabilities of banks in foreign currency difficult. In order to guarantee the timely repayment of these obligations, the Bank Fund for Savings Protection (*Fondo Bancario de Proteccion al Ahorro* -- FOBAPROA) established lines of credit in favor of the banks without sufficient resources to cover their obligations in foreign currency.

For its part, the Bank of Mexico issued new criteria to limit its risk as lender of last resort, as well as to eliminate the risk of interbank contagion, requiring collateral from banks to cover their overdrafts if these are of important amounts. These policies are part of a permanent effort to make the payments system more efficient.

The increase in interest rates and contraction of the economy have caused a substantial increase in the levels of non-performing loans of the banking system from 8.3 percent in September 1994 to 10.2 percent in March 1995[1]. It is expected that the deterioration of non-performing loans will continue for some time. In virtue of the foregoing, the Mexican banking system recorded a significant decapitalization, for which it was necessary to adopt measures to guarantee the strength and solvency of the banking system which are contained in the Financial Sector Restructuring Program.

II. ACTION PROGRAM TO STRENGTHEN THE UNITY AGREEMENT TO OVERCOME THE ECONOMIC EMERGENCY (PARAUSEE).

To confront the economic crisis, the Mexican Government adopted the PARAUSEE, which contains, among others, specific measures to strengthen the financial system.

The purpose of PARAUSEE is: to reduce the current account deficit to levels commensurate with the availability of external financing availability; to limit the inflationary impact of the devaluation; to maintain the Government's social programs; and to recover, in the shortest time possible, economic growth, price stability and employment levels.

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[1] These figures exclude Cremi and Unión.

The fundamental elements of this Program are: (i) an increase in the Value Added Tax (IVA) by 50 percent beginning April 1, from a 10% to a 15% rate (a zero percent rate is maintained for processed foods and medicines to protect the lower-income population); (ii) an increase in the price of goods and services provided by the public sector to reflect their cost structure after the devaluation (gasoline, electricity and other energy products); (iii) a reduction of programmable public spending by 9.8 percent in real terms, compared to 1994; (iv) the establishment of a limit of 2 percent limit of GDP on net loans granted by development banks to the private sector (half of its recorded level in 1994); (v) the protection of essential social spending; (vi) setting of a NP10 billion limit on domestic credit from the Banco de Mexico for 1995; (vii) maintenance of the floating exchange rate regime determined by the market; and (viii) deepening of structural change measures, particularly through privatizations of infrastructure and telecommunications.

Even though inflation during the first semester will be high, with the implementation of this Program, the Government hopes a rapid deceleration will occur during the second semester with a rate of about 5 percent achieved for the last quarter with this pattern continuing during 1996. Similarly, an interest rate reduction is expected, as well as a surplus in the trade balance of US$5.4 billion, which will be reflected in a reduction of the current account deficit from approximately 8 percent of GDP during 1994 to 4.3 percent by the end of 1995. Even though negative growth in the economy is expected for 1995, recovery is expected for 1996.

III. PROGRAM FOR RESTRUCTURING THE FINANCIAL SYSTEM (PRSF)

During the first semester of 1995, the Mexican authorities have undertaken a series of measures to address the banking crisis. These include: higher preventive reserve requirements; a temporary capitalization program; a strengthening of overall financial institution supervision, including the merger of the National Banking and Securities Commissions into a single entity; reforms to financial legislation to increase foreign and domestic investor participation in holding companies, banks and brokerage firms, as well as their acquisition by foreign financial institutions; a reduction in the limit on related credits from 20 percent of total portfolio to an amount equal to net capital; creation of investment units; and establishment of asset restructuring schemes. Among the more noteworthy of these measures are:

Temporary Capitalization Program: In response to the increase in reserve requirements for credit risks, and as a result of the decapitalization of the banking system, the Mexican Government, through FOBAPROA, established the Temporary Capitalization Program (*Programa de Capitalización Temporal* -- PROCAPTE).

The purpose of PROCAPTE is to facilitate the capitalization of banks that have levels below 8 percent of risk assets. Under this Program, FOBAPROA will acquire mandatory convertible subordinated debentures issued by participating banking institutions in amounts sufficient to increase their capitalization to 9 percent. The subordinated debentures must be converted by the fifth year. However, FOBAPROA will be able to convert earlier if basic capital is less than 2 percent (excluding PROCAPTE debentures) or when the capitalization level deteriorates by a percentage greater than 25% relative to the rest of the PROCAPTE banks. The duration of the program will be five years and there will be no fiscal impact.

In practice, it has been observed that PROCAPTE has created incentives for voluntary capitalization by bank shareholders.

Restructuring Program in UDIs: The Mexican Government, in coordination with the Mexican Bankers Association, has agreed to programs for restructuring into Investment Units (*Unidades de Inversión* --UDIs). The programs are based on the restructuring of credits in domestic currency into obligations denominated in UDIs with longer maturities.

UDIs are units of account in which commercial contracts may be denominated, principally deposits and banking credit. Its main characteristic is the maintenance of its value in constant real terms, since UDIs are adjusted daily by inflation.

Restructuring credits into UDIs permits the elimination of accelerated amortization due to inflation and reduces significantly the cash flow that the debtors must pay, since in credits denominated in these units inflation is capitalized and debtors have to pay only the real interest rate, permitting very important cash flow relief. This will also translate into an improvement in the quality of the banks' credit portfolios.

Finally, the fiscal impact of this scheme will be monitored and, if necessary, appropriate adjustments will be made.

Additional Measures: At the end of 1994, in the interest of availing itself of international experience, the Mexican Government agreed with the World Bank on a technical assistance loan for the financial sector which will support supervision and regulatory activities. Notwithstanding the measures taken during the first semester of 1995, it is believed necessary to continue deepening the restructuring of the financial system to guarantee its strength and efficiency. Accordingly, the Mexican Government has adopted the PRSF and has decided to modify the above-mentioned loan in order to adapt it to new circumstances and support the PRSF. It is expected that the PRSF will include a first phase with the immediate technical and financial support of the World Bank and the Inter-American Development Bank. Additionally, a second phase is foreseen to give continuity in the medium term to actions to strengthen the banking system, which would be supported by these financial institutions and other bilateral creditors.

The objectives of the PRSF are the following: (i) support the restructuring of those banks that require it, thereby containing the impact of the crisis and minimizing its fiscal costs; (ii) strengthen the capitalization of the commercial banks; (iii) modify accounting principles to make them consistent with international standards; (iv) reform prudential regulation to the extent necessary; (v) strengthen banking supervision; and (vi) change the regulatory framework in order to modernize the banking system. The principal measures contained in the PRSF are described in Annex 1 to this letter and include:

1) Holding actions: The CNBV has established measures to prevent banks from taking on excessive risks that may increase their losses. Such measures, which are described in Annex 1, will remain in force throughout the crisis.

2) Assessment of the banking system: In order to more quickly understand the current situation of the Mexican banking institutions, the CNBV has accelerated the conduct of on-site inspections, based on CAMEL procedures. Additionally, special diagnostic studies will be undertaken to provide a more thorough diagnosis of banks intervened by the CNBV, those under FOBAPROA control and those participating in PROCAPTE.

3) Banks restructuring: In order to correct the capitalization problems of some commercial banks and assure that they remain under private sector ownership, general restructuring criteria have been approved to be utilized in accordance with the particular circumstances of each bank, which are included in Annex 2 of this document. Specialized consultants will be hired to participate in the design and implementation of the plans for restructuring and sale.

4) Accounting principles and quality of financial information: Since accounting principles applied to the Mexican banks differ from international accounting practices, these principles will be modified to make them consistent with such practices. The foregoing will improve the quality of financial information available to the authorities and the general public.

5) Prudential regulation: In order to improve the security and soundness of financial institutions, compliance with prudential regulation in banking supervision will be strengthened. In addition, necessary modification will be made to such regulation so as to make it consistent with international practices.

6) Amendments to the legal regime: Studies will be undertaken to analyze the need for modifying the legal regime in order to: (1) determine the extent of FOBAPROA coverage in the future; (2) eliminate obstacles to restructuring and securitizing credits; and (3) facilitate secured transactions.

7) Development banking: The Government of Mexico believes it appropriate to achieve greater consistency in the application of criteria and, in general, improve the transparency of relations of development banks with commercial

banks. Accordingly, studies will be undertaken to analyze eligibility criteria, concentration of risk and interest rate policy in order to strengthen the development banking system. Annex 3 describes the actions taken in this area, as well as the expectations for the next few years.

The Government of Mexico believes that the implementation of the PRSF will strengthen and continue the process of modernizing the banking system and that, taken together, these measures will contribute to placing the financial system in a healthy position that accords with a modern economy. In order to ensure the success of the program, close coordination among the responsible authorities will be maintained.

Finally, it is of fundamental importance to underline the Government's willingness to carry forward the necessary changes that will allow for the development of a financial sector in general and for the banking system in particular, in such a way that these will support the national productive sector.

Signed

Guillermo Ortiz
Minister of Finance

Attachments

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN
Policy Matrix

I. MACROECONOMIC POLICY FRAMEWORK	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. Because of the unsustainable current account deficit, the Mexican peso was allowed to float on December 22, 1994. With the support of an IMF stand-by arrangement, the Government is implementing a comprehensive set of economic measures to stabilize the economy and improve confidence. The economic program covers tight fiscal and monetary policy; a floating exchange rate; acceleration of some structural reforms; and measures to address the financial sector's difficulties; the program is being implemented with substantial financial support of the IMF, the U.S. and others.	*1. Satisfactory progress in implementing the macroeconomic program announced on March 9, 1995. 2. Maintenance of the macroeconomic policy framework consistent with the objectives of the Financial Sector Restructuring Program (FSRP) and throughout the FSRP.

II. HOLDING ACTIONS TO LIMIT FINANCIAL LOSSES	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. There could be substantial risks that some of the troubled banks could behave in ways that would magnify and propagate financial losses. 2. CNBV has implemented a set of holding actions to immediately address the financial difficulties and limit financial losses. 3. Action Program: Keep holding actions in place at least until completion of on-site MACRO[1] inspections of the health of all banks, diagnostic studies of the banks, and satisfactory preparation and implementation of bank restructuring plans.	*1. CNBV prohibited payment of dividends by banks that receive PROCAPTE/FOBAPROA funds. *2. CNBV will use moral suasion to stop privatized[2] banks (outside PROCAPTE) from distributing dividends in 1995. *3. Required banks with a capitalization ratio below 8% to raise additional capital or enter PROCAPTE. *4. Provisioning requirements for privatized banks increased to the greater of: (a) 4% of the loan portfolio; (b) 60% of past due loans; or (c) the provision required from loan classification (Circular 13254-1137, dated February 22, 1995). *5. Roll-over loans separated for enhanced monitoring to insure that banks do not automatically capitalize interest and thereby avoid provisions (Circular 1229, dated January 11, 1995). *6. Limits placed on new lending by PROCAPTE banks (i.e., the increase in the capitalization ratio due to PROCAPTE funds can not be used to extend new lending). *7. CNBV has required banks to reduce large exposures and related party exposures. *8. CNBV and FOBAPROA created an inventory of operating restrictions for use depending on the condition of banks.

* Actions already taken.

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1. MACRO is the Spanish acronym of CAMEL (capital adequacy; asset quality; management; earnings; and liquidity, asset and liability management).

2. The term "privatized banks" refers to those banks that were returned to private ownership in 1991/92 and does not include banks operating under new charters granted since the privatizations.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN
Policy Matrix

III. DISCIPLINE IN THE PROVISION OF LIQUIDITY SUPPORT AND OTHER RESOURCES

Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. Achieve greater discipline and transparency in the provision of liquidity and other resources to the financial system 2. Action Program: Policies, guidelines and procedures that will result in greater discipline in the provision of liquidity and other resources to banks from (i) Banco de Mexico, and (ii) development finance entities (DFEs).[3]	*1. Banks required to post collateral in peso credit auctions per Banco de Mexico Circular telefax 23/95, dated March 20, 1995. 2. SHCP to present terms of reference, satisfactory to the Bank, for studies of: (a) the impact of establishing risk-based exposure limits for the liabilities of each financial intermediary (FI)[4] to DFEs; (b) the establishment of eligibility criteria for FI participation in DFE second-tier operations[5] (such study to include an analysis of the impact of establishing rating requirements from qualified private agencies); and (c) the current interest rate policy in domestic and foreign currency, including an evaluation of its incentive structure and impact on financial markets and final borrowers. 3. SHCP to prepare an action plan on the basis of such studies and take the necessary official action to implement such action plan.

IV. MANAGEMENT OF THE CENTRAL BANK'S CREDIT RISK AND RISK OF CONTAGION IN THE INTERBANK MARKET

Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. The Central Bank had borne substantial credit risk and exposure as lender of last resort due to inadequate controls on intra-day credit extended to banks. There was also risk of contagion from failure by insolvent banks to perform their obligations to solvent institutions. Reform of the intra-day market to make it a self-liquidating mechanism would eliminate the risk to the Central Bank and solvent participating banks. 2. Action Program: A program of actions to reduce the Banco de Mexico's credit risk and risk of contagion in the inter-bank market.	*1. Banco de Mexico has implemented a series of measures to reduce risk of contagion and the Central Bank's exposure to credit risk in extending daylight overdrafts. *2. Banco de Mexico has undertaken measures: (a) under Circular-telefax 16/95, dated March 3, 1995, regarding steps to reduce its credit risk[6]; (b) under Circular 2016/95, dated March 7, 1995, regarding steps to limit the risk of contagion in the inter-bank market[7]; and (c) under Circular 2017/15, dated March 10, 1995, requiring delivery versus payment in the trading of commercial banks liabilities.

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3. The term development finance entities NAFIN, Bancomext, FIRA, FIDEC, and FOVI.

4. The term financial intermediary includes all institutions such as banks, leasing and factoring companies, credit unions, etc.

5. The term second-tier operations refers to loans, guarantees, investment portfolio, interbank market operations and other risk assets of DFEs with FIs.

6. Pricing of intra-day credit, requirement of collateral for daylight overdrafts, debit caps for uncollateralized portion of daylight overdrafts, and requiring special non-interest earning clearing balances, if daylight overdraft are frequent.

7. Establishment of clearing house for large value transfers (Sistema de Pagos Electrónicos de Uso Ampliado - SPEUA).

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN
Policy Matrix

V. ASSESSMENT OF HEALTH OF THE BANKING SYSTEM	
Issues, Objectives and Action Program	Prior Actions/Commitments
1. The peso devaluation and its aftermath have had a severe impact on the banking system. High interest rates have affected both corporate and individual private borrowers. An accurate assessment of the true health of banks is essential to develop measures to restore solvency and soundness of financial institutions and thereby improve confidence in the financial system. 2. Action Program: (a) MACRO inspections to verify asset quality and provisions. Examiners from the US FDIC, OCC and Federal Reserve to begin training CNBV staff by June 15, 1995 with financing under FTAL. Additional technical assistance on supervision policy, asset classification criteria, manuals and training will be provided under the restructured FTAL. (b) Diagnostic studies to ensure an accurate assessment of the financial and operating condition of intervened and PROCAPTE banks.	1. Inspections: (a) Completion of on-site MACRO inspections, focusing on asset quality, on a targeted basis: (i) by September 30, 1995, for all privatized banks except four banks; and (ii) by December 31, 1995 for the remaining four privatized banks. (b) Conduct annual inspections thereafter. 2. Diagnostic Studies: (a) CNBV or FOBAPROA will employ an independent auditing firm for assistance in diagnostic studies of banks. (b) <u>For Intervened and PROCAPTE banks</u>: CNBV and FOBAPROA to complete diagnostic studies (applying uniform accounting standards consistent with internationally accepted standards (U.S. GAAP) and loan classification) with the assistance of independent auditing firm(s) of (i) two intervened banks by September 30, 1995; and (ii) all intervened banks and PROCAPTE banks as of May 31, 1995. (c) <u>For Banks not yet in PROCAPTE</u>: CNBV to (i) initiate diagnostic studies of banks (not in the PROCAPTE/FOBAPROA programs as of May 31, 1995) within 90 days of their joining the PROCAPTE scheme, being intervened by CNBV or coming under the control of FOBAPROA (without the bank going through PROCAPTE scheme); and (ii) complete such studies within four months from the starting date.

VI. RESTRUCTURING OF BANKS	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. In light of the deterioration in the financial condition of banks, tightening of regulations on asset classification as well as inspections, and deterioration of the enterprise sector, more banks may see their capital decline to levels below the minimum limits, and their ownership could then come under the control of FOBAPROA. 2. Legal changes to further liberalize shareholding by domestic and foreign investors made on February 15, 1995. 3. The Government will prepare the bank restructuring plans and implement thereafter agreed plans (i.e., liquidation, merger, or offer for sale) for the intervened banks quickly in a transparent manner according to market mechanisms.	*1. CNBV, SHCP and FOBAPROA have defined principles, processes, procedures, organizational arrangements, and methodologies for restructuring of banks including approaches to the treatment of non-performing loans ("operating guidelines"). [*] 2. SHCP has put into effect the final operating guidelines (see Attachment 2). 3. CNBV or FOBAPROA to retain/recruit investment banks and/or specialized consultants or firms to assist in the preparation of restructuring plans of banks. 4. The Government to prepare restructuring plans including implementation strategies in accordance with the operating guidelines: (a) by September 30, 1995, for two banks under FOBAPROA control[8]; and (b) for any remaining banks under FOBAPROA control within three months from the date of FOBAPROA taking control. The restructuring plans will be approved by CNBV, SHCP and FOBAPROA. 5. Implement the bank restructuring plans.

8. Including PROCAPTE banks, taken over by FOBAPROA.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN
Policy Matrix

VII. CORPORATE AND OTHER DEBT RESTRUCTURING	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. Enterprises have been undergoing structural reforms over the past several years, and a significant number of smaller enterprises in particular were experiencing difficulties in 1994. Financial distress in the corporate sector expanded rapidly in early 1995 due to high interest rates and effects of the devaluation, and intensified due to a decline in the value of assets used as collateral, and lack of access to alternative forms of financing. 2. The Government has introduced a series of loan restructuring programs based on the Unidad de Inversión (UDI) to enable banks to refinance loans to viable borrowers facing liquidity problems. The programs include industrial loans, housing loans, loans to states and municipalities, and loans financed through development banks. 3. Action Program: (a) Facilitate corporate and other debt restructuring based on sound guidelines and market discipline, with due consideration to fiscal costs. (b) Continue work on improvements in guidelines for supervision of restructured debts. (c) Keep continuing watch during inspections of 1995 on the sound use of the UDI scheme by banks.	[*] 1. Analyzed the estimated fiscal costs of the UDI scheme (including subsidy and tax revenue implications). 2. (a) Conduct a study of obstacles to voluntary debt restructuring (including recognition, execution and enforcement of out-of-court workouts and arbitration awards); and (b) adopt a plan of action by March 31, 1996 for removing unnecessary impediments to voluntary corporate debt restructuring, through appropriate changes in regulations and/or legal framework. 3. Beginning January 1, 1996, CNBV to review classification of assets in the UDI trust as they evolve, and re-classify every quarter, and require banks to build necessary provisions immediately. 4. CNBV to: (i) review by January 31, 1996 adequacy of criteria applicable to debt restructuring; (ii) formulate changes, as appropriate; and (iii) issue a circular with revisions, as necessary, to banks by March 31, 1996. 5. Before March 31, 1996: (i) analyze the initial implementation experience of the UDI scheme and associated fiscal costs; (ii) formulate changes, as appropriate; and (iii) publicize the revised scheme.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN
Policy Matrix

VIII. STANDARDS FOR ACCOUNTING, DISCLOSURE AND QUALITY OF FINANCIAL INFORMATION	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. Mexican Generally Accepted Accounting Principles (GAAP) differ in some significant respects from internationally accepted standards (U.S. GAAP). The principal differences for bank accounting are in the treatment of interest income on loans (and on restructured debt) and repurchase agreements, valuation of fixed assets, disclosure requirements and the definition of non-performing assets. Mexican banks generally prepare their financial statements according to CNBV guidelines reporting in accordance with the form of general ledger and rules published in CNBV circulars. 2. Draft regulations reconciling the U.S. and Mexican GAAP are under preparation. FTAL will provide TA as needed. 3. Action Program: (a) Formulate uniform, accounting standards consistent with internationally accepted principles (U.S. GAAP) and acceptable to the Bank, and require their use. (b) Strengthening of disclosure requirements. (c) Enforce audit guidelines. (d) Strengthen appraisal standards for real estate inclusive of methodology for determining derived investment value.	1. CNBV to formulate uniform accounting principles (including consolidation of financial statements), consistent with internationally accepted principles (U.S. GAAP) and consistent across all transactions and activities, for financial statements and regulatory reports of banks. 2. Issue, by September 30, 1995, revised, uniform accounting principles for banks, and require banks to use new accounting standards (including consolidation of financial statements) beginning January 1, 1996, for completion no later than for year end-1996 accounts. 3. Formulate, by September 30, 1995, uniform accounting principles, consistent with internationally accepted principles (U.S. GAAP) and consistent across all transactions and activities, for financial statements and regulatory reports for non-bank financial institutions that are affiliates of financial groups with bank affiliates (first draft). 4. Issue, by December 1, 1995, revised accounting standards (including consolidation of financial statements) for non-bank financial institutions that are affiliates of financial groups with bank affiliates. 5. Continue strengthening disclosure by banks to supervisory authorities requiring banks to submit new regulatory reports and special reports. 6. Continue ongoing efforts to improve disclosure by CNBV to the public[9]. *7. All credit bureaus required to provide services to all providers of credit (financial and non-financial institutions). 8. Improvements in quality of financial information: (a) CNBV to require auditors to strictly follow audit guidelines for audits of banks and brokerage firms, and monitor auditors' performance, beginning with audits of 1994 accounts[10];and (b) CNBV to complete, by March 31, 1996, a study of ways to improve appraisal standards for real estate, and to identify institution that can undertake the regulation of appraisers[11].

9. Including related party lending by banks.

10. Audit guidelines have been issued for brokerage firms (Circular 10-165 issued January 4, 1993), and banks (Circular 1222 issued November 14, 1994).

11. CNBV maintains register and has current qualification criteria.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Policy Matrix

IX. REFORM OF PRUDENTIAL REGULATIONS AND STRENGTHENING OF SUPERVISION

Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. Improve safety and soundness of financial institutions through modernization of prudential regulations, as necessary, and strengthened supervision based on accepted international practices. These measures will enhance the transparency of health of the financial institutions and thereby help prevent recurrence of systemic problems, as well as enhance the confidence of the international investment community in Mexico's financial system. They should also increase incentives for commercial bank management to measure and better manage exposure to risk. Carefully drafted regulations can also encourage self regulation and self-policing by financial institutions. 2. Financial Sector Technical Assistance Project (Loan No 3838-ME) is providing technical assistance. 3. Action Program: Revised standards for asset classification including provisioning.	1. CNBV has begun work on revisions required for supervisory purposes in asset classification and provisioning, and related party lending. Work is also underway on composition of Tier I capital for purposes of capital adequacy. 2. CNBV to issue supplemental internal instructions, for inspection of banks (including development banks) covering, inter alia: asset classification and provisioning, exclusion of de facto treasury stock (stock owned or financed directly or indirectly by related entities, or covered by repurchase agreements) for purposes of capital adequacy standards, composition of Tier I capital, large exposures and concentration, and related party lending. 3. CNBV will review the need for the issuance of new prudential regulations for banks, and thereafter will issue such new regulations to the extent necessary. 4. CNBV to issue new prudential regulations with respect to capital adequacy standards for brokerage firms.

X. LIABILITY PROTECTION SCHEMES

Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
1. There is a need to review the extent of liability protection provided by FOBAPROA and FAMV (types of entities that should be covered and the appropriate degree of coverage) in order to reduce moral hazard and overall liability.	1. Complete a study of liability coverage, by December 31, 1995, and formulate a set of options for implementing the appropriate level of coverage provided on large liabilities of covered financial entities and their affiliates, by March 31, 1996. 2. Approve and adopt revised protection scheme for phased implementation beginning January 1, 1997. 3. Regulations approved to eliminate FOBAPROA coverage of settlements through SPEUA by March 31, 1996.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Policy Matrix

XI. MODERNIZATION OF LEGAL/REGULATORY FRAMEWORK FOR LENDING	
Issues, Objectives and Action Program	Prior Actions/Actions to be Taken
Securitization of Bank and Non-Bank Originated Assets 1. Impediments to efficient securitization schemes importantly restrict the amount of credit available to some sectors (in particular, housing finance) and limit the market-oriented options available for restructuring and disposing of troubled bank assets. 2. Improved framework for securitization of bank and non-bank originated assets will help improve the efficiency of the financial system. 3. Action Program: (a) Establish clear legal/regulatory framework for securitization of bank and non-bank originated assets, including mortgages. **Secured Transactions** 1. Existing legal framework does not permit lending secured by many types of movable property, restricting credit availability and reducing the potential value of bank assets. 2. Improved framework for secured transactions will enhance the efficiency of the financial system. 3. Action Program: (a) Make necessary changes to the legal/regulatory framework for secured transactions. (b) Improved system of registries.	**Securitization of Bank and Non-Bank Originated Assets** 1. Conduct a study to identify remaining regulatory obstacles and legal impediments to asset securitization and recommend by December 31, 1995 actions to remove such obstacles and impediments. 2. CNBV and SHCP to initiate the process of removing legal and regulatory obstacles. **Secured Transactions** 1. Conduct a study to identify shortcomings of, and propose changes to, the legal/regulatory framework for secured transactions by December 31, 1995. 2. Initiate the process of improving the legal/regulatory framework for secured transactions.

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Operating Guidelines for Bank Restructuring

I. Background

In 1987 the Mexican Government established a trust, FOBAPROA (*Fondo Bancario de Protección al Ahorro*), administered by Banco de México. The purpose of this fund is to take actions to avoid and remedy financial problems that may arise in banks, as well as encourage the fulfillment of the obligations of such institutions. In order to comply with its objective, FOBAPROA plays the following roles: (a) bank restructuring; (b) deposit insurance; and (c) in some cases, lender of last resort.

FOBAPROA is financed by ordinary and extraordinary contributions, which are set on an annual basis and paid monthly by the banks. At the present time, the ordinary contributions are equal to 0.3% of the liabilities which are subject to the fund's protection, however this percentage could rise up to 0.5%. Extraordinary contributions may not exceed 0.7% of such liabilities. In addition, the Central Bank is authorized to extend loans to FOBAPROA.

In the area of bank restructuring, FOBAPROA has been performing the following roles:

1. It lends to banks under Government intervention (e.g., Cremi, Unión and Banpais, at present). In such cases its loan is equivalent to the sum of the estimated loss. In such cases, FOBAPROA may take as collateral all or a portion of the shares of the bank or the financial group affected. FOBAPROA has the right to vote the pledged shares (even without foreclosure) to write-off the capital and issue and subscribe new capital. In that event, FOBAPROA replaces former shareholders (who lose their equity) and tries to sell the bank to suitable investors.

2. It provides financial support to banks that have applied for capital where there were capital deficiencies but not irregular behavior. In these cases, FOBAPROA supplies capital, against a restructuring program agreed with the bank in question.

Before the current economic and financial crisis, the authorities were taking actions to modify several bank prudential regulations. At the present time, the *Comisión Nacional Bancaria y de Valores* (CNBV) is tightening its regulations on asset classification as well as its inspections. Eighty percent of the 18 commercial banks which were privatized since 1992 will be inspected by September 30, 1995, and the rest by December 31, 1995. Also, banks have been instructed to make provisions of: (1) 60% of past-due portfolio, or, (2) 4% of total portfolio as of March 1995, or (3) based on classification of assets, whichever is higher.

II. Current Situation

The difficulties that the Mexican economy is facing will have a negative impact on the banks' financial condition. This is why several mechanisms that go from debt restructuring to complete bank restructuring have been designed and will be adopted, depending on the specific problems of each institution.

The first of these mechanisms is the PROCAPTE (*Programa de Capitalización Temporal*) which was created under a Circular in February 24, 1995, with the purpose of providing core capital to under-capitalized banks, as well as improving the quality of their assets. This mechanisms can assist banks whose capital level is below 8% of risk weighted assets, and where shareholders have not recapitalized the bank due to the current economic conditions. Participation in the program is voluntary for banks with capital under 8%. However, for those banks with a ratio below 8%, the authorities will either impose recapitalization by FOBAPROA or suspend/revoke the charter. In both cases, the core capital is injected through the subscription of subordinated mandatory convertible debentures (term: 5 years), which are acquired by FOBAPROA with financing obtained from Banco de México. The proceeds of the subscription are deposited in the Central Bank. The size of the issue will be such that the capital level will rise to 9%.

The debentures can be retired if the shareholders inject the equivalent capital into the bank. FOBAPROA can accelerate convertibility and become a majority shareholder if the core capital level of the bank falls below 2% (excluding PROCAPTE debentures) of risk weighted assets or if its capitalization ratio trend deteriorates at a rate exceeding 25% of the rate of deterioration of the rest of the PROCAPTE banks. Once FOBAPROA becomes the majority shareholder, it dilutes or replaces entirely the previous shareholders and restructures the institution.

PROCAPTE banks will be subject to tighter supervision from the CNBV, discontinuing dividend payments and limiting new loans. Additionally, with the objective of avoiding further deterioration, the authorities will impose some of the holding actions to the banks (Annex II-A), as well as reporting requirements depending on the specific problems of each bank.

The basic criteria for imposing the holding actions and the reporting requirements will be the capital level without considering the capital obtained through PROCAPTE, as well as the rate of deterioration of each bank in particular according to its capability to generate cash flows.

To date, the banks under PROCAPTE mechanisms are: Serfin, Inverlat-Comermex, Bital, Confia, Centro and Oriente. Another bank, Mercantil Probursa, has a capitalization ratio below 8%, but has obtained from the Government a two month exemption while negotiating with Banco Bilbao Vizcaya to recapitalize it, becoming majority shareholder.

Due to the deterioration of the real sector, it is likely that more banks will enter the PROCAPTE program and that in some cases FOBAPROA will exercise its conversion rights on the subordinated debentures, becoming the potential majority shareholder of those banks. This institution will then have to restructure (i.e., recapitalize, close, liquidate, sell or merge) those banks. To minimize this transitory situation, principles and programs for the restructuring and sale of those banks and the other intervened banks will be established as set forth below.

III. Objectives, Principles and Methodology to be Followed by FOBAPROA and the Authorities in Resolution and Restructuring of Banks.

A. All bank restructuring methods will follow a set of public interest objectives that will govern the authorities' actions. These objectives are:

- Reducing systemic risk.
- Ensuring safety and soundness of banking institutions.
- Saving institutions and not shareholders.
- Promoting public confidence.
- Minimizing the overall cost of restructuring.
- Preventing intervention by the timely application of other methods.
- Minimizing the participation of the public sector.

Actions for bank restructuring will be based on the following principles that are drawn from the lessons of experience in other countries:

a. The basic principles for successfully restructuring insolvent banks are the joint achievement of: (1) the full coverage (compensation) of the losses, both in terms of stock and/or flows; (2) the change of the management that has been responsible for the insolvency; and (3) dilution or change of ownership.

b. The reconstruction of the capital base should initially be sought from the existing shareholders, especially if ownership is rather concentrated. If they are unable or unwilling to do so, FOBAPROA will do it, thereby eliminating or strongly diluting their ownership position.

c. The bank restructuring program will be conceived and implemented with reasonable speed (the need for thoroughness notwithstanding), since experience shows that delays usually increase the ultimate restructuring costs.

d. When recapitalization by FOBAPROA takes place, keeping the same management and ownership is likely to be: (1) unfair and perverse, because this would provide incentives for bad management; and (2) ineffective, since the same problems are likely to recur.

B. The methodology to be followed given the legal constraints in the Mexican context would be as follows:

a. When a bank proves to have a capital base below 8%, before being recapitalized via the PROCAPTE mechanism, shareholders will be explicitly requested to submit a satisfactory plan within a month to recapitalize the bank. If they do not respond affirmatively, PROCAPTE will undertake capitalization, but:

- The shareholders should be requested to formulate a short term turn-around plan containing immediate safeguard measures to arrest deterioration and improve the safety, efficiency and profitability of the bank; the execution of this plan will be subject to close supervision by the Government.

- The asset classification guidelines will be enforced promptly and stringently to the bank's accounts.

b. In the case banks whose capital adequacy ratio falls below zero percent, their ownership will be removed through the conversion of the subordinated debentures by FOBAPROA, and it will also become the owner of the intervened and insolvent banks through the write-off of the previous capital and the subscription of a new capital issue.

c. When FOBAPROA or CNBV decides to take control of an institution, either through FOBAPROA/PROCAPTE or by an intervention, management would be replaced fully or partly.

d. In this context, FOBAPROA will establish a program to recapitalize/rehabilitate, close, liquidate, sell or merge the banks under its control (Banco Obrero and already intervened banks will also form part of this program).

e. The sale or merger of banks will be carried out over time as banks are intervened or, if within PROCAPTE, when the debentures are converted. This would allow for a more manageable operation, experience will be gained and specialized teams could be developed for this kind of operation. The use of investment advisers is envisaged.

f. If the capital shortfall proves to be so severe (for instance, significant negative net worth) as to make the bank fundamentally financially non-viable, liquidation could be considered as an appropriate solution. The possible negative impact on the image of the banking system would be offset by the message of discipline sent to the market.

g. If liquidation is ruled out, acquisition or merger would be sought, but the conditions for a successful operation in either case would be: (1) recapitalization (after compensating losses) of the insolvent bank, prior or simultaneous to the sale or merger, (2) loss sharing mechanisms or equivalent process, and (3) sale to suitable investors (i.e., with requisite financial and managerial capacity, as well as moral character).

h. Insolvent banks could be sold as a legal entity to a single investor or split into two or more units for sale to more than one investor.

i. The institutions' recapitalization would be carried out by either of two means: (1) recapitalization by new owners, and (2) recapitalization by FOBAPROA. In both cases, the Government through FOBAPROA (or other entities) could acquire the non-performing loans or guarantee contingencies.

j. In case FOBAPROA (or other entities) acquires the non-performing loans portfolio, the attractiveness of the bank to sound investors for acquisition or merger, will be increased. Otherwise, the potential investors attracted would not be desirable and would likely try to use the bank to obtain dividends based on cosmetic accounts or to lend money to themselves.

k. The purchase of non-performing loans by FOBAPROA would generally be at book value, so that the full loss is removed from the insolvent bank and transferred to FOBAPROA (or another entity) as the restructuring institution. (However, if there is a loan loss reserve, the assets will be sold at market value as soon as possible, through auctions, securitization, or any other market mechanism, thus resulting in a loss.)

l. The non-performing assets removed from the balance sheet of the insolvent banks would either be transferred to the acquiring bank or to a special trust fund for recovery or disposal. Among possible incentives for better recovery, the recovery institution could be offered a commission. If the resources recovered exceed the estimated value of the assets bought by FOBAPROA, an arrangement would be established to return a part of that excess to FOBAPROA.

m. As an alternative to the acquisition of non-performing loans, FOBAPROA could guarantee a purchase price for a given period of time (put option), so as to facilitate the merger or acquisition process.

n. An additional alternative could be the creation of a "bridge bank" for each insolvent bank. The bridge bank would take over only the sound part of the insolvent bank and would then be sold. Bad assets, contingencies and litigation would be left with the bad bank for disposal/liquidation over a period of time.

o. Any restructuring plan will also have to ensure a sharp reduction in operational costs and rationalization of the branch network by interim management or the new owners.

p. Care will have to be exercised in the selection of individual banks susceptible of successful rehabilitation, and on the other hand, those fundamentally non-viable banks for which liquidation, merger or other modalities could be envisaged.

r. Pending the preparation of specific restructuring plans for those banks intended for rehabilitation/restructuring, short-term turn-around plans would be formulated and implemented by the banks' management, to arrest deterioration and contain losses.

The modalities for financing the bank restructuring program are discussed in the attached Annex II-B. The organizational arrangements for implementing the bank restructuring program are described in Annex II-C. The treatment of Non-Performing Assets is outlined in Annex II-D.

23 May, 1995

ANNEX I
Attachment II-A
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MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM
Inventory of Holding Actions to be Required of Banks[1]

Management	• Creation of a special taskforce to deal with problematic assets. • Creation of a risk management unit, with guidelines and internal limits established in conjunction with the Supervisory Authorities, (further control on market, credit and other risks). • Strengthen internal controls. • Strengthen management.
Expenditure	• Present a plan to reduce operating costs. (including staff cuts)
Assets	• Discontinue lending to adversely classified borrowers (D and E). • New lending to be limited to loan recoveries. • Prohibit any increase, interest capitalization or preferential treatment in related-party loans. • Envisage the sale of non-core assets. • Certain operations to be subject to approval by the Board: 1. Sale, acquisition or leasing of assets above a certain amount. 2. Credits above a certain amount. (to be determined by Supervisory Authorities)
Capital	• Require satisfactory recapitalization plan, including time schedule.
Liabilities	• Control dependence on volatile deposits.
Other	• Prohibit Owners/Directors and other related parties from trading services with the bank, as well as other transactions involving conflict-of-interest.

[1] These actions are applicable, at the discretion of the Supervisory Authorities, to commercial banks which encounter financial and/or operational difficulties, whether they are intervened or not.

In addition to the above, the Supervisory Authorities may impose any other Holding Action that they consider adequate.

Steps to be Followed During the Intervention in Credit Institutions

The CNBV has the legal power to intervene any credit institution in which severe irregular situations are found, so in these cases it is not necessary to wait for the institution to participate in the PROCAPTE program or for the conversion of the subordinated debentures.

Some of the characteristics of the intervention process are:

- The bank shall be intervened for the shortest possible time, with the understanding that the period of intervention will necessary be longer than that of those insolvent banks that do not present irregularities in their management.
- Professional interventors should be hired, and the use of other bank's personnel should be avoided. The CNBV is currently developing a list of possible candidates (former bankers) that could head the intervention.
- The intervention team should be well paid, and it should propose a scheme of performance-based incentives appropriate to the objectives to be achieved, which will be submitted to the authorities for review and approval.
- It is not advisable that the interventor act as sole administrator; a board of directors formed by the intervention team and/or by officers of other institutions should be used to provide guidance and some control.
- A mechanism through which the bank can triangulate its funding through FOBAPROA should be utilized.
- Good and bad assets should be isolated as soon as possible.

Independently of the causes that lead to the intervention, the authorities will notify the affected institution, pointing out the reasons and its legal foundation. Simultaneously an intervention team or an Interventor-Manager will be designated and will be in charge of managing the intervened institution with all its implications (procurement, dealing with debtors and creditors, human resources management, supervision of daily transactions, etc.) and reviewing the assets and liabilities in order to obtain, as soon as possible, a reasonable assessment of the economic and financial situation of the institution.

The intervention team will take the following steps:

1. Obtain a provisional balance sheet with figures updated to the previous day if the intervention begins during the opening of operations, or to the same day if the intervention begins at the closing of the day. If delay exists in the formulation of the provisional balance sheet, the most recent one available will be required and the preparation of the following will be supervised.

   The temporary balance sheet should be certified by the institution's officers as regards the accounting accuracy of all the operations.

2. Once the temporary balance sheet is obtained, a list of all the accounts contained in it will be required, and then verified.

3. The data system will be evaluated and taken under control, safekeeping the data basis and existing information. Specialized personnel will be used.

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4. Liquid or easily marketable assets will be controlled; as well as expensive goods such as jewels, works of art and cars; and the accounting ledgers, minutes of the Board of Directors and shareholders meetings.

5. The intervention will be notified to all the institutions that hold checking or investment accounts with the intervened bank, and the signatures of the leading interventor and/or his associates should be registered.

6. The institution's officers should be informed about their responsibilities, including the need for them to consult with or seek approval from the interventor on certain types of decisions. Likewise, a decision should be taken regarding the replacement of the management, fully or in part.

7. The powers (to take actions related to management, procurement, litigation, etc.) given by the institution will be evaluated and, as necessary, should be canceled.

8. A cash flow projection should be prepared for the first month of the intervention, and subsequently be extended to the following months.

9. The quality of the portfolio will be evaluated, establishing its degree of soundness and liquidity and estimated term for recovery, using the following procedures:

    - Verify the operations' supporting documents, selectively or in full.
    - Send letters to the bank's debtors verifying the acceptance of their debt. All major loans should be included, as well as a selection of the rest.
    - Visits should be made, with the intention of verifying addresses and collecting information.
    - Reviewing important loans for which there is little or no documentation in the files.
    - Identify if there are non-performing loans registered as performing and investigate the situation of transactions that have been renewed continuously.
    - Stop renewals until the characteristics and situation of the borrower have been satisfactory established.

MEXICO

FINANCIAL SECTOR RESTRUCTURING PROGRAM

Operating Guidelines for Bank Restructuring

Financing of Bank Restructuring

The financing of bank restructuring should take into account the following guidelines:

(a) The present funding of FOBAPROA with contributions from the banking system is by far insufficient to cover the restructuring needs already identified and those that are likely to be identified in the future. As a supplement, the Central Bank currently provides advances to FOBAPROA. Current financing is still insufficient. One or more of the following additional funding formulae should be contemplated:

(i) Increase the lending by the Central Bank to FOBAPROA.

(ii) Increase of the current contributions of 0.3% of annual deposits from the banking community, within the limit authorized of 1.2%.

(iii) Advances from the banking community against future contributions.

(iv) Bonds to be issued by FOBAPROA or another Government agency (bearing market interest rates).

(v) Other arrangements, as appropriate.

(b) As regards fiscal implications, the Central Bank advances will be reimbursed overtime by FOBAPROA, through the future contributions of the banking community and the proceeds of the liquidation of assets. Reimbursement to the Central Bank should be a priority. Any lending of last resort supplied by the Central Bank or FOBAPROA should be recognized and reimbursed overtime.
While FOBAPROA, as a restructuring agency, is supposed to bear the loss as a result of the cleaning up of the banks, this loss will also be

recovered overtime from the collection of the banks' contributions and the proceeds from the liquidation of assets.

(c) The monetary impact of restructuring should be diminished and spread overtime by the use of bonds rather than cash, whenever possible. In the short term, the impact will be limited to the interest payments. The impact of bond redemption can be phased out over a long period of time. If cash is used to inject capital and/or to clean up bad assets, it could be earmarked for the restructured bank to immediately place it in Government securities available on the market, in order to mop up the liquidity provided by FOBAPROA.

MEXICO

FINANCIAL SECTOR RESTRUCTURING PROGRAM

Operating Guidelines for Bank Restructuring

Organizational Arrangements

FOBAPROA presently has different degrees of control over a number of banks, i.e., intervened banks in which FOBAPROA has taken control, PROCAPTE banks and Banco Obrero. It is expected to take over control of an additional number of banks, under the PROCAPTE scheme, in the near future. Intervention of other banks in the future is also not to be excluded. The above participation in the supervision of banks involves several types of managerial activities:

1) interim management (or intervention gerencial) of intervened banks;
2) management of banks once FOBAPROA has become majority shareholder;
3) monitoring of turn-around plans for PROCAPTE banks;
4) supervision of banks under FOBAPROA ownership;
5) organization of sales and mergers of banks; and
6) monitoring of assets recovery and liquidation carried out by the restructured bank under new ownership.

These activities can be grouped in two levels: a) the management team itself which should be located in the banks, and b) monitoring or supervision of various managerial activities, as well as organization of sales and mergers, which should be located in FOBAPROA. The following guidelines are suggested for both levels of activity:

(a) Bank Management. It should be borne in mind that some time may elapse between intervention or take-over of a bank's ownership and sale to other shareholders. In this interim period, banks should be run as a normal institution, rather.than frozen while waiting for sale. At least normal commercial activities and verification of the real situation of the bank in question are required, through the proposed diagnostic audit studies. Additionally, turn-around plans can be put in place if the sale of the bank takes a long time. To this effect, a small team of managers should be appointed in each bank, rather than a single *interventor*. This team of managers could primarily be recruited from the market (including secondments from others banks) and can be supplemented by some managers from the ranks of the bank in question. Having those teams available requires an early and systematic search activity, in order to ensure that new appointments can be made expeditiously.

(b) Monitoring of Various Managerial Activities (as described above) and Sales or Mergers. These tasks would involve the formation of a small but strong management team in FOBAPROA. These managers should be ideally recruited from the market, at salaries that would ensure their competence and independence. They should have experience in:

- Banking operations, (including bank analysis and assets evaluation).
- Legal matters.
- Mergers and acquisitions.
- Administration.

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MEXICO

FINANCIAL SECTOR RESTRUCTURING PROGRAM

Operating Guidelines for Bank Restructuring

Treatment of Non-Performing Assets

Removal of some or all bad assets from the balance sheet of insolvent banks could be an alternative to make such banks more attractive to potential purchasers, making it easier for new management to concentrate on building a sound institution. Consequently, a set of mechanisms will be established to manage the recovery or liquidation of non-performing and lower quality assets of restructured banks. The more dubious assets (i.e., those most likely to represent losses and those least amenable to valuation) would be removed from insolvent banks, while better assets would remain on the balance sheet of the restructured banks. The mechanisms will include one or more of the following:

- purchase of bad assets by FOBAPROA or by the Federal Government of Mexico. This mechanism is currently in place and FOBAPROA has already purchased impaired portfolios from intervened banks.

- establishment of one or more special purpose mechanisms to purchase such assets. Such entity or entities will be established and controlled by FOBAPROA, and be governed by commercial law. Arrangements may be established between the special purpose entity or entities and private parties (including banks) for management and disposal of assets.

- transfers of such assets to a "collecting" bank (which may be the now-restructured bank), asset liquidator or liquidating trust. Such transfers may be subject to partial guarantees or loss sharing by the Government or FOBAPROA, which would be tantamount to a discount.

- agreement of FOBAPROA to share some of the losses on such assets with the shareholders of the restructured bank.

- securitization of such assets.

The funding for the purchase of bad assets from banks should consist of an appropriate mix of cash and non-cash modalities (e.g., issuance of medium-term bonds bearing market interest rates) so as to minimize its monetary impact while still paying due attention to the liquidity needs of restructures banks.

To the extent that non-performing or lower quality assets are managed by FOBAPROA, or a special purpose vehicle or vehicles controlled by FOBAPROA, such entity or entities should be staffed with first class professionals from the market with experience in asset management, recovery and liquidation. Market-oriented approaches (such as auctions and securitization) will be favored.

23 May, 1995

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Policy Guidelines for Development Banking
During the Current Administration
(English translation of original document in Spanish)

Over the course of the past few years, the country has witnessed a profound process of economic reforms. This have covered all sectors of the economy, among which the financial sector has been characterized as one of those experiencing the greatest changes.

The development finance system was not exempt from this process of reform. Notable among the measures that were taken to modernize it were its rationalization to operate increasingly as a second-tier system and the application of very strict prudential regulations.

The rationalization of the system involved the dissolution, closing or merger of those entities that had completed the mission that justified their creation or those that duplicated functions. With this, unnecessary competition among entities was eliminated in substantial measure.

The restructuring of the development banking system into a second-tier system brought several benefits. One of these was that it improved the allocation of resources, since by transferring risk to private intermediaries incentives were generate to adequately assess the profitability of projects.

Prudential regulation was intensified with the introduction of the Capital Rules and the Portfolio Classification Rules for development banks. It is important to note that their application is stricter than that of commercial banks. The capital ratio for development banks required by the financial authorities is 10% of risk assets, while for commercial banks it is 8%. Preventive provisions for credit risk rise to 10, 45, 80 and 100%, respectively for credits classifies from B to E, while for commercial banks these are 1, 20, 50 and 100%, respectively.

At the same time that the process of restructuring the operations of the development banks was advancing, these measures also better oriented the development system toward serving sectors that, due to market failures, were not adequately served by commercial banks.

In addition to the measures already mentioned, several tasks remain to be undertaken that would result in improving the capacity of the development banking system to meet its objectives. However, the implementation of these actions must be effected in an appropriate manner given the current economic situation.

In the short term, development bank operations will be limited due to the need to create preventive reserves to cover the requirements associated with the recent deterioration of credit portfolios as well as the financial ceilings that permit development banks to channel to the private sector a maximum net credit flow equivalent to 2% of GDP.

To overcome this situation, and so that projects that are viable in the medium and long term may continue to advance, in 1995 an ambitious program of debt restructuring with different schemes will be put into effect, most notably, the Investment Unit. In addition, new loans will be granted this year, mainly to those sectors most affected by the current economic emergency.

The current administration has set a series of objectives within a broader policy umbrella that seek to improve the capacity of development banks to fulfill their mission of promoting development. To perform these actions and achieve better results, diagnostic studies of the operations of development banks will be carried out, in light of the successful experience of other countries. The main lines of actions supported by the results of these studies are as follows:

a) Further the strategy of liberalizing intermediation margins with the goal of avoiding a poor allocation of credit in the least vulnerable sectors. In particular, the process of liberalizing margins in foreign currency operations will continue, and in a gradual fashion the same process will be initiated for non-bank financial intermediaries, since in these cases the incentives and monitoring possibilities exist to prevent the application of oligopolistic rates to the final borrower.

b) Deepen the policy of specialization of development banks to avoid the waste of resources due to competition among entities that seek the same goals. In those cases where it is impossible to avoid duplication of functions, given that it is more efficient to integrate operations in a chain of production, equal rates and margins among similar programs of different developments banks will be fostered to avoid arbitrage.

c) It is necessary to analyze in depth the effects on the efficient operation of the market and the control of financial margins applied to commercial banks, to identify alternatives that both meet the objective of channeling resources to sectors that do not have access to commercial banks and reduce distortions generated in the capital markets by such controls.

d) Continue the trend of decreasing the risk exposure of development banks. For this, in addition to continuing the trend towards increasing second-tier operations and maintaining the current capital and reserve requirements, as well as the individual exposure limits of the development banks with each financial institutions, the establishment of aggregate exposure limits for the entire development credit system with each financial intermediary will be sought.

e) Further, in addition to the rules that entered into force in 1994 to regulate the granting of credit by NAFIN and BANCOMEXT to non-bank financial intermediaries, it will be necessary to design a methodology for development banks to rate such intermediaries, as an aid in determining if they are appropriate candidates for credit.

f) Continuance of the trend of development banks limiting their operation to sectors that as a result of the presence of market failure evidence private benefits that are lower than the social benefit will be an objective. In particular, greater emphasis will be placed on attention to micro, small and medium firms, to housing of social interest, and to low income agricultural producers.

g) The process of reducing fiscal transfers will continue. These currently support less than 3% of the total portfolio of the development banks. This will be achieved by promoting more efficient operations.

h) The CNB will conduct analyses to promote the clarification of portfolios of non-bank financial intermediaries and the creation of appropriate reserves.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

I. MACROECONOMIC POLICY FRAMEWORK		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. Because of the unsustainable current account deficit, the Mexican peso was allowed to float on December 22, 1994. With the support of an IMF stand-by arrangement, the Government is implementing a comprehensive set of economic measures to stabilize the economy and improve confidence. The economic program covers tight fiscal and monetary policy; a floating exchange rate; acceleration of some structural reforms; and measures to address the financial sector's difficulties; the program is being implemented with substantial financial support of the IMF, the U.S. and others.	*1. Satisfactory progress in implementing the macroeconomic program announced on March 9, 1995. 2. **Before Board approval**: The macroeconomic policy framework is consistent with the objectives of the Financial Sector Restructuring Program (FSRP)	1. **Before Loan Effectiveness**: The macroeconomic policy framework is consistent with the objectives of the Financial Sector Restructuring Program (FSRP) 2. **Before Second Tranche release**: The macroeconomic policy framework is consistent with the objectives of the Financial Sector Restructuring Program (FSRP)

* Actions already taken.

1. The IDB loan has the same conditionality as the World Bank loan, and, therefore, references to "the Bank" in the matrix should be read to mean "the World Bank and the IDB."

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

II. HOLDING ACTIONS TO LIMIT FINANCIAL LOSSES		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. There could be substantial risks that some of the troubled banks could behave in ways that would magnify and propagate financial losses. 2. CNBV has implemented a set of holding actions to immediately address the financial difficulties and limit financial losses. 3. Action Program: Keep holding actions in place at least until completion of on-site MACRO[2] inspections of the health of all banks, diagnostic studies of the banks, and satisfactory preparation and implementation of bank restructuring plans.	*1. CNBV prohibited payment of dividends by banks that receive PROCAPTE/FOBAPROA funds. *2. CNBV will use moral suasion to stop privatized[3] banks (outside PROCAPTE) from distributing dividends in 1995. *3. Required banks with a capitalization ratio below 8% to raise additional capital or enter PROCAPTE. *4. Provisioning requirements for privatized banks increased to the greater of: (a) 4% of the loan portfolio; (b) 60% of past due loans; or (c) the provision required from loan classification (Circular 13254-1137, dated February 22, 1995). *5. Roll-over loans separated for enhanced monitoring to insure that banks do not automatically capitalize interest and thereby avoid provisions (Circular 1229, dated January 11, 1995). *6. Limits placed on new lending by PROCAPTE banks (i.e., the increase in the capitalization ratio due to PROCAPTE funds can not be used to extend new lending). *7. CNBV has required banks to reduce large exposures and related party exposures. *8. CNBV and FOBAPROA created an inventory of operating restrictions for use depending on the condition of banks.	

2. MACRO is the Spanish acronym of CAMEL (capital adequacy; asset quality; management; earnings; and liquidity, asset and liability management).

3. The term "privatized banks" refers to those banks that were returned to private ownership in 1991/92 and does not include banks operating under new charters granted since the privatizations.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

III. DISCIPLINE IN THE PROVISION OF LIQUIDITY SUPPORT AND OTHER RESOURCES		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. Achieve greater discipline and transparency in the provision of liquidity and other resources to the financial system 2. Action Program: Policies, guidelines and procedures that will result in greater discipline in the provision of liquidity and other resources to banks from (i) Banco de Mexico and (ii) development finance entities (DFEs).[4]	*1. Banks required to post collateral in peso credit auctions per Banco de Mexico Circular telefax 23/95, dated March 20, 1995.	1. **Loan Effectiveness:** SHCP to present terms of reference, satisfactory to the Bank, for studies of: (a) the impact of establishing risk-based exposure limits for the liabilities of each financial intermediary (FI)[5] to DFEs; (b) the establishment of eligibility criteria for FI participation in DFE second-tier operations[6] (such study to include an analysis of the impact of establishing rating requirements from qualified private agencies); and (c) the current interest rate policy in domestic and foreign currency, including an evaluation of its incentive structure and impact on financial markets and final borrowers. 2. **Before Second Tranche release:** SHCP to review results of studies with the Bank and prepare an action plan on the basis of such studies and take the necessary official action to implement such action plan.

4. The term development finance entities includes NAFIN, Bancomext, FIRA, FIDEC, and FOVI.

5. The term financial intermediary includes all institutions, such as banks, leasing and factoring companies, credit unions, etc.

6. The term second-tier operations refers to loans, guarantees, investment portfolio, interbank market operations and other risk assets of DFEs with FIs.

Matrix of Policy Actions[1]

IV. MANAGEMENT OF THE CENTRAL BANK'S CREDIT RISK AND RISK OF CONTAGION IN THE INTERBANK MARKET		
Issues, Objectives and Action Program	Prior Actions/Commitments	Loan Effectiveness/Second Tranche Actions
1. The Central Bank had borne substantial credit risk and exposure as lender of last resort due to inadequate controls on intra-day credit extended to banks. There was also risk of contagion from failure by insolvent banks to perform their obligations to solvent institutions. Reform of the intra-day market to make it a self-liquidating mechanism would eliminate the risk to the Central Bank and solvent participating banks. 2. Action Program: A program of actions to reduce the Banco de Mexico's credit risk and risk of contagion in the inter-bank market.	*1. Banco de Mexico has implemented a series of measures to reduce risk of contagion and the Central Bank's exposure to credit risk in extending daylight overdrafts. *2. Banco de Mexico has undertaken measures: (a) under Circular-telefax 16/95, dated March 3, 1995, regarding steps to reduce its credit risk[7]; (b) under Circular 2016/95, dated March 7, 1995, regarding steps to limit the risk of contagion in the inter-bank market[8]; and (c) under Circular 2017/15, dated March 10, 1995, requiring delivery versus payment in the trading of commercial banks liabilities.	

7. Pricing of intra-day credit, requirement of collateral for daylight overdrafts, debit caps for uncollateralized portion of daylight overdrafts, and requiring special non-interest earning clearing balances, if daylight overdraft are frequent.

8. Establishment of clearing house for large value transfers (Sistema de Pagos Electrónicos de Uso Ampliado - SPEUA).

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

V. ASSESSMENT OF HEALTH OF THE BANKING SYSTEM		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. The peso devaluation and its aftermath have had a severe impact on the banking system. High interest rates have affected both corporate and individual private borrowers. An accurate assessment of the true health of banks is essential to develop measures to restore solvency and soundness of financial institutions and thereby improve confidence in the financial system. 2. Action Program: (a) MACRO inspections to verify asset quality and provisions. Examiners from the US FDIC, OCC and Federal Reserve to begin training CNBV staff **by June 15, 1995** with financing under FTAL -- Technical Assistance on supervision policy, asset classification criteria, manuals and training requested, and will be provided under the restructured FTAL. (b) Diagnostic studies to ensure an accurate assessment of the financial and operating condition of intervened and PROCAPTE banks.	1. Inspections: (a) Complete on-site MACRO inspections, focusing on asset quality, on a targeted basis: (i) **by September 30, 1995**, for all privatized banks except four banks; (ii) **by December 31, 1995** for the remaining four privatized banks; and (iii) review results with the Bank. (b) Conduct annual inspections thereafter. 2. Diagnostic Studies: (a) <u>For intervened and PROCAPTE banks</u>: CNBV and FOBAPROA to complete diagnostic studies (applying uniform accounting standards consistent with internationally accepted standards (U.S. GAAP) acceptable to the Bank, and loan classification) with the assistance of independent auditing firm(s) of (i) two intervened banks and review results with the Bank, **by September 30, 1995**; and (ii) all intervened banks and PROCAPTE banks as of **May 31, 1995**, and review results with the Bank, **by December 15, 1995**. (b) <u>For banks not yet in PROCAPTE</u>: CNBV to (i) initiate diagnostic studies of banks (not in the PROCAPTE/FOBAPROA programs as of **May 31, 1995**) within 90 days of their joining the PROCAPTE scheme, being intervened by CNBV or coming under the control of FOBAPROA (without the bank going through PROCAPTE scheme); (ii) complete such studies within four months from the starting date; and (iii) review results with the Bank soon thereafter.	1. **Before Loan Effectiveness**: CNBV or FOBAPROA has employed an independent auditing firm, according to terms of reference satisfactory to the Bank, for assistance in diagnostic studies of banks, and initiated diagnostic study of at least one intervened bank. 2. **Before Second Tranche release**: (a) CNBV and FOBAPROA to review results of completed diagnostic studies of intervened and PROCAPTE banks with the Bank. (b) Satisfactory execution of CNBV's inspection program of banks, and review results with the Bank.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

VI. RESTRUCTURING OF BANKS

Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. In light of the deterioration in the financial condition of banks, tightening of regulations on asset classification as well as inspections, and deterioration of the enterprise sector, more banks may see their capital decline to levels below the minimum limits, and their ownership could then come under the control of FOBAPROA. 2. Legal changes to further liberalize shareholding by domestic and foreign investors made on February 15, 1995. 3. The Government will prepare the bank restructuring plans and implement thereafter agreed plans (i.e., liquidation, merger, or offer for sale) for the intervened banks quickly in a transparent manner according to market mechanisms.	*1. CNBV, SHCP and FOBAPROA have defined principles, processes, procedures, organizational arrangements, and methodologies for restructuring of banks including approaches to the treatment of non-performing loans ("operating guidelines"); and have submitted to the Bank the draft document for discussion at negotiations. 2. **Before Board Approval:** *SHCP has put into effect the final operating guidelines, acceptable to the Bank. 3. The Government to furnish for review with the Bank restructuring plans including implementation strategies prepared in accordance with the operating guidelines, approved by CNBV, SHCP and FOBAPROA: (a) by **September 30, 1995**, for two banks under FOBAPROA control[9] and (b) for any remaining banks under FOBAPROA control within three months from the date of FOBAPROA taking control. 4. Implement the bank restructuring plans.	1. **Before Effectiveness:** CNBV or FOBAPROA to retain/recruit investment banks and/or specialized consultants or firms, with satisfactory terms of reference, to assist in the preparation of restructuring plans of banks. 2. **Before Second Tranche release:** (a) The Government to furnish the restructuring plans prepared in accordance with the operating guidelines including implementation strategies approved by CNBV, SHCP and FOBAPROA, for review with the Bank, for all banks under FOBAPROA control. (b) Continued progress, satisfactory to the Bank, in implementation of the bank restructuring plans.

9. Including PROCAPTE banks, taken over by FOBAPROA.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

VII. CORPORATE AND OTHER DEBT RESTRUCTURING		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. Enterprises have been undergoing structural reforms over the past several years, and a significant number of smaller enterprises in particular were experiencing difficulties in 1994. Financial distress in the corporate sector expanded rapidly in early 1995 due to high interest rates and effects of the devaluation, and intensified due to a decline in the value of assets used as collateral, and lack of access to alternative forms of financing. 2. The Government has introduced a series of loan restructuring programs based on the Unidad de Inversión (UDI) to enable banks to refinance loans to viable borrowers facing liquidity problems. The programs include industrial loans, housing loans, loans to states and municipalities, and loans financed through development banks. 3. Action Program: (a) Facilitate corporate and other debt restructuring based on sound guidelines and market discipline, with due consideration to fiscal costs. (b) Continue work on improvements in guidelines for supervision of restructured debts. (c) Keep continuing watch during inspections of 1995 on the sound use of the UDI scheme by banks.	1. **Before Board approval**: *Analyze and review with the Bank estimated fiscal costs of the UDI scheme (including subsidy and tax revenue implications). 2. (a) Conduct a study of obstacles to voluntary debt restructuring (including recognition, execution and enforcement of out-of-court workouts and arbitration awards); (b) review findings with the Bank **before December 31, 1995**; and (c) agree on a plan of action **by March 31, 1996** for removing unnecessary impediments to voluntary corporate debt restructuring, through appropriate changes in regulations and/or legal framework. 3. **Beginning January 1, 1996**, CNBV to review classification of assets in the UDI trust as they evolve, and re-classify every quarter, and require banks to build necessary provisions immediately. 4. CNBV to: (i) review **by January 31, 1996** adequacy of criteria applicable to debt restructuring; (ii) review findings with the Bank **by February 29, 1996**; (iii) formulate changes, as appropriate; and (iv) issue a circular with revisions, as necessary, to banks **by March 31, 1996**. 5. **Before March 31, 1996**: (i) analyze the initial implementation experience of the UDI scheme and associated fiscal costs; (ii) review findings with the Bank; (iii) formulate changes, as appropriate; and (iv) publicize the revised scheme.	

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FINANCIAL SECTOR RESTRUCTURING LOAN
Matrix of Policy Actions[1]

VIII. STANDARDS FOR ACCOUNTING, DISCLOSURE AND QUALITY OF FINANCIAL INFORMATION		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. Mexican Generally Accepted Accounting Principles (GAAP) differ in some significant respects from internationally accepted standards (U.S. GAAP). The principal differences for bank accounting are in the treatment of interest income on loans (and on restructured debt) and repurchase agreements, valuation of fixed assets, disclosure requirements and the definition of non-performing assets. Mexican banks generally prepare their financial statements according to CNBV guidelines reporting in accordance with the form of general ledger and rules published in CNBV circulars. 2. Draft regulations reconciling the U.S. and Mexican GAAP are under preparation. FTAL will provide TA as needed. 3. Action Program: (a) Formulate uniform, accounting standards consistent with internationally accepted principles (U.S. GAAP) and acceptable to the Bank, and require their use. (b) Strengthening of disclosure requirements. (c) Enforce audit guidelines. (d) Strengthen appraisal standards for real estate inclusive of methodology for determining derived investment value.	1. Issue, **by September 30, 1995**, revised, uniform accounting principles, acceptable to the Bank, for banks and require banks to use new accounting standards (including consolidation of financial statements), **beginning January 1, 1996**, for completion no later than for year end-1996 accounts. 2. Formulate, **by September 30, 1995**, uniform accounting principles, consistent with internationally accepted principles (U.S. GAAP) acceptable to the Bank, and consistent across all transactions and activities, for financial statements and regulatory reports for non-bank financial institutions that are affiliates of financial groups with bank affiliates (first draft). 3. Issue, **by December 1, 1995**, revised accounting standards for non-bank financial institutions that are affiliates of financial groups with bank affiliates. 4. Continue strengthening disclosure by banks to supervisory authorities requiring banks to submit new regulatory reports and special reports, and review progress with the Bank **by September 30, 1995.** 5. Continue ongoing efforts to improve disclosure by CNBV to the public,[10] and review progress with the Bank **by September 30, 1995.** *6. All credit bureaus required to provide services to all providers of credit (financial and non-financial institutions). 7. Improvements in quality of financial information: (a) CNBV to require auditors to strictly follow audit guidelines for audits of banks and brokerage firms, and monitor auditors' performance, **beginning with audits of 1994 accounts**[11]. (b) CNBV to complete, **by March 31, 1996**, a study of ways to improve appraisal standards for real estate, and to identify institution that can undertake the regulation of appraisers[12].	1. **Before Loan Effectiveness**: CNBV to formulate uniform accounting principles (including consolidation of financial statements), consistent with internationally accepted principles (U.S. GAAP) acceptable to the Bank, and consistent across all transactions and activities, for financial statements and regulatory reports of banks. 2. **Before Second Tranche release**: (a) CNBV to issue regulations acceptable to the Bank for revised uniform accounting principles consistent with internationally accepted principles (U.S. GAAP) for banks, for application **beginning January 1, 1996**, and **completion no later than year end-1996 accounts.** (b) Issued revised accounting standards (including consolidation of financial statements), acceptable to the Bank, for non-bank financial institutions that are affiliates of financial groups with bank affiliates.

10. Including related party lending by banks.

11. Audit guidelines have been issued for brokerage firms (Circular 10-165 issued January 4, 1993), and banks (Circular 1222 issued November 14, 1994).

12. CNBV maintains register and has current qualification criteria.

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FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

IX. REFORM OF PRUDENTIAL REGULATIONS AND STRENGTHENING OF SUPERVISION		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. Improve safety and soundness of financial institutions through modernization of prudential regulations, as necessary, and strengthened supervision based on accepted international practices. These measures will enhance the transparency of health of the financial institutions and thereby help prevent recurrence of systemic problems, as well as enhance the confidence of the international investment community in Mexico's financial system. They should also increase incentives for commercial bank management to measure and better manage exposure to risk. Carefully drafted regulations can also encourage self regulation and self-policing by financial institutions. 2. Financial Sector Technical Assistance Project (Loan No 3838-ME) is providing technical assistance. 3. Action Program: Revised standards for asset classification including provisioning.	1. CNBV has begun work on revisions required for supervisory purposes in asset classification and provisioning, and related party lending. Work is also underway on composition of Tier I capital for purposes of capital adequacy. 2. **Before Board approval**: CNBV to furnish the Bank with a complete set of prudential regulations for banks.	1. **Before Second Tranche release**: (a) CNBV to issue supplemental internal instructions, acceptable to the Bank, for inspection of banks (including development banks) covering, inter alia: asset classification and provisioning, exclusion of de facto treasury stock (stock owned or financed directly or indirectly by related entities, or covered by repurchase agreements) for purposes of capital adequacy standards, composition of Tier I capital, large exposures and concentration, and related party lending. (b) CNBV to review with the Bank the need for the issuance of new prudential regulations for banks and to issue such new regulations to the extent necessary (such determination to be acceptable to the Bank). (c) CNBV to issue new prudential regulations with respect to capital adequacy standards for brokerage firms.

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

X. LIABILITY PROTECTION SCHEMES		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
1. There is a need to review the extent of liability protection provided by FOBAPROA and FAMV (types of entities that should be covered and the appropriate degree of coverage) in order to reduce moral hazard and overall liability.	1. Complete a study of liability coverage, **by December 31, 1995**, and formulate a set of options for implementing the appropriate level of coverage provided on large liabilities of covered financial entities and their affiliates, for review with the Bank **by March 31, 1996**. 2. Approve and adopt revised protection scheme for phased implementation **beginning January 1, 1997**. 3. Regulations approved to eliminate FOBAPROA coverage of settlements through SPEUA **by March 31, 1996**.	

MEXICO
FINANCIAL SECTOR RESTRUCTURING LOAN

Matrix of Policy Actions[1]

XI. MODERNIZATION OF LEGAL/REGULATORY FRAMEWORK FOR LENDING		
Issues, Objectives and Action Program	Prior Actions/Commitments	Effectiveness/Second Tranche Actions
Securitization of Bank and Non-Bank Originated Assets 1. Impediments to efficient securitization schemes importantly restrict the amount of credit available to some sectors (in particular, housing finance) and limit the market-oriented options available for restructuring and disposing of troubled bank assets. 2. Improved framework for securitization of bank and non-bank originated assets will help improve the efficiency of the financial system. 3. Action Program: (a) Establish clear legal/regulatory framework for securitization of bank and non-bank originated assets, including mortgages.	**Securitization of Bank and Non-Bank Originated Assets** 1. Conduct a study to identify remaining regulatory obstacles and legal impediments to asset securitization and make the recommendations for removing such obstacles and impediments available to the Bank **by December 31, 1995**. 2. CNBV, and SHCP to initiate the process of removing legal and regulatory obstacles.	
Secured Transactions 1. Existing legal framework does not permit lending secured by many types of movable property, restricting credit availability and reducing the potential value of bank assets. 2. Improved framework for secured transactions will enhance the efficiency of the financial system. 3. Action Program: (a) Make necessary changes to the legal/regulatory framework for secured transactions. (b) Improved system of registries.	**Secured Transactions** 1. Conduct a study to identify shortcomings of, and propose changes to, the legal/regulatory framework for secured transactions and make recommendations available to the Bank **by December 31, 1995**. 2. Initiate the process of improving the legal/regulatory framework for secured transactions.	

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Key Economic Indicators

	Actual				*Estimated*	*Projected*				
Indicator	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
National Accounts (% GDP at current market prices)										
Gross Domestic Product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture	7.9	7.6	8.3	8.2	-	-	-	-	-	-
Industry	30.3	29.6	27.9	27.9	-	-	-	-	-	-
Services	61.8	62.8	63.7	63.9	-	-	-	-	-	-
Total Consumption	78.3	79.7	81.0	81.4	80.8	77.4	76.8	76.9	76.7	76.1
Gross Domestic Fixed Investment	18.4	19.2	20.5	20.1	20.7	18.8	19.1	20.0	21.5	22.4
Government Investment	4.8	4.5	4.1	4.1	4.0	3.9	4.0	4.2	4.3	4.4
Private Investment (includes increase in stocks)	18.0	19.0	20.3	18.7	20.5	14.9	15.6	16.8	17.6	18.7
Exports (GNFS)	15.6	13.6	12.4	12.3	13.3	24.0	24.5	25.1	25.4	26.1
Imports (GNFS)	16.7	16.8	17.9	16.5	18.6	20.1	20.8	23.0	24.0	25.3
Gross Domestic Savings	21.7	20.3	19.0	18.6	19.2	22.6	23.2	23.1	23.3	23.9
Gross National Savings	19.8	18.3	17.0	16.4	17.0	19.2	20.0	20.5	20.9	21.6
Memorandum Items										
Gross Dometsic Poduct (US $ million at current prices)	247,057	290,529	334,356	365,857	375,471	250,303	287,301	313,573	343,247	382,354
Gross National Product per capita (Current Price US$, Atlas method)	2,580	2,976	3,425	3,722	4,006	3,259	3,017	2,913	3,234	3,547
Real annual growth rates (%, calculated from 1987 prices)										
Gross Domestic Product at market prices	4.5	3.6	2.8	0.4	3.8	-4.8	2.0	4.7	5.5	5.0
Gross Domestic Income	5.7	3.2	3.1	0.6	3.6	-4.2	2.3	5.1	5.6	4.9
Real annual per capita growth rates (%, calculated from 1987 prices)										
Gross Domestic Product at market prices	2.7	1.5	0.7	-1.7	1.7	-6.5	0.1	2.8	3.6	3.0
Total Consumption	3.2	2.6	1.6	-1.8	1.5	-13.2	0.5	3.0	2.4	1.2
Private Consumption	3.7	2.8	1.8	-2.2	1.8	-9.6	-0.6	3.0	3.3	1.7
Public Finance (% of GDP at current market prices)										
Current Revenues	20.4	19.0	19.8	18.4	18.9	21.8	21.1	21.5	22.0	22.3
Current Expenditures	15.1	12.0	10.8	11.2	12.0	15.1	14.5	15.0	15.8	16.3
Current Account Surplus or Deficit	5.2	6.9	9.0	7.1	6.9	6.7	6.6	6.5	6.3	6.0
Capital Expenditure	3.8	3.8	3.9	3.3	3.9	4.0	4.1	4.5	4.8	5.0

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Key Economic Indicators

	Actual			*Estimated*		*Projected*				
Indicator	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Monetary Indicators										
M2/GDP (at current market prices)	26.6	31.1	31.8	33.0	34.6	n.r.	n.r.	n.r.	n.r.	n.r.
Growth of M2 (%)	46.2	47.2	20.4	14.4	18.3	n.r.	n.r.	n.r.	n.r.	n.r.
Private Sector Credit Growth/ Total Credit Growth (%)	222.4	212.3	243.0	238.5	87.2	n.r.	n.r.	n.r.	n.r.	n.r.
Price Indices (1987=100)										
Merchandise Export Price Index	111	103	104	102	109	111	114	118	121	125
Merchandise Import Price Index	113	114	115	116	119	120	123	126	129	132
Merchandise Terms of Trade Index	98	91	91	87	92	92	93	93	94	95
Real Exchange Rate (LCU/US$)	1.3	1.2	1.1	1.0	1.1	1.6	1.4	1.4	1.3	1.3
Real Interest Rates	11.7	4.6	5.1	8.2	10.5	21.2	12.6	10.1	7.3	3.5
Consumer Price Index (% Growth Rate) (Period Average)	26.7	22.7	15.5	9.8	7.1	34.4	22.9	17.8	16.3	14.7
GDP Deflator (% Growth Rate)	29.7	21.8	14.8	9.7	7.1	34.8	22.9	14.5	14.4	14.8

n.r. = projections not required

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ANNEX IV
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MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Balance of Payments

Indicator	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
	Actual				*Estimated*	*Projected*				
Balance of Payments (US$ million)										
Exports (GNFS)	38,411	39,695	41,451	44,806	50,883	60,190	70,755	79,297	89,444	103,602
Merchandise f.o.b.	30,390	30,905	32,259	35,453	41,146	49,264	57,645	63,924	71,713	83,542
Imports (GNFS)	41,214	49,037	59,681	59,952	71,597	52,325	61,801	74,723	86,889	102,014
Merchandise f.o.b.	31,272	38,496	48,193	48,924	59,687	43,183	52,024	63,885	75,408	89,509
Resource Balance	-2,803	-9,342	-18,230	-15,146	-20,714	7,864	8,953	4,574	2,554	1,588
Net Current Transfers (including official current transfers)	3,978	2,745	3,021	2,688	4,014	3,096	3,238	3,387	3,544	3,708
Current Account Balance (after official capital grants)	-7,450	-14,893	-24,804	-23,391	-28,863	-754	-287	-3,565	-5,660	-7,239
Net Private Foreign Direct Investment	2,633	4,761	4,393	4,901	8,030	6,000	7,800	8,000	10,000	11,000
Long-Term Loans (Net)	8,542	3,888	-348	3,057	1,470	19,851	-4,092	-5,075	-8,696	-5,126
Other Capital (Net, including errors and omissions)	-491	14,381	21,932	21,475	477	-26,500	0	3,400	6,000	6,000
Change in Reserves	-3,234	-8,137	-1,173	-6,043	18,885	1,404	-3,422	-2,760	-1,644	-4,635
Memorandum items:										
Resource Balance (% of GDP at current market prices)	-1.1	-3.2	-5.5	-4.1	-5.5	3.1	3.1	1.5	0.7	0.4
Real annual growth rates (1987 prices) ($)										
Merchandise Exports f.o.b.	10.3	9.3	3.4	12.5	8.2	17.6	14.2	7.3	8.7	12.9
Primary	5.0	3.7	-3.3	-8.1	-6.7	12.4	-5.3	-0.1	4.5	7.7
Manufactures	12.3	12.0	9.5	20.9	13.8	20.0	19.1	8.7	9.9	14.4
Merchandise Imports c.i.f.	20.9	21.9	24.0	0.3	19.7	-28.8	18.4	19.6	15.1	15.7

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ANNEX V
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FINANCIAL SECTOR RESTRUCTURING PROGRAM

External Capital and Debt

	Actual			Estimated		Projected				
Indicator	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Total Debt Outstanding and Disbursed (US$ million)	106,026	115,362	113,424	118,027	131,206	160,818	162,946	158,023	146,703	135,094
Net Disbursements (US$ million)	16,954	9,834	1,762	4,628	1,804	29,680	2,129	-4,923	-11,320	-11,609
Total Debt Service (US$ million)	11,455	13,727	20,774	20,900	24,539	18,108	25,158	23,742	29,214	28,781
Debt and Debt Service Indicators (%)										
TDO/XGS	243.0	252.8	239.8	236.6	230.2	248.9	215.4	185.2	153.1	122.9
TDO/GDP	42.9	39.7	33.9	32.3	34.9	64.2	56.7	50.4	42.7	35.3
TDS/XGS	26.3	30.1	43.9	41.9	43.1	28.0	33.2	27.8	30.5	26.2
IBRD Exposure Indicators										
IBRD DS/Public DS	16.0	16.4	11.2	15.9	14.4	17.1	12.4	13.3	11.2	10.8
IBRD DS/XGS	3.6	4.0	4.0	3.8	3.5	3.6	3.4	3.0	2.6	2.4
IBRD Portfolio Share (by FY)	11.5	11.7	12.0	12.0	12.0	12.3	12.3	11.9	11.2	10.7
IFC (US$ million) (by FY)										
Loans	119	69	67	53	133	190	293	304	354	
Equity and Quasi-Equity	20	60	64	36	21	39	83	81	73	
MIGA										
MIGA Guarantees (US$ million)	0	0	0	0	0	0	0	0	0	0

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MEXICO
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Aggregate Data on the Mexican Banking System

Table 1
Mexican Monetary Aggregates, 1991-1994
(in millions of NP, as of end year/month)

	1991	1992	1993	1994
Currency in circulation	32,416	38,012	43,228	51,870
Demand deposits	77,479	88,459	105,683	102,649
M_1	109,895	126,471	148,911	154,519
Bankers' acceptance	8,579	15,725	25,025	31,370
Other short-term bank instruments	150,646	181,903	196,936	269,019
M_2	269,120	324,099	370,872	454,908
Cetes	30,047	34,818	71,204	19,258
Tesobonos (FC)	1,001	1,046	4,498	109,483
Pagafes (FC)	72	--	--	--
Bondes	14,872	12,998	13,756	3,019
Commercial paper	3,111	2,643	3,563	4,058
M_3	318,223	375,603	463,892	590,724
Longer-term bank instruments	20,971	30,833	52,975	79,834
Ajustabonos	32,442	31,929	32,523	15,840
Pagares (private enterprises)	2,249	9,261	14,665	15,060
Bonos	23	23	23	8
Obligaciones quirografarias	8,394	10,646	10,642	7,875
Obligaciones hipotecarias	993	1,226	1,066	1,352
Ficorca	4,687	--	--	--
Fondos del sistema de ahorro	--	5,503	16,061	28,622
M_4	387,982	465,024	591,849	739,296

Source: Banco de México, Dirección de Investigación Económica, Indicadores Económicos.

Aggregate Data on the Mexican Banking System

Table 2
Breakdown of Mexican Monetary Aggregates by Currency, 1991-1994
(in millions of NP, as of end year/month)

CURRENCY	1991	1992	1993	1994
Pesos	106,799	122,491	144,442	146,033
Foreign currency	3,096	3,980	4,469	8,486
M_1	109,895	126,471	148,911	154,519
Pesos	240,117	294,783	332,441	385,111
Foreign currency	29,003	29,316	38,431	69,796
M_2	269,120	324,099	370,872	454,908
Pesos	288,147	345,242	420,964	411,445
Foreign currency	30,076	30,361	42,928	179,279
M_3	318,223	375,603	463,892	590,724
Pesos	344,412	423,201	537,473	542,669
Foreign currency	43,570	41,823	54,376	196,627
M_4	387,982	465,024	591,849	739,296

Source: Banco de México, Dirección de Investigación Económica, Indicadores Económicos.

Aggregate Data on the Mexican Banking System

Table 3
Composition of Mexican Internal Public Debt, 1991-94
(in millions of NP, as of end year/month)

Instrument	1991	1992	1993	1994
Cetes	72,375	59,338	81,014	39,701
Ajustabonos	38,988	36,271	33,695	28,602
Bondes	57,953	36,848	17,036	8,316
Tesobonos	927	922	3,842	94,679
Other	72	24	24	8
Total	170,315	133,403	135,611	171,306
Held by:				
Banco de Mexico	34,668	30,123	9,865	14,825
Commercial banks[1]	55,450	21,054	2,460	6,123
Bondes	41,732	17,949	396	60
Ajustabonos	5,087	3,014	434	1,199
Cetes	8,630	91	1,226	1,237
Tesobonos	1	--	404	3,627
Development banks	808	175	51	2,205
Other financial institutions	931	1,229	1,231	--
Non-bank public sector entities	2,602	4,680	4,999	6,501
Private enterprises & individuals	75,856	76,142	117,005	141,652
Cetes	29,022	34,222	69,809	18,995
Ajustabonos	31,185	29,425	29,423	13,672
Bondes	14,552	11,437	13,273	2,563
Tesobonos	1,001	1,035	4,477	106,414
Other	96	23	23	8

[1] These figures are slightly lower than those of CNB.

Source: Banco de México, Dirección de Investigación Económica, Indicadores Económicos.

Aggregate Data on the Mexican Banking System

Part I

Table 4
Aggregate Balance Sheet of Mexican Commercial Banks[1], 1992 -94
(in millions of NP, as of end year/month)

	1992	1993	1994
ASSETS			
Cash and banks	12,996	13,402	19,921
Investment portfolio for trading[2]	48,101	46,759	85,883
Investments in subsidiaries	8,149	9,755	12,022
Loan portfolio			
Current	279,198	340,825	471,010
Past due	18,756	30,527	43,544
Gross	297,954	371,352	514,554
Provisions for bad debts	9,072	13,045	20,849
Loan portfolio (net)	288,882	358,307	493,705
Receivables under repo agreements	80,729	123,653	171,114
Assets given in lieu of loan repayment	1,133	2,515	3,702
Other receivables	2,741	3,305	6,661
Fixed assets (net)	5,968	7,284	9,407
Other assets	10,183	12,681	19,355
Total assets	458,882	577,661	821,770
LIABILITIES			
Demand deposits	90,251	108,687	107,326
Savings deposits	2,010	1,812	1,906
Time deposits	178,579	217,468	304,708
Total deposits	270,840	327,967	413,940
Bankers' acceptances	4,364	5,119	6,429
Money market repo agreements	12,066	7,869	16,540
Payables under repo agreements	80,131	123,125	175,436
Interbank funds	36,553	47,677	121,206
Due to government institutions	4,994	6,062	8,425
Other demand and time liabilities	19,149	20,587	32,656
Other liabilities	1,981	1,872	2,471
Total liabilities	430,080	540,278	777,103

Table 4
Aggregate Balance Sheet of Mexican Commericial Banks[1], 1992-94
(in millions of NP, as of end year/month)

	1992	1993	1994
Capital stock	2,408	4,650	10,231
Reserves	8,953	10,656	17,211
Profit from previous years	118	198	35
Revaluation surplus	10,858	12,921	13,962
Profit for the year (period)	6,007	8,392	3,661
Undistributed earnings from subsidiaries	458	566	(433)
Stockholders' equity	28,802	37,383	44,667
Total liabilities + stockholders' equity	458,882	577,661	821,770
CONTINGENT LIABILITIES			
Discounted loans	38,953	49,774	79,651
Guarantees	1,565	2,709	4,218
Irrevocable lines of credit	13,160	12,922	20,218
Total	53,678	65,405	104,087

[1] Aggregates exclude two banks (Union and Cremi) which were intervened in September 1994. At the end of June 1994, the two banks combined operated 272 branches, employed 8,542 persons, had stockholders' equity of 2,227 million new pesos (equivalent to 5.1% of the system's total equity) and assets of 35.3 billion new pesos (equivalent to 5.2% of the system's total assets).
[2] Including fixed-income securities (i.e., comprising mostly bankers' acceptances and promissory notes or *pagarés*), government securities and shares.

Source: Comisión Nacional Bancaria.

Aggregate Data on the Mexican Banking System

Table 5
Aggregate Income Statement of Mexican Commercial Banks[1], 1992-94
(in millions of NP)

	1992	1993	1994
Interest income	82,642	105,310	119,962
Interest expense	56,802	72,134	84,497
Net interest income[2]	25,840	33,176	35,465
Other income (net)[3]	7,442	8,792	7,409
Operating income	33,282	41,968	42,874
Staff expenses	9,675	12,067	14,173
Administrative expenses	10,013	11,800	13,851
Operating expenses	19,688	23,867	28,024
Amortization and depreciation	668	770	1,686
Loan loss provisions	4,101	7,441	10,829
Write-offs (loans)	624	272	554
Write-offs (securities)	1,373	537	1,288
Less: Recoveries	1,886	1,327	2,378
Less: Other non-operational income	619	1,066	2,183
Other expenses (net)	4,261	6,627	9,796
Profit before tax and profit-sharing	9,333	11,474	5,054
Income taxes	2,580	2,389	1,121
Profit-sharing payments	747	693	273
Net profits[4]	6,007	8,392	3,660

[1] Aggregates exclude two banks (Union and Cremi), which were intervened in September 1994.
[2] Including income from loan fees and fees paid to financial intermediaries.
[3] Including net commission income, net foreign exchange income, dividends and other net operational income.
[4] Excluding undistributed earnings from subsidiaries, which amounted to 458 million new pesos in 1992, 566 million new pesos in 1993, and a loss of 434 million new pesos in 1994. The net profits of 1992 and 1993 are overstated, since a number of banks created loan loss reserves through a charge on capital without passing through the income statement. It is estimated that these charges amounted to 1.1 billion new pesos in 1992 and almost 1.7 billion new pesos in 1993.

Source: Comisión Nacional Bancaria.

Aggregate Data on the Mexican Banking System

Table 6
Cost of Intermediation of Mexican Commercial Banks[1], 1992-94
(as a percentage of average total assets[2])

	1992	1993	1994
Interest income	19.48	20.32	17.14
Interest expense	13.39	13.92	12.08
Net interest income	6.09	6.40	5.07
Other income (net)	1.76	1.70	1.06
Operating income	7.85	8.10	6.13
Staff expenses	2.28	2.33	2.03
Administrative expenses	2.36	2.28	1.98
Operating expenses	4.64	4.61	4.01
Amortization and depreciation	0.16	0.15	0.24
Loan loss provisions	0.97	1.44	1.55
Write-offs (loans)	0.15	0.05	0.08
Write-offs (securities)	0.32	0.10	0.18
Less: Recoveries	0.44	0.26	0.34
Less: Other non-operational income	0.15	0.20	0.31
Other expenses (net)	1.01	1.28	1.40
Profit before tax and profit-sharing	2.20	2.21	0.72
Income taxes	0.61	0.46	0.16
Profit-sharing payments	0.17	0.13	0.04
Net profits[3]	1.42	1.62	0.52

[1] Excluding two banks (Union and Cremi), which were intervened in September 1994.
[2] Estimated as the arithmetic mean of two successive end year/period figures.
[3] Excluding undistributed earnings (losses) from subsidiaries.

Source: Comisión Nacional Bancaria.

Aggregate Data on the Mexican Banking System

Table 7
Classification of Gross Credit Risks and of Loan Loss Provisions Taken by Mexican Commercial Banks, 1991-94
(in millions of NP, as of end year/month)

Classification/level of risk	1991	1992	1993	1994
A Minimal	158,488	241,793	309,002	425,496
B Low	26,681	37,690	53,574	73,762
C Moderate	7,182	12,716	19,679	27,130
D High	2,651	4,958	9,367	14,921
E Loss	1,299	3,190	3,686	6,739
Not classified	11,659	9,560	3,996	3,114
Exempt	6,089	3,647	2,364	3,055
Gross credit risks[1]	214,049	313,554	401,668	554,217
Provisions taken by category				
B	104	379	696	808
C	628	2,170	3,940	5,506
D	919	2,903	5,319	9,183
E	1,002	3,213	2,787	4,481
Past due interest	--	407	303	870
Total provisions	5,072[2]	9,072	13,045	20,848
Additional provisions required by category				
B	115	43	--	--
C	578	269	--	--
D	282	139	--	--
E	53	104	--	--
Additional provisions required	1,028	556	--	--

[1] Aggregates exclude Union and Cremi. Gross credit risks include gross loans (inclusive of past due interest) plus off-balance sheet risks (i.e., discounted loans, guarantees and irrevocable lines of credit). Classification relates to previous quarter.
[2] Including an amount of 2,419 million new pesos in reserves for write-offs.

Source: Comisión Nacional Bancaria.

Aggregate Data on the Mexican Banking System

Table 8
Sectoral Breakdown of Gross Credit Risks and of Past Due Credits of Mexican Commercial Banks,[1] 1992-94
(in millions of NP)

	End December 1992			End December 1994		
Sector	Gross credit risks[2]	Past due credits[3]	Ratio (%)	Gross credit risks[2]	Past due credits[3]	Ratio %
Credit cards	28,691	2,363	8.24	31,003	4,135	13.34
Durable goods	11,592	1,132	9.76	13,080	3,503	26.78
Consumer credit	40,283	3,495	8.68	44,083	7,638	17.33
Agriculture, fisheries and mining	29,611	2,063	6.97	44,192	4,564	10.33
Commerce	59,253	3,569	6.02	124,839	10,513	8.42
Industry	90,338	3,771	4.17	158,639	9,621	6.06
Services and other activities	49,050	1,056	2.15	121,446	6,095	5.02
Government	8,934	23	0.26	18,812	45	0.24
Housing	51,647	387	0.75	103,205	2,409	2.33
Other commercial banks	4,088	5	0.12	14,010	3	0.02
Not specified	22,191	360	1.62	2,143	--	--
Total	355,395	14,729	4.14	631,369	40,888	6.48
of which:						
In pesos	273,393			444,359		
In foreign currency	82,002			187,010		

[1] Including Union and Cremi
[2] Including gross loans (inclusive of past due interest) plus off-balance sheet risks (i.e., discounted loans, guarantees and irrevocable lines of credit).
[3] Excluding past due interest.

Source: Banco de México, Dirección de Investigación Económica, *Indicadores Económicos.*

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Summary of Principal Financial Sector Legislation

Credit Institutions Law; CNBV Law

The *Ley de Institutiones de Crédito* was introduced in July 1990 and has been amended on a number of occassions. It replaced the earlier *Ley Reglamentaria del Servicio Público de Banca y Crédito*, which was drafted to govern the activities of banks nationalized in 1982. The Credit Institutions Law is intended to provide an appropriate legal framework for the capital structure, activities and supervision of the reprivatized commercial banking system. Together with the the Financial Groups Law, it established the conglomerate banking system in effect in Mexico today. The Credit Institutions Law also governs the activities and supervision of the seven state-owned development banks.

The Credit Institutions Law prescribes limitations on the activities of both the private commercial banks and the state-owned development banks. It originally provided that the *Comisión Nacional Bancaria* (established under earlier legislation) was the chief supervisory authority for both commercial and development banks. The *Ley de la Comisión Nacional Bancaria y de Valores*, which went into effect on May 1, 1995 provided for the merger of the *Comisión Nacional Bancaria* with the *Comisión Nacional de Valores*, the principal regulator of securities industry. The goal of the merger of the commission was to achieve greater coordination and efficiency in the regulation and supervision of financial entities. The CNBV's governance and powers of investigation, supervision and intervention of banks are now established in the CNBV Law.

The Credit Institutions Law established FOBAPROA (successor to an earlier bank support fund) and defines the legal basis for its provision of preventive support to troubled banks, which may be secured by a pledge of the shares of a commercial bank recipient of such support or its financial holding company (see "February 15 Amendments -- Activities and Supervision of Financial Institutions," below). The maximum contributions that may be assessed commercial banks to fund FOBAPROA are defined in the Credit Institutions Law.

The maximum levels of foreign investment in Mexican-controlled banks and the limitations on the capital structure and activities of foreign-controlled commercial banks are also set forth in the Credit Institutions Law. Since the February 15, 1995 amendments to Mexican financial sector legislation, foreign investors as a group may own up to 49% of the voting shares of a Mexican-controlled commercial bank. In addition, foreign investors may hold non-voting shares which may represent up to 40% of the voting shares (see "February 15 Amendments -- Liberalization of Investment Restrictions on Foreign and Corporate Investment," below). Commercial bank subsidiaries of foreign financial institutions are permitted to operate in Mexico, subject to the market share limitations negotiated under NAFTA.

Financial Groups Law

The *Ley Para Regular las Agrupaciones Financieras* was introduced at the same time as the Credit Institutions Law. The Financial Groups Law provides for the formation of financial groups comprised of a single holding company with a majority interest in two or more of the following financial service entities: commercial banks; brokerage firms; foreign exchange houses; leasing companies; factoring companies; insurance companies; bonding companies; financial warehouses and mutual fund managers. To qualify as a financial group, the holding company must control at least two of a commercial bank, brokerage company or insurance company. Otherwise, it must be made up of at least three financial entities, not including mutual fund operators. A financial group may not hold two or more of the same type of financial entity, other than insurance companies and mutual fund operators.

Pursuant to the Financial Groups Law, a financial holding company is responsible on an unlimited basis for the liabilities and losses of each of its subsidiaries. Since the amendments to this law published on February 15, 1995, the supervisory commissions (CNBV and CNSF) have authority to intervene a financial group if there is cause to intervene any subsidiary. Preventive support provided by FOBAPROA or FAMV to a commercial bank or brokerage firm subsidiary of a financial group may be secured by a pledge of the shares of the financial group (see "February 15 Amendments -- Activities and Supervision of Financial Institutions," below).

The maximum levels of foreign investment in Mexican-controlled financial groups and the limitations on the capital structure and activities of foreign-controlled financial groups are also set forth in the Financial Groups Institutions Law. These provisions are identical to those of the Credit Institutions Law applicable to commercial banks (see "February 15 Amendments -- Liberalization of Investment Restrictions of Foreign and Corporate Investment," below).

Capital Markets Laws

The *Ley del Mercado de Valores* was introduced in January 1975 and has been substantially amended since then. It is the principal legislation governing the securities markets (public offerings and secondary market trading of securities) and the activities of brokerage firms. The Capital Markets Law is intended to promote efficiency and sound practices, encourage public confidence and domestic and foreign investment through the securities markets.

The Capital Markets Law originally established the *Comisión Nacional de Valores* as the supervisory authority for the capital markets and the securities brokerage firms. The CNV was merged with the CNB pursuant the CNBV Law effecctive May 1, 1995. (see "Credit Institutions Law; CNBV Law" above). The Capital Markets Law provides for the establishment of the Fund for Support to the Securities Market (*Fondo de Apoyo al Mercado de Valores* - FAMV), and defines the legal basis for its provision of preventive support to troubled brokerage firms, which may be secured by a pledge of the shares of a brokerage firm recipient of such support or its financial holding company (see "February 15 Amendments -- Activities and Supervision of Financial Institutions," below).

The maximum levels of foreign investment in Mexican-controlled brokerage firms and the limitations on the capital structure and activities of foreign-controlled brokerage firms are also set forth in the Capital Markets Law. Since the February 15, 1995 amendments to Mexican financial sector legislation (see below), foreign investors as group may own up to 49% of the voting shares of a Mexican brokerage firm (see "February 15 Amendments -- Liberalization of Investment Restrictions of Foreign and Corporate Investment," below).

February 15 Amendments

One component of the Zedillo administration's response to the events following the December 1994 devaluation was the enactment of reforms to Mexican financial sector legislation published in the *Diario Oficial* on February 15, 1995 and effective the following day. The purposes of these amendments are to encourage additional capitalization of financial institutions and assure continued public confidence in domestic financial markets. The two principal elements of the reforms to the Credit Institutions Law, Financial Groups Law and Capital Markets Law are: (a) modifications governing the shareholding structure of financial holding companies, commercial banks and brokerage firms intended to encourage greater investment in the equity of financial institutions by Mexican corporations and foreign portfolio investors and financial institutions; and (b) toughening of federal laws governing (i) purchase by commercial banks of shares of affiliates, (ii) pledges of the equity of financial institutions as collateral for "preventive support" provided by FOBAPROA and FAMV (the support funds for banks and broker-dealers, respectively), and (iii) administrative and management intervention of financial holding companies.

Liberalization of Investment Restrictions on Foreign and Corporate Investment

Restrictions on overall and per shareholder investment in financial institutions applicable to Mexican and foreign individuals and corporations were significantly loosened, with the goal of attracting additional Mexican and foreign capital to the financial sector.

Mexican-Controlled Financial Institutions

In accordance with the new legislation, voting shares of Mexican-controlled financial holding companies, commercial banks and brokerage firms are now represented by Series A shares representing at least 51% of the voting capital and Series B shares representing the remainder. Mexican individuals and companies <u>majority</u> owned and controlled by Mexicans are now permitted to hold Series A shares. Both Mexican and non-Mexican individuals and corporations may invest in Series B shares. Under earlier law, Series A shares of financial holding companies and commercial banks could be held only by Mexican individuals. Only companies owned exclusively by Mexicans could hold Series B shares.[1] The amendments mean that companies that are merely majority owned and controlled by Mexicans are now permitted to hold voting shares of any series in financial holding companies, commercial banks and brokerage firms. The amendments permit foreign individuals and companies as a group to hold as much as 49% of the voting capital of a Mexican-controlled financial holding company, commercial bank or brokerage firm. Under earlier law, no more than 30% of the voting capital of such entities was eligible for investment by non-Mexicans.[2]

The new legislation also increases the maximum amount of non-voting Series L shares (eligible for ownership by both Mexicans and foreigners) that a financial holding company, commercial bank or brokerage house may issue to 40% of the voting share capital (Series A and B) from the earlier limit of 30%.

The recent amendments loosen the per shareholder limitations on control of Mexican-controlled banks. Before the amendments, no single individual or company could ordinary hold more than 5% of the share capital of a financial holding company or commercial bank. However, the Ministry of Finance was empowered to grant authorization for holdings of up to 10%.[3] The Ministry of Finance is now authorized to permit a single shareholder to hold Series A and B shares representing up to 20% of the share capital of a bank or financial holding company.[4]

Foreign-Controlled Institutions

Mexican law provides for a special category of foreign-controlled financial holding companies, commercial banks and brokerage houses, where provided for by treaty (such as the NAFTA). Foreign-controlled commercial banks and brokerage houses are ordinarily subject to individual and aggregate market share limitations.[5] Before the amendments, at least 99% of the share capital of such entities was required to be owned (directly or indirectly) by a single foreign financial institution. A foreign financial institution is now permitted to hold as little as 51% of the share capital of a foreign-controlled financial holding company, commercial bank or brokerage house. The intent of this component of the amendments is to encourage strategic alliances between foreign and Mexican financial institutions. Since the amendments permit a foreign-owned financial holding company to hold as little as 51% of the share capital of its subsidiary commercial bank or brokerage firm, a foreign financial institution may therefore control a commercial bank or brokerage firm with an investment representing little more than 25% of the total capital of such affiliate (by holding only 51% of the shares of the holding company which in turn holds only 51% of the shares of the affiliate bank or brokerage firm).

The amendments now permit the Ministry of Finance to waive the market share limitations provided for in NAFTA on a case-by-case basis for Mexican-controlled banks that are converted into foreign-controlled banks, as long as the resulting foreign-controlled bank has no more than a 6% market share and foreign-controlled banks in the aggregate represent no more than 25% of the total capital of the banking system. The purpose of empowering the Ministry of Finance to lift the NAFTA limitations in such cases is to encourage foreign financial institutions to enter the Mexican

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[1] By contrast, the Capital Markets Law, which governs brokerage firms, did not require that a portion of the capital stock of a brokerage firm be reserved for Mexican individuals. Nor was there a requirement that companies investing in the series of shares reserved for nationals be exclusively owned by Mexicans.

[2] Before the amendments, the capital stock of Mexican-controlled financial holding companies and commercial banks held by foreigners was represented by Series C shares. Series C shares will now be converted to Series B shares.

[3] The corresponding limitations for brokerage firms were 10% and 15%.

[4] The laws governing financial groups and commercial banks already provided an exception for investments of up to 20% by foreign financial institutions where the Ministry of Finance determined that the shareholding of the financial entity in question was otherwise diversified.

[5] The initial limitations under NAFTA are, respectively, 1.5% and 8% of the market, measured as a percentage of the total capital of the banking system.

market by shoring up a troubled Mexican-controlled bank rather than establishing a new subsidiary bank. The amendments explicitly recite that the purpose of the 6% and 25% market share limits (which were added to the legislation during its consideration by the Mexican Congress) is to assure Mexican control of the domestic payments system. In effect, these limitations mean that Mexico's three largest banks (Banco Nacional de Mexico, Bancomer and Banca Serfin) are not eligible for conversion to foreign control. It remains to be seen whether foreign financial institutions will find the prospect of exceeding the market share limitations under NAFTA a sufficient incentive to purchase an existing Mexican bank, with its attendant risks. Spain's Banco Bilbao Vizcaya, which currently holds in excess of 20% of the shares of Grupo Financiero Probursa-Mercantil, is currently negotiating for the conversion of its interest in this financial group into majority ownership.

Activities and Supervision of Financial Institutions

The laws governing the activities and supervision of financial institutions were also importantly strengthened by the recent amendments. Commercial banks are now prohibited from investing in shares of capital stock of companies that are shareholders of the bank or its financial group or in companies related through ownership and control with such shareholders. This prohibition was thought especially necessary in light of the loosening of restrictions on investments by industrial companies in commercial banks (discussed above).

Pursuant to the Credit Institutions Law and the Capital Markets Law, two "support funds" (FOBAPROA and FAMV) were created to provide "preventive support" to banks and brokerage houses to prevent defaults on obligations to depositors, customers, counterparties and bondholders. Prior to the recent amendments, extensions of such preventive support could be secured by a pledge of shares of capital stock of the beneficiary bank or brokerage firm.[6] The new amendments effected changes intended to facilitate the rapid intervention and disposition of decapitalized banks. Preventive support" may now be provided directly to the bank or brokerage firm or to the financial holding company to be channeled to such affiliate. In the later case, such support can be collateralized by a pledge of shares of capital stock of the financial holding company.

The rules governing the pledge of shares of the institution (financial holding company, commercial bank or brokerage firm) receiving support from FOBAPROA or FAMV have been toughened in the following two ways: (i) such pledges now have the status of preferential liens (and in the case of commercial banks, preferential liens of public interest); and (ii) the granting of such pledges conveys to FOBAPROA or FAMV the right to exercise all corporate and ownership rights over such pledged shares (including voting rights). The laws continue to require shares pledged in return for preventive support to be valued at seventy-five percent of book value for purposes of calculating the number of shares required to be pledged as collateral for the preventive support provided by FOBAPROA or FAMV. Immediately following the entry into force of the recent amendments, the authorities acted under the new legislation to restructure the share capital of Banca Cremi and Banco Union (two banks intervened in September 1994 after the discovery of massive fraud that left such banks decapitalized and in need of preventive support) to eliminate the interests of the old shareholders. The share capital of these two banks is now wholly-owned by FOBAPROA.

The amendments also granted the Banking and Securities Commissions (now merged into the CNBV) powers of administrative and management intervention of financial holding companies. Such new powers are similar in reach to those the Banking and Securities Commissions already possessed in respect of commercial banks, brokerage firms and auxiliary credit institutions. The CNBV may immediately take control of a financial holding company if in its judgment there are irregularities affecting its stability or solvency and which put in danger the interests of the public or its creditors. In addition, a financial holding company may be intervened if there is an intervention of any one of its affiliated financial institutions.

May 19, 1995

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[6] The laws also contemplate liquidity support to solvent banks that could be secured by assets other than the shares of the financial institution.

MEXICO
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Summary of Significant Differences between CNBV's Accounting Practices for Banks and Generally Accepted Accounting Principles in the United States ("U.S. GAAP")

Principal Differences Between U.S. and Mexican GAAP

Explanatory Note

Financial statements of corporations in Mexico are prepared under Mexican generally accepted accounting principles ("Mexican GAAP"), which differ in some important aspects from U.S. generally accepted accounting principles ("U.S. GAAP"). Accounting guidelines for financial institutions also vary from those set by Mexican GAAP for other Mexican corporations. Mexican credit institutions generally prepare their financial statements in accordance with guidelines established by the National Banking and Securities Commission (CNBV). Banking regulations require credit institutions to arrange their accounts according to an authorized chart of accounts, to follow the accounting rules published in the CNBV circulars, and at times to follow explicit authorizations issued by the authorities according to special agreements made under special circumstances. Summarized below are the major accounting differences between the CNBV's accounting guidelines for Mexican banks and U.S. GAAP for banks.

Loan Loss Provisions

CNBV. Under CNBV guidelines, general loan loss provisions are required to be provided, based on a classification of individual loans of at least 80% of the loan portfolio. The criteria for classification of individual loans encompass many factors, with payment status and collateral valuation weighing most heavily. There are also criteria to consider certain types of loans as past due. The loan portfolio and related accrued interest is required to be classified quarterly, and the provision is adjusted by applying certain provisioning percentages to the various credit risk classifications, which range from "A"-minimal risk to "E"-loss (which can be written off under CNBV rules). The rules permit the creation of loan loss provisions through a change in capital reserves (without passing through the income statement), which results in overstating profits. Commencing February 22, 1995, the CNBV requires all banks to increase the level of provisions to the higher of: (a) 4% of the loan portfolio; or (b) 60% of past due loans; or (c) actual provisions required as a result of the quarterly loan classification.

The increase or decrease in the provisions is recognized in the next quarter's income. However, because of the difficulties involved in compiling the provisions, banks are allowed to defer recognition of reserve changes for an additional quarter. The base for the portfolio classification includes contingent credits, but excludes loans to the Mexican Government and to Banco de Mexico.

U.S. GAAP. Under U.S. GAAP, an allowance for possible loan losses is provided based on management's estimate of the losses inherent in the loan portfolio. The allowance analysis is usually performed periodically, with provisions being charged to current operations. Specific reserves are provided after consideration of a borrower's financial condition and the estimated fair value of the underlying collateral. General reserves are provided after considering such factors as the economy in lending areas, delinquency statistics and trends, past loss experience and estimated future loss experience.

Interest Income on Loans

CNBV. Under CNBV guidelines, interest on loans is accrued and credited to income based on the principal amount outstanding. Interest continues to accrue on all loans except loans where the entire principal balance of the underlying loan is past due.

Unpaid interest is included within the loan classification and rating system for determining the amount of loan loss provisions. No reversal of past-due interest income is permitted under CNBV rules.

U.S. GAAP. Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on all loans is discontinued when in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

Troubled Debt Restructuring

CNBV. The accounting procedures for restructured loans are regulated by CNBV Circular No. 1229. Separate accounts are to be maintained for such loans, and a memorandum account may also be kept for control purposes. The circular sets out parameters to be considered for restructuring a loan, which involve changes in interest rates, maturities, amounts of additional or new collateral. There is, however, no limit on the amount of interest earned on restructured loans.

U.S. GAAP. Under U.S. GAAP, depending on the terms of the restructuring, recognition as interest income of unpaid accrued interest, which is due at the time of restructuring may be limited. Recognition of cash receipts which are received after the restructuring may also be limited.

Investments in Subsidiaries, Affiliated Companies and Other Equity Investments

CNBV. Prior to 1992, investments in shares of the subsidiaries (ownership 50% or greater) were recorded at acquisition cost, and adjusted annually to values determined by CNBV for each individual entity. Increases in the valuation amount were recorded as a revaluation surplus, a component of stockholders' equity, and decreases in value below cost were charged to operations. Beginning in 1992, in accordance with changes in CNBV regulations, investments in subsidiaries are required to be accounted for under the equity method, recognizing the equity in the net income or loss as a separate account of stockholders' equity.

Investment in other equity investments (ownership of less than 50%) were, prior to 1992, accounted for in the same manner as subsidiary companies described above. Since 1992, equity investments quoted on the Mexican Stock Exchange are required to be carried at the quoted market value. Investments not quoted on the stock exchange are required to be carried at the related equity in the book value of affiliates, when audited financial statements are available. If audited financial statements are not available, the CNBV will determine the carrying value.

U.S. GAAP. Under U.S. GAAP, equity investments of less than 20% are to be recorded using the cost method, with a valuation reserve for the excess of cost over market value. Decreases in market value below cost are recorded directly as a component of equity, except for permanent impairments, which are recorded against operations. Investments of 20% to 50% are recorded using the equity method, and investments of more than 50% are consolidated with certain exceptions related to operating control of the company.

Repurchase Agreements

CNBV. Under the CNBV's accounting principles, when a sale of securities under an agreement to repurchase the same or similar securities takes place, the obligation to repurchase is recorded in addition to recording the transaction as a decrease in securities. The future obligation to repurchase is recorded as a liability and an asset is also recorded for the security to be received. The accounting treatment is similar for securities purchased under an agreement to resell. There is no differentiation between long-term and short-term transactions. In Mexico, repo transactions are included in the balance sheet.

U.S. GAAP. Under U.S. GAAP, short-term transactions are treated as either sales or financing transactions, depending on various transaction criteria, especially the degree of control the seller has over the securities to be repurchased. In transactions accounted for as financings, payable and receivables for the future sale or purchase obligation are recorded but changes to the investment accounts are not recorded. Long-term transactions are treated as sales.

Fixed Income Securities

CNBV. CNBV accounting principles, introduced in December 1994, require banks to value securities at market value but allow them to report unrealized gains or losses as memorandum items (off balance sheet). Gains or losses on the basis of market valuation are not accounted for through the income statement.

U.S. GAAP. U.S. GAAP requires such gains or losses to be credited or charged to income in the income statement.

Revaluation of Fixed Assets

CNBV. The CNBV's accounting practices required land and buildings to be carried at the appraised value, which must be approved by the CNBV annually. Since 1994, the revaluation of land and buildings is only required every three years. Increases in the valuation amount (linked to inflation through CNBV price indices) are recorded as a revaluation surplus, a component of stockholders' equity. Decreases in value first reduce any revaluation surplus, and decreases below original cost are recorded against operations for the year. Depreciation, based on the useful life of assets, is recorded only on the historical cost amount. Prior to 1992, these rules applied only to land and buildings. In 1992, these rules were extended to all premises, furniture and equipment. Computer equipment is revalued only if it has been acquired in foreign currency.

U.S. GAAP. Financial statements prepared in the U.S. are not adjusted for inflation. Real estate is stated at cost less accumulated depreciation. U.S. GAAP prohibits the write-up of fixed assets to market value. One exception is the revaluation of assets and liabilities of acquired entities under the purchase method of accounting.

Goodwill and Acquisitions

CNBV. The CNBV guidelines do not normally[1] permit banks to recognize goodwill. The purchase premium associated with the privatization of banks in 1991-92 was recorded by the parent holding company. That purchase premium is not allocated to the assets and liabilities of the banks nor is the purchase premium amortized against income. Holding companies can record goodwill and amortize it over a period of up to 25 years. An "accelerated amortization" is also permisiable.

U.S. GAAP. Purchase accounting under U.S. GAAP requires the allocation of the purchase price to the fair value of assets acquired and liabilities assumed with any unallocated cost recorded as goodwill. Goodwill should be amortized using the straight-line method over the period estimated to be benefited, but the amortization period for banks should not exceed 25 years. Based upon various criteria, goodwill resulting may be "pushed-down" to the acquired company's financial statements.

Loan Fees

CNBV. The CNBV's accounting practices permit the recognition of all loan fees as income when received.

U.S. GAAP. Under U.S. GAAP, loan fees, less the direct cost of originating the loan, are deferred and amortized to income over the life of the related loan by the interest method.

Pension Costs

CNBV. Under the CNBV's accounting practices, entities recognize pension expense based on the liability determined by actuarial computations, as approved by it. Recent changes to CNBV accounting practices have resulted in a convergence of

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[1] Recently, an exception has been made for one new bank where goodwill was recorded in an acquisition.

its practices with Mexican GAAP, which are closer to the requirements of U.S. GAAP guidelines.

U.S. GAAP. U.S. GAAP requires application of the unit credit actuarial method and recognition of compensation costs of an employee's pension over the employee's estimated service period. U.S. GAAP also requires recognition of a minimum liability when the accumulated benefit obligation exceeds the fair value of plan assets. Gains and losses on plan assets may be deferred if they fall within certain limits.

Extraordinary Items

CNBV. The CNBV's accounting practices do not have established criteria for distinguishing and reporting extraordinary items.

U.S. GAAP. Under U.S. GAAP, events or transactions that are both unusual in nature and occur infrequently are reported as extraordinary items.

Income Taxes and Employees Statutory Profit Sharing

CNBV. The CNBV's accounting practices require income tax expense to be recorded based on taxable income, with no provision for timing differences between taxable and book income. Similar treatment is also applicable to Mexican statutory employees' profit sharing ("PTU") as income tax accounting treatment is required for PTU.

U.S. GAAP. Under APB 11, U.S. GAAP requires deferred taxes to be provided on all timing differences, at the tax rate in effect at the time the differences arise. Under FASB Statement No. 109, which is effective for fiscal years beginning after December 15, 1992, U.S. GAAP requires deferred taxes on essentially all temporary differences between book and tax bases of assets and liabilities, at the tax rate expected when the temporary differences reverse. For deferred tax assets, a valuation allowance is recognized if it is more likely than not that some portion or all of the asset will not be realized.

Earning Per Share

CNBV. An earnings per share presentation is not required under CNBV accounting practices.

U.S. GAAP. Under U.S. GAAP, public entities are required to report earnings per share, based on the weighted average number of common shares outstanding during the period and additional common shares assumed to be outstanding, to reflect the dilutive effect of common stock equivalents and all other potentially dilutive securities.

Financial Statement Presentation and Disclosure

CNBV. The format of the financial statements is generally set by the CNBV. The CNBV through circulars also sets guidelines for the disclosure of certain information in financial statements (e.g. disclosure requirements for loan portfolio classification). There are no specific rules that provide for disclosures in bank financial statements. The common practice is to follow Mexican GAAP disclosures.

U.S. GAAP. Under U.S. GAAP, additional disclosures have to be made when preparing financial statements of banks, such as:

(1) Disclosure in financial statements according to FASB Statement No. 105, "Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk."
(2) Disclosure in financial statements according to FASB Statement No. 107, "Disclosures about Fair Value of Financial Instruments."
(3) Cash flow statements.

May 20, 1995.

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Structure and Powers of FOBAPROA

History

The Bank Fund for Savings Protection (*Fondo Bancario para Protección al Ahorro* - FOBAPROA) is the successor to the Preventive Support Fund for Commercial Banks (*Fondo de Apoyo Preventivo a las Instituciones de Banca Múltiple* - FONAPRE), which was established in 1986. FOBAPROA is governed under Article 122 of the Credit Institutions Law (*Ley de Instituciones de Crédito*), the principal statute governing the activities of commercial and development banks, which went into effect on July 18, 1990. Article 122 describes the purpose of FOBAPROA as to serve as a mechanism for preventive support to commercial banks and to protect savings.

Legal Status

FOBAPROA is a trust (*fideicomiso*) administered by the Banco de Mexico. After enactment of the Credit Institutions Law, FONAPRE's trust agreement was substantially modified to comply with the requirements for FOBAPROA set out in Article 122. This modified trust agreement now governs the powers and procedures of FOBAPROA.

Administration and Governance

The day-to-day operations of FOBAPROA are administered by the Banco de Mexico. However, policy decisions for FOBAPROA are made by FOBAPROA's Technical Committee. The Technical Committee is composed of nine members. Four are named by the Ministry of Finance and Public Credit, one of whom must be the Minister himself. Three members are appointed by the Banco de Mexico, one of whom must be the Governor thereof. The last two members are selected by the National Banking and Securities Commission (a dependency of the Ministry of Finance) and must include the President of the Commission.

Funding

Article 122 of the Credit Institutions Law provides that the Ministry of Finance may establish regular and extraordinary contributions to be paid by commercial banks to capitalized FOBAPROA. Regular and extraordinary contributions are limited under the Credit Institutions Law to 0.5% and 0.7% of obligations subject to protection, respectively. Contributions to FOBAPROA are collected by the Banco de Mexico directly from the deposits of the commercial banks maintained with it. In addition to the periodic assessments described above, new entrants are assessed an initial contribution based on their expected share of the market after their first three years of operations.

FOBAPROA is empowered to and has funded its activities with borrowings from the Central Bank. It may also borrower from the Government through the Ministry of Finance. The financial statements of FOBAPROA are not publicly available and the government does not publicly disclose the amount of capital or other resources available to FOBAPROA.

Obligations Subject to Protection

The Credit Institutions Law does not obligate FOBAPROA to explicitly guarantee or insure any obligations of any commercial bank. However, Article 122 does provide that each year in the month of December FOBAPROA must publish an announcement of the maximum amount of the obligations of commercial banks it intends to protect in the following year. As noted earlier, the amount of annual contributions made by each bank is determined as a percentage of obligations subject to protection.

The announcements made at the end of 1993 and 1994 stated that, in accordance with the tradition of the Mexican financial authorities, FOBAPROA would continue to endeavor, to the extent of its resources, to assure the performance of all the obligations of participating banks, except for subordinated debt. According to representatives of FOBAPROA, the National Banking Commission and private lawyers, that these announcements do not create a legal obligation of FOBAPROA or the Government to insure any deposits or take any specific action in the event of the failure of a bank to pay any obligation. Depositholders or bondholders of a Mexican bank would not be entitled to make a claim against FOBAPROA in the event of an uncovered default by any such bank, as they might were FOBAPROA explicitly a deposit insurance entity.

Preventive Support and Collateral

Article 122 of the Credit Institutions Law provides that FOBAPROA may require guarantees in exchange for preventive support provided by it to a troubled bank. Such guarantees may take the form of a lien over the shares of the bank. For such purposes, the amount of shares required to be pledged in return for such support is calculated based on a value of 75% of the shares' book value. Amendments to the Credit Institutions Law made on February 15, 1995 provide that FOBAPROA's lien on the shares of a commercial bank is a preferential lien of public interest (with preference over preexisting encumbrances) and conveys on FOBAPROA the power to exercise any of the corporate rights inherent in those shares without having to execute its lien over such shares.

PROCAPTE

FOBAPROA is the administrator of the Temporary Capitalization Program (*Programa de Capitalización Temporal* - PROCAPTE) described in Annex X.

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

English Translation of PROCAPTE Scheme (Banco de Mexico Circular of February 24, 1995)

BANCO DE MEXICO

February 24, 1995

To Commercial
Banking Institutions

Re: Temporary Capitalization Program (PROCAPTE)

We refer to the Program that the financial authorities have agreed to implement, having heard the opinion of the Mexican Bankers Association, to strengthen the capital of the commercial banking institutions that, due to the circumstances that the markets are experiencing and not their individual operational circumstances, are unable to meet capitalization requirements established in the rules issued by SHCP, after the establishment of appropriate preventive reserves.

The referenced program, hereafter referred to as PROCAPTE--Temporary Capitalization Program--consists of the placement of subordinated debentures convertible into shares of capital stock of the bank that issues them. The institutions that enter the program must deposit the proceeds of such placement in the Banco de Mexico for a term and yield equal to those of the debentures.

Following are the relevant characteristics and program conditions:

1. The program will operate with financing granted by the Banco de Mexico to the Bank Fund for Savings Protection (FOBAPROA), which in addition to acquiring the above-mentioned debentures, will handle PROCAPTE's administration independent of its traditional programs.

2. Application for entry into the Program must be presented in writing, by a letter signed by the institution's General Manager, during the last week of the month preceding that in which it is intended the support be received, with the obligation of later presenting the financial information requested by FOBAPROA and summoning the Stockholder Assembly to approve corresponding agreements.

3. The referenced Program will have a duration of 5 years, entering in effect as of March 31, 1995, during which time the institutions that enter must maintain a capital coefficient of at least 9%. This coefficient may be decreased to 8.5% if this decrease is the result of the establishment of preventive reserves. The period may be reduced if the program administrator considers that favorable market conditions exist such that institutions can recapitalize themselves. Accordingly, the PROCAPTE administrator reserves the right, upon one year's notice, to demand that the institution acquire all or part of the subordinate debentures.

This mechanism has as its exclusive purpose to meet the mentioned coefficent, taking into consideration the sum of risk assets, including accessories, corresponding to the month of February 1995.

4. The issuer will have the right to acquire all or part of the debentures in the same proportion that it increases its capitalization coefficient, without considering the debentures corresponding to the program.

5. The capitalization necessary to support any future growth must come from the institution's own resources, such as profits and surplus, and/or with subordinated debentures not convertible into stock; these last up to 50% of basic capital, without taking into consideration the above-mentioned debentures.

6. The debentures must be mandatorially convertible at maturity into series "A" or series "B" capital stock of the institution, at the election of FOBAPROA. FOBAPROA may exercise the right of early conversion only if the basic part of

the institution's net capital, without considering these debentures, reaches less than 2% of risk assets, or that the index of individual net capital, also not considering these debentures, records a decrease superior to the percentage resulting from algebraically subtracting from 25% the percentage variation of the arithmetic average coefficient registered by the group of banks participating in the Program. This measurement will be made on a quarterly basis, considering the capital coefficient that served as the base to enter "PROCAPTE."

7. During the program's duration, the institution may not place shares or subordinated debentures mandatorially convertible into capital other than those discussed herein, except in the case of the acquisition of debentures by the issuer as described herein, nor distribute dividends. These agreements must be approved by the Shareholders Assembly and the appropriate authorities no later than the date intended for the issuance of such debentures.

8. Yield and conversion terms: The yield should be that necessary such that the amount of the issuance maintains its value in real terms, in accordance with the variation of the "National Index for Consumer Prices."

Conversion will be made under the following terms:

For the sum of subordinated debentures, the institution must deliver the amount of shares resulting from the application of the following formula:

$$\boxed{NA = \frac{OS}{\dfrac{CC - OS}{A}}}$$

Where:

NA = Number of shares obtained by conversion.

CC = The accounting capital which is the lesser of, accounting capital on the last day of the month immediately preceding the date of conversion and the arithmetic average of the accounting capital on the last day of the three months preceding such date. The figures must be approved by the National Banking Commission and an external auditor.

OS = Amount of the debentures issued for purposes of "PROCAPTE" added with its yields.

A = Number of shares in circulation on the date of conversion. If an institution has issued other mandatory convertible debentures, the number resulting from applying to this issuance the conversion formula agreed in the corresponding documentation would be added to the number of shares; this calculation would be made on the date of and only for effects of this calculation.

The administrator of PROCAPTE will have the right to request a review by the National Banking Commission, or an external auditor, of the accounting records of a Program participant, while such institution remains in the Program and for 6 months thereafter. Therefore, during this period the results of conversion may be adjusted accordingly to the results of such review.

9. The Program has been designed in such a manner that under normal circumstances FOBAPROA will not necessarily exercise the conversion of Debentures; in the event that the Fund exercises its right of conversion according to the applicable provisions, it will dispose of corresponding shares as soon as possible to the investing public.

10. The deposit which the institution establishes with the resources transferred by PROCAPTE will earn interest equal to that generated by the debentures in question and will be considered terminated on the conversion date or acquisition date by the issue of debentures.

Additionally, the Shareholders Assembly must adopt the necessary agreements for the issuance of the convertible debentures, it also being required that any loss suffered by the institution must be recognized before the conversion date.

ANNEX X
Page 3 of 3

This program shall be voluntary. Application by an institution to be considered in this program as well as all corresponding financial and legal information must be delivered to the addresses indicated below, expressing conformity with the terms and conditions of the program shown in this paper.

The financial authorities have stated that after February 1995, exceptions will not be granted to institutions related to capitalization requirements established in the rules issued by the Ministry of Finance and Public Credit, with the exception of those credit institutions that during the present month have expressed their interest in participating in this program. At the same time, please be informed that the authorities will continue to give priority to the terms and conditions of the present program.

The present communication supercedes those of January 16th and 25th of this year.

Sincerely,

BANCO DE MEXICO
In its Capacity as Fiduciary of FOBAPROA

Lic. Angel Palomino Hasbach
Fiduciary Delegate

C.P. Manuel Camacho Tellez
Fiduciary Delegate

Send requests to:
Banco de Mexico - FOBAPROA - Temporary Capitalization Program
Paseo de la Reforma No. 10, Piso 18 (Torre Caballito)
Col. Tabacalera

Banco de Mexico - Private Financial Intermediaries Division
Av. 5 de Mayo No. 6, 6° Piso, Col. Centro

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Principles of Corporate Debt Restructuring Under the UDI Scheme

The economic crisis has made it difficult for many debtors to service bank loans. To minimize the bankruptcy of firms that are viable in the long-run but cannot meet debt service payments under current conditions, the Government of Mexico is reducing impediments to voluntary debt restructuring and actively promoting debt restructuring, because of the acute nature of the crisis. The official corporate debt restructuring schemes are called "Support Programs" (*Programas de Apoyo)*. The Support Programs will expedite the restructuring of loans equal to about NP170 billion (approximately US$28 billion), which represents about 10% of Mexico's projected 1995 GDP. These programs include the restructuring of (a) private corporate loans, (b) household mortgages, (c) development bank loans (primarily) to final borrowers (e.g. SMEs) or to banks and non-bank financial institutions that on-lend such funds, and (d) loans to states and municipalities

This Annex (a) describes the Investment Unit (*unidad de inversion*, or UDI) which is a crucial component of the Support Programs, (b) describes each of the five Programs, (c) analyzes the lending and funding rates of the restructuring program and the provisioning requirements, and (d) discusses the implementation risks of the Support Programs.

I. Investment Unit (UDI)

A. The UDI: a Constant Value Unit of Account

A central pillar of the Support Programs is the UDI. The UDI is a unit of account that maintains a constant real value. UDI financial instruments eliminate the inflation-uncertainty component of interest rates which should facilitate voluntary debt restructuring at lower real interest rates. Furthermore, the UDI forms the basis of the Government sponsored debt restructuring programs. Approximately NP170 billion of existing loans that have short-run floating nominal interest rates will be rapidly rescheduled into UDI loans with fixed long-run real interest rates.

The key legal and regulatory documents establishing the UDI are summarized in the boxes XI.1 and XI.2.

<u>Box XI.1: UDI Circular Issued by the Banco de Mexico April 3, 1995</u>

<u>Use</u>:	Banks are authorized to denominate in UDIs: (a) liabilities of greater than three months and (b) assets of any term. Repurchase agreement terms are limited to between three months and 360 days.
<u>Interest</u>:	A single rate of interest must apply.
<u>Net Position Limit</u>:	Net UDI positions of banks and of financial groups (excluding banks, which report separately) are limited to 40% of net capital, with consolidation of all local and foreign subsidiaries required. An entity breaching the net position limit is subject to fines and must abide by Banco de Mexico guidance in reducing net positions within a required time frame.
<u>Index</u>:	The national consumer price index, applicable to UDI value adjustment, is established with the base year of 1994 equal to 100.

As approved by the Mexican Congress on March 30, 1995, the UDI may be used as unit of account for most financial instruments. The UDI has not been authorized as a medium of exchange. Thus, to effect a transaction involving UDIs, the amounts expressed in UDIs must be converted into NP. UDIs are not authorized for demand deposits. In addition, UDIs are not authorized for use in the denomination of non-financial transactions, such as labor contracts, purchase agreements, and commercial agreements.

Box XI.2: Congressional Decree of March 30, 1995

Article	
1. Definition:	UDI: a unit of account whose NP value is published periodically in the official gazette by the Banco de Mexico.
Use:	(a) Peso-pay financial instruments pertaining to operations between financial intermediaries; (b) peso-pay financial liabilities--except checking obligations and, generally, any amounts under commercial contracts.
2. Payments:	In NP ("local currency"), calculated by multiplying the UDI amount times the value of the UDI corresponding to the day of payment.
3. Index Adjustment:	Banco de Mexico to determine and publish the daily value by means of a methodology based on the national consumer price index (*indice nacional de precios al consumidor,* IPNC)
4. Financial Code:	Adjustments in UDI value are defined as interest.
5. Tax Law:	(a) Adjustments in UDI value are not considered interest for purposes of determining the inflationary component of nominal interest; (b) adjustment in UDI value is considered as nominal income ; (c) adjustment in UDI value does not accrue for purposes of calculating net monetary exposure to inflation; (d) withholding is 15% on interest paid on UDI instruments, versus 20% on the first 10 percentage points of interest on instruments not denominated in UDIs.

B. UDI Value Indexation and Methodology

Coinciding with the introduction of the UDI, the Government will use a re-based consumer price index. The re-based index updates the component weights within the INPC to match those resulting from the 1989 versus the older 1978 household survey. The re-based index also extends coverage to include 48 Mexican cities, up from 37 cities while it also incorporates new goods and eliminates others. The market basket will now include 313 consumer goods, up from 303 goods. The re-based index is set at 100 for December 31, 1994 and will provide the information to calculate the daily UDI value.

The calculation by the Banco de Mexico of the daily UDI value is based on a 10-day lagged value of the re-based INPC. Hence, the daily UDI value schedule published on the 10th of each month is based on the change in the INPC for the last half of the previous month. This lagged INPC then defines the inflation rate applicable for days 11 through 25 of the current month. Likewise, the daily UDI schedule published on the 25 the of each month, for days 26 (of the current month) through 10 (of the subsequent month), is based on the change in the INPC for the first half of the current month.

The UDI value for each day is calculated according to a non-linear interpolation of the INPC index between the beginning and ending dates of the published schedule. The Banco de Mexico indicates that this is essentially the method used in Chile to calculate the *Unidad de Fomento* (UF), except that in Chile the household survey is carried out monthly rather than bi-monthly.

The starting value of the UDI was set equal to NP1.00 on April 4, 1995. The NP equivalent value of the UDI for a given date is applicable for the conversion of UDI amounts into NP at any time during that day. The daily UDI value schedule is now published in the official gazette (*Diario Oficial de la Federacion)*, according to the value set by the Banco de Mexico for the prospective bi-monthly period.

As a transitionary device to immediately establish the use of UDIs, beginning on April 4, 1995, a special UDI value schedule was published for April 4 to 10, as follows:

Date	Value
April 4, 1995	1.00
April 5, 1995	1.001918
April 6, 1995	1.003840
April 7, 1995	1.005766
April 8, 1995	1.007695
April 9, 1995	1.009628
April 10, 1995	1.011564

Hereafter, the UDI value schedule will be published bi-monthly, beginning with April 11 to 25, and then April 26 to May 10, etc.

II. Objectives and Approach of the UDI Restructuring Programs

The UDI restructuring initiative represents a major support action by the Government. The central objective of the roughly US$28 billion Support Program is to rapidly restore the financial and operational health of commercial bank debtors who, except for the ill effects of the current crisis, are viable entities. The Support Programs will ultimately help (a) private sector companies, (b) households, (c) development banks and (d) states and municipalities. Each of these subsidiary programs has, or will, receive UDI allocations for restructuring. Thus far the first three support programs relating to private sector companies and households shown in Box XI.3 below have been officially authorized in the amount of NP147 billion or US$24 billion. The additional programs for states and municipalities and the Development Banks are estimated to be on the order of NP23 billion or approximately US$4 billion. Preliminary allocations for these additional programs are shown in detail in Box XI.3 on the following page.

The centerpiece of the Support Program is the substitution of generally short-term floating rate loans linked to the Cetes rate or other local benchmarks, for new long-term UDI loans that carry a fixed real interest rate. (For household mortgages, there is a 6 percent real interest rate cap.)

A substantial number of commercial bank borrowers have insufficient cash to continue meeting the current high nominal rates of interest that reflect the market's sudden shift to an expectation of 100% inflation in the immediate term and 40 - 50% over the coming year. To maintain payment performance for otherwise good credit risks, commercial banks have made new loans to cover part of the current interest payments. Re-lending of this sort is based on the logic that in a newly evolved high inflation environment, debt repayment effectively is partially made via payments of higher amounts of interest. High nominal interest rates compensate for the depreciating real value of outstanding principal.

1. Productive Plant Support Program (local currency) (*Programa de Apoyo a la Planta Productiva - moneda nacional)*

This Program includes NP76 billion equivalent (about 9% of total outstanding commercial bank loans) of

Box XI.3: Programas de Apoyo Subsidiary Programs
(in NP billion equivalent)

Program	UDI Allocation	Target Borrower and Type of Credit
1. *Programa de Apoyo a la Planta Productiva (moneda nacional)*	76.0	Private sector corporations with loans denominated in local currency
2. *Programa de Apoyo a la Planta Productiva (moneda extranjera)*	37.7	Private sector corporations with loans denominated in foreign currency (allocation is US$5.8 billion)
3. *Programa de Apoyo para los deudores de creditos hipotecarios*	33.4	Households with mortgage loans
4. *Programa de Reestructuracion de los Creditos de Estados y Municipios*	11.2	States and Municipalities
5. *Programas de Restructuracion de la Banca de Desarollo*	11.8	Final borrowers (e.g. SMEs Agricultural borrowers) when the Development Bank is a first tier lender and bank and non-bank financial intermediaries when the Development Bank is a second tier lender
TOTAL	170.1	

UDI refinancing. The companies will be selected by the banks and subject to CNBV regulations that define the viability of companies seeking to restructure their debts. The scheme only applies to credits within the loan portfolio of the commercial banks as of December 1994. It also applies to all loans inclusive of those classified as D and E. However, in these cases, viability must be demonstrated to the CNBV and D and E loan restructuring cannot obtain the grace periods available under the stated restructuring options (see table below).

The mechanics of this scheme are illustrated in Chart I with T-accounts and include the following:

- The debtor receives UDI loans from a new trust.
- The trust purchases the old NP loan from the commercial bank (who remains liable for payment defaults by the debtor).
- The trust funds the loan purchase by issuing 4% UDI securities to the Government.
- The Government funds the UDI loan by issuing long-term Cetes-based securities (only payable at final maturity), with mandatory re-investment of interest to maintain the real value of the principal of these securities (e.g., a form of zero-coupon bond). The bonds issued by the Government are of maturities similar to that of the maturity of the restructured UDI loans in the trust.
- These Government bonds are placed with the commercial bank that had created the UDI trust.

In this manner the commercial banks have substituted the restructured loan portfolio with holdings of government debt. At the same time the Government is funding the trust(s) created by the commercial bank at UDI+ 4% while issuing debt obligations to the commercial bank at nominal interest rates that may have realized real interest rates of more than UDI + 4%. Repayment of the new UDI financing would be over 5 - 12 years, with up to 7 years of grace, in six possible options where the commercial bank will have to set up a separate trust in the case of each option provided.

repayment option	term in years	grace period in years
1.	12	7
2.	10	4
3.	8	2
4.	10	0
5.	7	0
6.	5	0

During the repayment phase, the Government funds the difference between the stated real interest paid on its UDI loan and the realized real interest rate paid on the Cetes-based NP securities that provide funding for the UDI loans. The commercial banks (a) maintain a constant real value of NP invested in the Cetes-based securities, to match the real value remaining on the UDI loan balance as it amortizes, (b) retain credit risk for the performance of the debtor; (c) are responsible for loan supervision; (d) contribute an annual "topping up" amount, whereby they make good on any shortfalls of cash received by the trust due to payment defaults. The commercial banks also (e) contribute quarterly any amounts by which the rate on the Mexican social security savings accounts ("SAR" accounts) exceeds 4%, as further explained below, and they (f) contribute immediately for the required additional provisioning upon a downgrading of credit classification by CNBV examiners in contrast to the 90-180 days permitted on non-UDI loans.

2. Productive Plant Support Program (foreign currency) ***(Programa de Apoyo a la Planta Productiva -moneda extranjera):***

The Program equals US$5.8 billion, (about 18% of all commercial bank credit denominated in US dollars) of UDI refinancing for private sector companies. This program is quite similar to the first program. Chart II illustrates the initial refinancing transaction. The principal difference is that the commercial banks would invest in Tesobonos issued by the Government, rather than in Cetes-based securities, and, in addition, they would make best efforts to renew their external US dollar liabilities. If they cannot renew their external lines, they would replace the amounts of such lines with borrowings from FOBAPROA. This program has been finalized.

3. Mortgage Debtor Support Program ***(Programa de Apoyo para los Deudores de Creditos Hipotecarios)***

This Programa equals NP33.4 billion (about 34% of outstanding mortgages) of UDI refinancing for households selected by the commercial banks. This is essentially identical to the first program described above, except in three respects: (a) the borrowers are Mexican households with mortgage debt; (b) the UDI trust funding rate is 2% rather than 4% and the borrower interest charge is capped at 6%; (c) the term of the new UDI loans is 15, 20, 25, and 30 years. This program is not completely finalized.

4. State and Municipal Debt Restructuring Program ***(Programa de Reestructuracion de los Creditos de Estados y Municipios):***

This Program equals NP11.2 billion of loans to states and municipalities selected by commercial banks. This Program will have three unique features: (a) only credits by commercial banks to the states and municipalities registered with SHCP will be eligible; (b) the rate of interest payable on the restructured loan will be a function of the extent of prepayment; and (c) the term of the new UDI loan will be 5 years without grace or 8 years with two years grace. It is expected that some states and municipalities may make use of the extra revenue realized form the VAT (IVA) in order to prepay a greater amount of the loans to the commercial banks so as to obtain better terms. This program has been finalized.

5. Development Bank Restructuring Program (*Programas de Reestructuracion de la Banca de Desarrollo*)

This Programa equals NP11.8 billion equivalent of UDI refinancing for either final borrowers from development banks such as SMEs or to commercial banks or non-bank financial intermediaries that have liabilities to Development Banks. Specifically, NP3.4 billion will be provided to permit UDI refinancing to final borrowers in the context of Development Bank first-tier operations where they are making direct loans to SMEs or agricultural producers. This program will be offered under the same conditions and options as for companies (Productive Plant Support Program). In the case of Development Bank second-tier operations, a program of NP1.5 billion will support restructuring of the loans (or rediscounts) by Development Banks with commercial banks and NP7.0 billion will apply to restructuring of loans by Development Banks to non-bank financial intermediaries. The maturities for the restructuring of loans with commercial banks will range from 5 to 12 years without grace while those for non-banks will run from 10 to 5 years without grace. This program is preliminary and subject to further revision.

III. Lending and Funding Rates and Provisioning

A. The UDI Trust Lending Rate Structure

Under the UDI restructuring program for private sector companies (in local currency) the UDI Trust lending rate is a single fixed rate, derived as follows:

UDI Trust Lending Rate	=	4% to cover the funding rate	+	*about* 5% to cover credit risk or other intermediation risks	+	3% to cover loan administration

The 4% component is paid quarterly to the UDI trust which passes it on to the Government. The 3% component is paid quarterly to the UDI trust and is passed on to the commercial bank who retains credit risk for the restructured loan and who is responsible for loan supervision. The amount for credit risk and other intermediation risks is expected to be about 5% for restructured loans to corporations, but this will be determined by the market.

The corresponding amounts proposed for the UDI program for restructured mortgages are: 2% to cover the UDI Trust funding rate; up to a maximum of 4% to cover intermediation and loan administration. In this way the mortgagee is subject to a maximum real borrowing cost of 6% real.

The intermediation amount is not paid quarterly. It remains in the UDI trust to establish additional provisioning for the loan and is paid out to the commercial banks pro-rata with any principal maturities.

UDI loans are repaid in NP on annual maturity dates in maturities of equal real value in terms of UDIs, or in "flat" payments (as in a standard mortgage in the US). For instance, a five-year restructured loan of 500 UDIs, to be paid in equal maturities after one year of grace, would pay the NP value for the relevant date of 125 UDIs each year for four years.

B. The UDI Trust Funding Rate Structure

Under the restructuring program for private sector corporations, the UDI trust funding rate is derived as follows:

UDI Trust Funding Rate	=	4% real paid as current interest	+	(SAR(r) - 4%) deposited into the UDI Trust and paid pro-rata with principal maturity payments

SAR(r) is the real rate of interest paid on SAR accounts, or 4%, whichever is greater. In effect, the 4% component is paid by the borrower of the UDI trust and passed on to the Government. Any amount by which SAR(r) exceeds 4% is paid by the relevant commercial bank and remains in the trust to establish additional provisioning. Available cash balances are invested in UDI trust securities. In this way, the UDI trust securities purchased by the Government to fund the UDI trust, earn at least the same rate of real interest as that paid by the Government on SAR accounts, except that in the case of UDI trust securities, only the 4% component is paid out on a current basis.

C. Market References for the UDI Trust Funding Rate

During the current period, the real rate of interest paid on SAR accounts, i.e., SAR(r), is 6.85%. This is an administered rate set every two months by joint decision of SHCP and the Banco de Mexico. By contrast, the market's real rate of interest applicable to funding (i.e., the market rate for 28-day CETES minus inflation) amounted to an average of 5% in Mexico over 1970 to the present. However, the rate was highly volatile, with a standard deviation of 1,600 basis points. The CETES real rate amounted to an average of 8% over the PACTO years (i.e., 1988 to the present), with a lower standard deviation, reflecting a period of increased stability. Thus, the funding rate applicable to the UDI trust will likely incorporate a present value subsidy.

In terms of short-term rates, current nominal rates of interest for two benchmarks in Mexico, as at April 5,1995, are as follows:

CETES	75.00 %	(28-day treasury bill)
TIIP	88.62 %	(28-day tasa de interes interbancaria)

During the month of March 1995, the inflation rate was reported as 5.9% which, annualized, amounts to about 100%. Based on this experience and the Government's announced price and VAT increases, the authorities are projecting 8% inflation for April. Thus, while Mexico is currently experiencing negative short-term real interest rates, historically Mexico has had high positive long-term real rates.

The extremely high volatility of Mexico's real rate of interest has a strong negative impact on the local capital market, and the introduction of the real fixed-rate feature of the UDI restructuring program is considered one of its most beneficial features.

D. Provisioning Under the UDI Restructuring Program

Provisioning in the UDI trust is to be carried out as follows.

(a) There is an initial 15% provision for all loans.
(b) Thereafter, the commercial bank must augment provisions when asset quality deteriorates as determined by the CNBV or the commercial banks.
(c) Importantly, prior to restructuring "C" and "D" loans require 20% and 60% provisioning respectively. Thus, at present, the guidelines would permit a release of reserves to be used as credits against future provisioning requirements. However, Government authorities believe that an average number of A and B loans will be restructured so that such a release of reserves will not be large. In addition the Government will be undertaking special inspections of UDI restructured loans placed in trust.

Furthermore, it is important to note that commercial bank must add to the UDI trust the difference between the SAR rate of interest and 4% (if positive) times the value of the restructured loan portfolio. Also, all amounts paid by the debtor toward the "credit risk and other intermediation risk" component of the UDI trust lending rate are applied to establish additional reserves in the UDI trust. At final payment and liquidation of the UDI trust, all amounts owed to the Government are paid out, prior to making payments to the commercial banks.

IV. Implementation and Risks of the UDI Restructuring Program

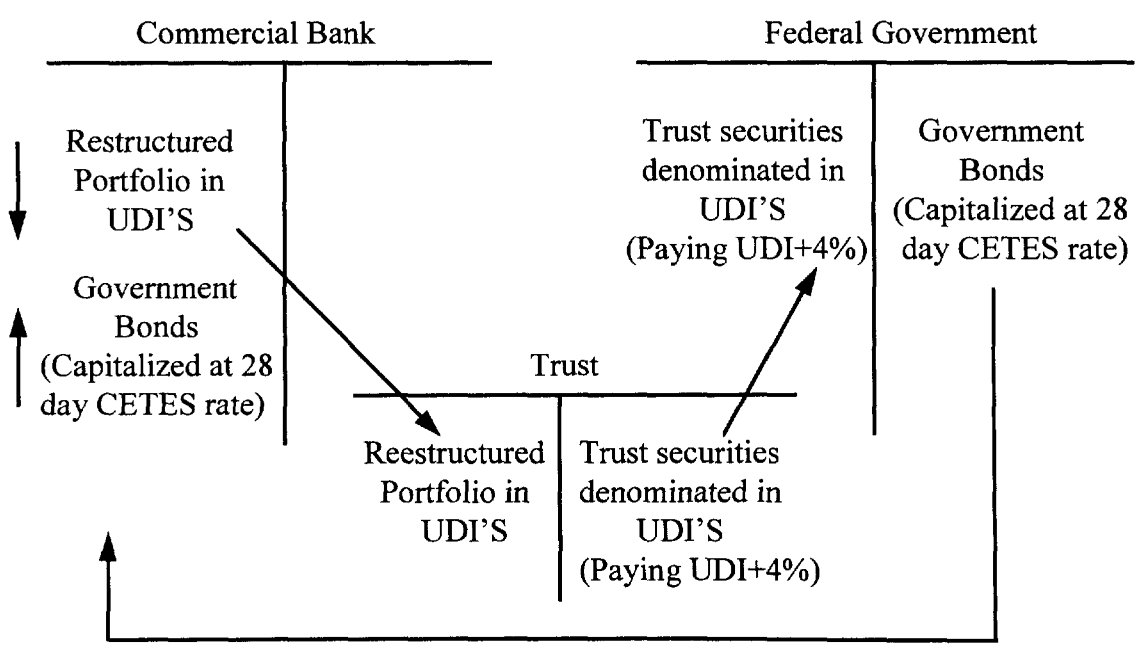
The proposed UDI restructuring program will be implemented quickly, because it provides strong incentives and few drawbacks for creditors and debtors to reach agreement. Some of the potential positives and negatives are listed below:

Creditors:
+ Resolves potentially viable, but currently non performing, assets
+ May release provisions from non performing assets to build general provisions
+ Reduces administrative cost of work out of viable assets
+ Generates income
- Uncertain payment obligation to trust
- Poor use of resources if non viable companies refinance

Debtors:
+ Reduces debt service (from 80 - 100% range to 8 - 10%)
+ Subsidizes (initially) rate of interest
+ Reduces management time spent on crisis management
- Rationed, not available to all bank debt

There are two major risks associated with the Support Programs. First, some banks may seek to reschedule nonviable borrowers to avoid recognizing losses. To mitigate this risk, the CNBV will not permit grace periods for restructured loans originally classified D or E. In addition, special inspections will be undertaken of UDI trusts and if such assets are found to be non-performing provisions will be required. Also, there could be large fiscal costs associated with the Programs if the realized real CETES interest rates is higher than the SAR rate (or 4% which ever is higher) or if the loan quality of restructured loans worsens. To mitigate fiscal surprises, the Government has agreed to review the fiscal financing position of the Program with the Bank during the course of its implementation.

Chart I: Schematic of the Support Programs for UDIs:



MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Legal/Regulatory Obstacles to Securitization and Secured Transactions

Securitization

Securitization is an important mechanism for providing banks with fresh resources to lend and for efficiently allocating risks among investors with different appetites for risk. For a number of years the Mexican authorities have worked on improving the regulatory framework of securitization in the context of fostering a market for mortgage securities. Significant progress has already been made on the appropriate treatment for banks that securitize assets. However, the existing regulations need to be refined to address in detail the form and treatment of specific securitization instruments (both mortgage-backed securities and others) and legal obstacles in a number of areas at both the federal and state levels need to be addressed before a significant market in securitized assets can develop.

Securitization can also be an important element in devising market-oriented solutions to disposing of bank assets. Economic interests in securitized pools of assets can be prioritized, creating a range of securities with risk characteristics appropriate for different types of investors. Healthy banks as well as troubled institutions may substantially clean up their balance sheets and reduce their portfolio of risky loans by transferring assets through securitization schemes to different types of investors willing to accept different degrees of risk. In addition, securitization schemes could serve as a means of returning to the private sector assets that come into the possession of the Government in the course of the bank resolution process.

As a step to improving the framework for asset securitization, the Government will conduct a study to identify remaining regulatory obstacles and legal impediments to asset securitization and make the recommendations for removing such obstacles and impediments available to the Bank by December 21, 1995. Thereafter, CNBV and SHCP will initiate the process of removing such remaining legal and regulatory obstacles.

Secured Transactions

By all accounts, Mexico's system for pledging movable goods as collateral and enforcing such pledges urgently needs to accommodate a broader set of permitted transactions at lower transactions costs. The types of movable goods that may be the subject of an enforceable pledge without delivery of the collateral to the lender are limited to certain types of identifiable property. Floating charges and enforceable pledges of after-acquired property and proceeds are in practice not available. The public registries where security interests are recorded, which are administered by the states and the Federal District, have historically been poorly maintained. Searching and recording such liens as may legally be filed is often expensive and time-consuming. Uniformity of operating practices among registries is lacking.

In the absence of consistent laws and efficient procedures for securing loans by a pledge of movable goods in the possession of the borrower, the vast majority of lending by Mexican financial institutions to small and medium-sized enterprises, as well as to largest companies, is secured by personal guarantees and real estate. This has a number of negative consequences for the health of the banking system and the availability of credit to borrowers on reasonable terms. The value of bank assets is overly sensitive to movements in the residential and commercial real estate markets since real property most often represents the only practical collateral. Lending is biased toward larger and older companies more likely to have interests in real property that can serve as collateral. More dynamic start-ups, and small and medium enterprises, often operate in rented or fully mortgaged premises, so potentially beneficial lending by banks to such borrowers is limited, reducing bank profits. The attractiveness of the Mexican financial sector to investors is also limited by the poor system of secured transactions. Foreign banks that might otherwise invest in, or directly enter, the Mexican market find that profitable lines of business available to them in other countries are closed off. Finally, manufacturer and dealer credit (most often secured by movable goods sold by dealers to small and medium-sized enterprises) has little opportunity to develop and compete with bank lending.

The Government, recognizing the importance of secured transactions to the health of a modern financing system, is committed to updating the legal framework and improving the functioning of the registries for both real and movable property. A study to identify the shortcomings of, and propose changes to, the legal/regulatory framework for secured lending will be conducted and the recommendations made available to the Bank by December 31, 1995. Thereafter, the Government will initiate the process of improving the legal/regulatory framework for secured transactions on the basis of such recommendations.

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM
STATUS OF BANK GROUP OPERATIONS IN MEXICO
SUMMARY OF IBRD OPERATIONS
(As of March 31, 1995)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation) Bank	IDA	Undisbursed
114 loans fully disbursed				14,551.84		
Of which SECALs, SALs, Program Loans, and Interest Support						
Ln. 1929-ME	1981	BANOBRAS	Railway IV	149.88		
Ln. 2331-ME	1983	BANCOMEXT	Export Development	349.33		
Ln. 2745-ME	1987	BANCOMEXT	Trade Policy Loan I	498.63		
Ln. 2777-ME	1987	BANCOMEXT	Export Development II	246.37		
Ln. 2882-ME	1988	BANCOMEXT	Trade Policy Loan II	500.00		
Ln. 2916-ME	1988	NAFIN	Steel Restructuring	100.00		
Ln. 2918-ME	1988	NAFIN	Agricultural Sector Loan	300.00		
Ln. 2919-ME	1988	NAFIN	Fertilizer Sector	200.00		
Ln. 3085-ME	1989	BANOCOMEXT	Financial Sector Adjustment	486.41		
Ln. 3087-ME	1989	NAFIN	Industrial Sector Policy	497.51		
Ln. 3086-ME	1989	NAFIN	Public Enterprise Reform	499.39		
Ln. 3159-ME	1990	BANCOMEXT	Interest Support Loan	1,260.00		
Ln. 3207-ME	1990	BANOBRAS	Road Transport & Telecom.	380.00		
Ln. 3309-ME	1991	BANCOMEXT	Export Sector	25.00		
Ln. 3357-ME	1991	NAFIN	Agricultural Sector Adj. II	400.00		
			Subtotal	5,892.52		
Ln. 2658-ME	1986	NAFIN	Agricultural Dev. Proderith II	88.30		26.91
Ln. 2666-ME	1986	BANOBRAS	Municipal Strengthening	40.00		0.34
Ln. 2669-ME	1986	BANOBRAS	Solid Waste Management Pilot	25.00		8.24
Ln. 2824-ME	1987	BANOBRAS	Urban Transport I	90.98		15.50
Ln. 2858-ME	1987	NAFIN	Small/Medium-Scale Industry IV	100.00		0.32
Ln. 2916-ME	1988	NAFIN	Steel Sector Restructuring	321.01		49.78
Ln. 3047-ME	1989	NAFIN	Industrial Restructuring	250.00		9.01
Ln. 3083-ME	1989	NAFIN	Hydroelectric Development	460.00		38.42
Ln. 3140-ME	1990	BANOBRAS	Low-Income Housing II	350.00		5.37
Ln. 3189-ME	1990	NAFIN	Transmission & Distribution	450.00		66.14
Ln. 3208-ME	1990	BANOBRAS	Telecomm. Technical Assistance	22.00		0.44
Ln. 3271-ME	1991	BANOBRAS	Water Supply & Sanitation	300.00		0.56
Ln. 3272-ME	1991	NAFIN	Basic Health Care	180.00		63.80
Ln. 3310-ME	1991	NAFIN	Decentralization & Regional Develop.	350.00		11.97
Ln. 3358-ME	1991	NAFIN	Technical Training III	152.00		51.27
Ln. 3359-ME	1991	NAFIN	Mining Sector Restructuring	200.00		103.63
Ln. 3407-ME	1992	NAFIN	Primary Education	250.00		90.44
Ln. 3419-ME	1992	NAFIN	Irrigation & Drainage Sector	400.00		195.71
Ln. 3461-ME	1992	BANOBRAS	Environment/Natural Resources	50.00		35.13
Ln. 3465-ME	1992	NAFIN	Agricultural Technology	150.00		126.76
Ln. 3475-ME	1992	NAFIN	Science & Technology Infrastructure	189.00		144.58
Ln. 3497-ME	1992	BANOBRAS	Housing Market Development	450.00		137.04
Ln. 3518-ME	1993	NAFIN	Initial Education	80.00		66.56
Ln. 3542-ME	1993	NAFIN	Labor Market & Prod.	174.00		98.39

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

STATUS OF BANK GROUP OPERATIONS IN MEXICO

SUMMARY OF IBRD OPERATIONS
(As of March 31, 1995 - US$ millions)

Credit/ Loan No.	Fiscal Year	Borrower	Purpose	Amount in US$ million (less cancellation)		
				Bank	IDA	Undisbursed
			Enhancement			
Ln. 3543-ME	1993	NAFIN	Transport Air Pollution Control	220.00		187.24
Ln. 3559-ME	1993	BANOBRAS	Medium Cities Transport	200.00		186.16
Ln. 3628-ME	1993	BANOBRAS	Highway Rehab. & Traffic Safety	480.00		335.73
Ln. 3704-ME	1994	NAFIN	On-Farm & Minor Irrigation Network	200.00		180.66
Ln. 3722-ME	1994	NAFIN	Primary Education II	412.00		380.20
Ln. 3750-ME a>	1994	BANOBRAS	N. Border I Environment	368.00		368.00
Ln. 3751-ME a>	1994	BANOBRAS	Water/Sanitation II	350.00		350.00
Ln. 3752-ME a>	1994	BANOBRAS	Solid Waste II	200.00		200.00
Ln. 3778-ME	1995	NAFIN	Rainfed Areas Development	85.00		75.23
Ln. 3790-ME	1995	NAFIN	Second Decentralization	500.00		460.00
Ln. 3805-ME a>	1995	NAFIN	Technical Education/Training	265.00		265.00
Ln. 3838-ME a>	1995	NAFIN	Financial Sector T.A.	23.60		23.60
			Sub-total	8,425.89		4,358.13
			Total	22,977.73		
			Of Which has been repaid	7,468.29		
			Total now held by the Bank	15,509.44		
			Amount sold : 92.34			
			Of which has been repaid: 92.34			
			Total Undisbursed	4,358.13		4,358.13

a> Not yet effective

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM
STATUS OF BANK GROUP OPERATIONS IN MEXICO
SUMMARY OF IFC INVESTMENTS

(As of March 31, 1995 - US$ millions)

Fiscal Year Committed	Company	Type of Business	Original Gross Commitments IFC Loan	IFC Equity	Partici-pants	Total	Held by IFC	Held by Partici-pants	Undisbursed (Including Participants)
1958	Bristol de Mexico S.A. /a	Aircraft Engine Overhaul	0.52	-	-	0.52	-	-	-
1958/59	Industrias Perfect Circle S.A. /a	Industrial Equipment	0.80	-	-	0.80	-	-	-
1961	Aceros Solar S.A. /a	Twist Drills	-	-	0.28	0.28	-	-	-
1962/5/6/8	Fundidora Monterrey S.A. /a	Steel	1.81	21.45	0.48	23.74	-	-	-
1963	Quimica del Rey S.A. /a	Sodium Sulphate	0.07	-	0.68	0.75	-	-	-
1963	Tubos de Acero de Mexico(Tamsa) /a	Stainless Steel Pipes	0.81	-	0.19	1.00	-	-	-
1964/66	Industria del Hierro S.A.	Construction Equipment	-	1.96	-	1.96	-	-	-
1970	Minera del Norte /a	Iron Ore Mining	0.75	-	0.75	1.50	-	-	-
1971	Celanese Mexicana S.A. /a	Textiles	8.00	-	4.00	12.00	-	-	-
1972	Promotora Papel Periodico SACV /a	Pulp & Paper /b	-	0.03	-	0.03	-	-	-
1973/79	Cementos Veracruz S.A. /a	Cement	11.35	-	4.50	15.85	-	-	-
1974/81	Cancun Aristos Hotel /a	Tourism	0.98	0.32	-	1.30	-	-	-
1975/78	Mexinox S.A. /a	Stainless Steel	12.00	3.18	-	15.18	-	-	-
1978/95	Tereftalatos Mexicanos, S.A. /a	Petrochemicals	39.00	-	20.00	59.00	20.00	20.00	40.00
1978/81/84	Papeles Ponderosa S.A. /a	Pulp & Paper	6.20	4.96	4.50	15.66	-	-	-
1979/81/87	Hotel Camino Real Ixtapa, S.A.	Tourism	-	4.20	-	4.20	4.20	-	-
1979/84	Empresas Tolteca, S.A. /a	Cement	30.00	7.95	138.00	175.95	-	-	-
1979	Conductores Monterrey, S.A.	Electrical Wire & Cable	8.41	-	13.00	21.41	1.49	-	-
1980	Industrias Resistol, S.A. /a	Particle Board	8.00	-	17.00	25.00	-	-	-
1980	Minera Real de Angeles, S.A. /a	Mining	30.00	-	80.00	110.00	-	-	-
1980	Vidrio Plano de Mexico, S.A. a/	Flat Glass	15.00	-	99.90	114.90	-	-	-
1981/86	Grupo Industrial Alfa (Giasa) a/	Pulp & Paper	15.50	-	44.00	59.50	-	-	-
1981	Corp Agroindustrial, S.A.(Univasa) /a	Agribusiness	6.30	3.00	5.00	14.30	-	-	-
1984	Capital Goods Facility /a	Capital Goods Financing	34.00	-	66.00	100.00	-	-	-
1984/88/94	Metalsa, S.A.	Auto Chassis	32.00	1.40	35.00	68.40	24.63	35.00	25.00
1985	Proteison, S.A. de C.V. /a	Agribusiness	1.95	0.82	-	2.77	-	-	-
1985	Prom. Industriales Mexicanas, S.A.	Petrochemicals	32.00	-	4.40	36.40	13.50	-	-
1986/88	Celulosa Y Papel de Durango,S.A.CV	Pulp & Paper	10.00	3.07	-	13.07	-	-	-
1987	Agromex (AESA) /a	Veg. & Fruit Processing	1.50	0.50	-	2.00	-	-	-
1987	Industrias Sulfamex, S.A. DE C.V. a/	Chemicals & Petrochemicals	2.00	0.50	-	2.50	-	-	-
1989	Cicasa Constr. Guar. Fac /a	Cons't. Guarantee Facility	20.00	-	-	20.00	-	-	-
1988	Sealed Power de Mexico	Auto Assembly	9.00	-	-	9.00	0.75	-	-
1988/95	Sigma Alimentos, S.A. de C.V.(Salumi)	Food & Food Processing	40.96	7.00	32.00	79.96	27.00	32.00	7.50
1988	Vulica Shipping Company	Industrial services	-	-	-	0.00	16.50		-
1988	Crescent Market Aggregates	Construction Materials	73.00	-	-	73.00	24.14	-	-
1988	Apasco, S.A. de C.V.	Cement & Const. Materials	46.00	-	-	46.00	14.33	-	-
1991/92/93	Apasco, S.A. de C.V. /c	Cement & Const. Materials	49.91	-	-	49.91	-	-	-
1994	Apasco, S.A. de C.V. /c	Cement & Const. Materials	10.00	-	40.00	50.00	10.00	40.00	-
1989	Banca Serfin	Development Finance	60.00	-	-	60.00	52.00	-	-
1989	Cementos Mexicanos	Cement & Const. Mat	60.00	-	8.00	68.00	11.43	-	-
1989	Grupo Femsa/Visa	Consumer Goods Conglomera	80.00	27.60	-	107.60	57.78	-	-
1989/92	Polimar (ABS), S.A. de C.V.	Petrochemicals	19.10	-	-	19.10	9.56	-	-
1990	Bancomer Credit Line /a	Development Finance	20.00	-	-	20.00	-	-	-
1990	Banco Nacional de Mexico	Development Finance	60.00	-	-	60.00	39.64	5.00	2.40
1990/91	Condumex, S.A. de C.V. /c	Electromanufacturing	35.00	9.54	18.00	62.54	24.06	9.00	-
1990	Indelpro, S.A. de C.V.	Petrochemicals	31.00	-	3.00	34.00	24.75	1.13	-
1991	Mexico Fund /a	Money & Capital Markets	-	-	6.57	6.57	-	-	-
1991	Petrocel, S.A.	Chemicals & Petrochemicals	32.00	-	-	32.00	28.00	-	-
1991	Vitro Flotado S.A. de C.V.	Glass & Related Manufacturing	25.00	-	101.00	126.00	24.38	63.13	-
1991	Vitro, S.A.	Glass & Related Manufacturing	-	10.17	8.04	18.21	10.17	-	-
1992	Aislantes Leon S.A. de C.V.	Battery Manufacturing	10.00	7.03	-	17.03	9.50	-	-
1992	Banco Mercantil del Norte, S.N.C.	Development Finance	20.00	-	-	20.00	-	-	-
1992	Celular de Telefonia, S.A. de C.V.	Telecommunications	15.00	1.00	37.00	53.00	16.00	36.73	2.88
1992	Grupo Financiera Probursa S.A. de CV	Development Finance	-	7.50	-	7.50	7.50	-	-
1992	Grupo Industrial Bimbo,S.A. de C.V.	Bakery	25.00	-	75.00	100.00	21.43	58.33	-
1992/93	Grupo Posadas S.A. de C.V.	Tourism	20.00	3.72	33.50	57.22	20.00	33.50	-
1992	Mexico City Toluca Toll Road	Transport & Storage	13.75	-	-	13.75	9.55	-	-
1993	Celulosa y Derivados S.A. de C.V.	Textiles/Packaging	11.00	-	26.00	37.00	11.00	24.07	-

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

STATUS OF BANK GROUP OPERATIONS IN MEXICO

SUMMARY OF IFC INVESTMENTS
(As of March 31, 1995 - US$ millions)

Fiscal Year Committed	Company	Type of Business	Original Gross Commitments IFC Loan	IFC Equity	Partici-pants	Total	Held by IFC	Held by Partici-pants	Undisbursed (Including Participants)
1993	Masterpak S.A. de C.V.	Timber, pulp & paper	12.00	–	28.00	40.00	12.00	25.93	–
1994	Alimentos Naturales (Banorte–Sabrosa)	Food & agribusiness	–	–	–	0.00	3.00	–	–
1994	Aurum Heller, Factoraje	Financial Services	–	0.98	–	0.98	0.98	–	–
1994	Grupo Idesa, S.A. de C.V.	Chemicals & Petrochemicals	15.00	8.00	42.50	65.50	23.00	42.50	35.50
1993/94	Grupo Operador de Terminales Maritimas S.A. (GOTM)	Industrial Services	4.00	2.00	6.00	12.00	3.71	–	–
1994	Internacional de Ceramica	Cement & constr materials	21.00	–	17.50	38.50	21.00	17.50	–
1994	Mexicana de Cobre, S.A.	Nonferoous metals	25.00	–	35.00	60.00	25.00	35.00	–
1994	Banorte–Pyosa, S.A. de C.V.	General manufacturing	–	–	–	0.00	9.70	–	–
1994	Banorte–Arancia	General manufacturing	–	–	–	0.00	7.30	–	–
1995	Compania Tratadora de Aguas Negras de Puerto Vallarta (CTAPV)	Industrial Services	7.00	–	–	7.00	7.00	–	5.00
1995	Baring Venture Partners de Mexico	Financial Services	–	0.15	–	0.15	0.15	–	–
1995	Mexiplus Puertos	Infrastructure	–	1.04	–	1.04	1.04	–	–
	Total Gross Commitments /d		1,178.67	139.06	1,054.78	2,372.51			
	Less: Cancellations, Terminations, Repayment, & Sales		588.35	82.24	575.97	1,246.56			
	Net Commitments Now Held e/		590.33	56.82	478.81	1,125.96	647.15	478.81	118.28
	Pending Commitments:								
	Baring Venture	Financial Services	–	10.00	–	10.00			
	Total Commitment Held and Pending Commitments		590.33	66.82	478.81	1,135.96			
	Total Undisbursed Commitments		50.28	0.00	68.00	118.28			

a/ Investments which have been fully cancelled, terminated, written–off, sold, redeemed, or repaid.

c/ Excludes placements of $30.0 million (Apasco), $20.0 million (Vitro), and $19.8 million (Condumex)

d/ Consists of approved and signed projects (including underwriting, but excluding swap transactions i.e., Banca Serfin US6.5 million, Indelpro $6.0 million, Banamex $40.0 million and Grupo Posadas II $6.5 million).

e/ Held Commitments consist of disbursed and undisbursed investments.

MEXICO
FINANCIAL SECTOR RESTRUCTURING PROGRAM

Supplementary Data Sheet

I. Timetable of Key Events

(a)	Time taken to prepare the program:	3 months
(b)	Missions:	March and April 1995
(c)	Negotiations:	May 1995
(d)	Planned date of effectiveness:	June 1995

II. Special Conditions

(a) Conditions of Loan Effectiveness

(i) Satisfactory continued implementation of the economic stabilization program described in the Letter of Financial Sector Development Policy.

(ii) Satisfactory progress in the execution of the FSRP.

(iii) Recruitment of an independent auditing firm to assist in the preparation of diagnostic studies of banks, and initiation of the diagnostic study of at least one intervened bank, satisfactory to the Bank.

(iv) Recruitment of investment banks or specialized consultants or firms to assist in the preparation of restructuring plans of banks.

(v) Formulation of uniform accounting principles (including consolidation of financial statements) consistent with internationally accepted principles (U.S. GAAP), and consistent across all transactions and activities for financial statements and regulatory reports of banks.

(vi) Submission of terms of reference for studies on: (i) the impact of establishing risk-based exposure limits for the liabilities of each FI with regard to the DFEs; (ii) the establishment of eligibility criteria for FI participation in DFE second tier financial operations and the impact of establishing rating requirements by qualified private agencies; and (iii) the interest rate policy in domestic and foreign currency, including an evaluation of its incentive structure and its impact on financial markets and final borrowers.

(b) Conditions of Second Tranche Release.

(i) Satisfactory continued implementation of the economic stabilization program described in the Letter of Financial Sector Development Policy.

(ii) Satisfactory progress in the execution of the FSRP.

(iii) Review with the Bank of the results of all completed diagnostic studies for PROCAPTE banks and intervened banks.

(iv) Satisfactory progress in executing CNBV's inspection program of banks and review of the resultswith the Bank.

(v) Submission to the Bank for its review of the restructuring plans of banks under FOBAPROA control (including implementation strategies), prepared in accordance with the Operating Guidelines for bank restructuring, and approved by CNBV, SHCP and FOBAPROA.

(vi) Satisfactory progress in the execution of the bank restructuring plans.

(vii) Issuance of regulations for revised uniform accounting principles (including consolidation of financial statements) for banks consistent with internationally accepted accounting principles, for application beginning January 1, 1996 and completion no later than for year-end 1996 accounts.

(viii) Issuance of revised accounting principles (including consolidation of financial statements) for non-bank financial institutions that are affiliates of financial groups with bank affiliates consistent with internationally accepted accounting principles.

(ix) Issuance of supplemental internal instructions, for inspection of banks (including development banks) covering, inter alia, asset classification and provisioning, exclusion of de facto treasury stock (stock owned or financed directly or indirectly by related entities, or covered by repurchase agreements) for purposes of capital adequacy standards, composition of Tier I capital, large exposures and concentration, and related party lending.

(x) Review with the Bank of the need for the issuance of new prudential regulations for banks, and issuance of such regulations to the extent necessary.

(xi) Issuance of new prudential regulations with respect to capital adequacy standards for brokerage firms.

(xii) (a) Review of the results of the studies (see II (a)(vi) above) with the Bank; (b) preparation of an action plan on the basis of such reviews; and (c) necessary official action for the implementation of such action plan on the basis of a phased implementation schedule.

IMAGING

Report No: P- 6616 ME
Type: PR