Report of Michael W. Mackey on the Comprehensive Evaluation of the Operations and Functions of The Fund for the Protection of Bank Savings "FOBAPROA" and Quality of Supervision of the FOBAPROA Program 1995-1998

July 1999

Foreword

I would like to thank each member of the Hiring Committee, Fauzi Hamdán Amad, Jorge Estefan Chidiac, Jorge Silva Morales, Santiago Gustavo Pedro Cortés and Gloria Lavara Mejia, for their support and direction throughout this project.

I would also like to thank my partners and staff and, in particular, David Murray who had the responsibility for the management of the project, Stephen Hume for the regulatory thread, Tony Power and Susan Mingie for the banking thread, Rey Gonzalez for coordination of administration and special areas and Gary Moulton and Bill Dovey for the investigative review section of this report.

Finally, I want to extend my thanks to each of the firms of Reporting Accountants that took part in the review of the banks; Despacho Alfonso Ochoa Ravize,Contadores Públicos y Consultores en Administración, S.C., Galaz, Gomez, Morfin, Chavero, Yamazaki, S.C., Juan Antonio Cedillo y CIA, S.C., Leal Y Martin Contadores Públicos, S.C., and Lebrija, Alvarez y Cia, S.C./HLB.

Without the enthusiasm and tireless dedication of the entire staff, this report would never have been completed in such a timely and professional manner.

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Michael W. Mackey

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I INTRODUCTION

Background

Effective September 7, 1998, Michael W. Mackey was engaged by a hiring committee ("Hiring Committee") created by the Congress of Mexico ("Congress") to examine the Fund for the Protection of Bank Savings ("FOBAPROA"). In particular, Mr. Mackey was asked to evaluate the performance of FOBAPROA in the rehabilitation of Mexico's financial institutions and to assess the performance of those charged with the obligation to supervise FOBAPROA's activities, including its Technical Committee, the Ministry of Finance and Public Credit ("SHCP"), the Bank of Mexico and the National Banking and Securities Commission ("CNBV") for the period from January 1, 1995 to June 30, 1998. In some instances, information has been provided and comments made regarding relevant events that occurred following June 30, 1998, in order that, where necessary, the report will be current.

The section of this report entitled Methodology contains, among other things, a description of the documentary and other information that was provided and on which the conclusions in this report are based. In addition, that section also describes the difficulties that were encountered in securing information and the obstacles that were necessary to overcome in order to ensure that all relevant information was made available. Notwithstanding such difficulties and the limits which the absence of some information placed on this report, we are confident that the information ultimately made available is sufficient to understand and comment upon the use and application of funds by FOBAPROA and the regulatory and supervisory framework within which FOBAPROA operated.

Following a description of the facts regarding the establishment of FOBAPROA, its operations (particularly during the period from 1995 to 1998), and the regulatory and supervisory environment in which FOBAPROA operated, the report contains an evaluation of FOBAPROA and of the performance of those involved in its management and supervision. It then concludes with an examination of the fiscal costs associated with the programs in which FOBAPROA was involved and an analysis of certain reportable transactions. While the report identifies and comments upon a number of problems that arose relating to FOBAPROA, the review led to the conclusion that, while the structure of FOBAPROA and the programs in which it was engaged are not free from criticism, FOBAPROA, at considerable cost, provided protection for depositors and a partial (and perhaps temporary) resolution to the problems created by a weak and undercapitalized banking system.

Prior to 1991, when the privatization of the national banks of Mexico began, there was no apparent recognition of a need for a strong and independent regulatory system nor were well defined rules and procedures relating to creditors' rights, bankruptcy laws and the protection of depositors necessary to ensure the survival or operation of the banking system.

When new banks emerged following the privatization process, the regulatory and legislative environment that existed was not equipped nor were those agencies charged with sufficient responsibility to deal with the numerous issues and challenges that were presented by the private ownership of the banking system. As many of these new banks were, from the beginning, undercapitalized and therefore fragile, they were not in a position to cope easily with the challenges posed by the peso crisis in 1994 and the impact that inflation and high interest rates had on the quality of their loan portfolios. As a result of such fragility and the problems created by, in some cases, inappropriate activities by the new owners and inexperienced management, serious questions arose regarding the financial viability of many of these banks and, indeed, the entire financial system. The bank and debtor programs in which FOBAPROA participated were, in retrospect, being introduced not to deal with individual issues facing one or more banks, but were rather being called upon to cope with a banking industry that faced systemic challenges that threatened its survival.

Beginning in 1994, the regulators and supervising agencies made improvements in the design and implementation of procedures for more closely supervising the banks in order to be able to recognize problems and develop solutions. Actual and proposed changes to the legislative framework affecting both the banking industry and its regulation will also have considerable impact on the health and stability of the banking system. In this report, in addition to examining the role and operation of FOBAPROA, we have identified many of these improvements and commented on them as they have affected FOBAPROA and may affect similar programs in the future.

In the final analysis, however, even with Mexico enjoying an improved economic climate, many of the banks continue to be significantly undercapitalized and subject to the pressures and risks that attend poor loan portfolios, concentrated ownership, inexperienced management and a regulatory and supervisory environment that is not prepared to allow insolvent or heavily subsidized banks to fail. Until the process of consolidation in the banking sector is completed in order to assist in attracting new capital and until the risk of failure is shared by both the public and private sectors through a functioning deposit insurance scheme, Mexico will continue to face significant costs in supporting its banking system.

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We reserve the right to review all calculations and opinions included or referred to in this report and, if we consider it necessary, to revise our conclusions in light of any information existing during the period of this evaluation that becomes known to us after the date of this report.

This report and the evaluations that have been made do not constitute a financial audit, but rather are a review and analysis based upon the specific questions that the mandate requested be addressed. Therefore, this report should not be considered an audit of any of the financial statements or records of CNBV, FOBAPROA, SHCP, the Bank of Mexico or the individual banks or the internal controls of these agencies and institutions. As set out elsewhere in this report, the terms of reference of this review were different than that of a financial audit and are not to be considered to provide the same information and level of assurance as a financial audit.

II TERMS OF APPOINTMENT

BANKING SECTOR ISSUES IDENTIFIED BY CONGRESS LEADING TO APPOINTMENT

During 1998, the executive power of the government requested Congress to approve a plan to recognize the FOBAPROA debt as public debt. Congress was unwilling to approve such a plan without first conducting a review of all components of the amount at issue. In addition, Congress wished to ensure that the restructuring programs that had been implemented were effectively designed to achieve their objectives, that the bank and debtor programs were appropriately supervised, and that the impact of these programs on individual banks, and on the financial system as a whole, was as intended.

SIX BLOCKS

In order to meet its objectives, Congress wanted answers to a series of questions, known as blocks. A Hiring Committee was created to engage Michael W. Mackey to provide answers to the six blocks, which are described below.

Block 1. Evaluation of the performance and supervision of FOBAPROA and of the institutions assigned to monitor and supervise its operations

This part of the review involved the evaluation of the way in which the entities involved in the supervision of FOBAPROA fulfilled their mandate, and whether they complied with the rules of regulation and supervision and the level of efficiency with which the goals of the established policies were reached.

Block 2. Review of the origin and overall use of the funds, and nature of the liabilities of FOBAPROA for the rehabilitation of the financial institutions in Mexico

For the purposes of this aspect of the review, the accounting for funds that FOBAPROA disbursed during the period under review was determined, differentiating among the sources from which FOBAPROA obtained funding, the mechanisms or instruments utilized to secure it and the conditions of financing agreements. The use of the funds distributed during the rehabilitation of the banking system was identified by program and recipient banking institution.

Block 3. Review of fiscal costs

For the purposes of this review, an analysis was performed of the methodology used by FOBAPROA to calculate the fiscal costs of the programs implemented for financial rehabilitation and as well, a review of the financial assessment of those costs was undertaken. Each program and recipient institution was identified, the registered annual variations and originating sources have been analyzed, and the costs of the acquisition of loan portfolios has been determined. Similarly, the sunk financial costs including consulting, legal, and appraisal fees have been quantified.

In addition, the amounts recovered by FOBAPROA from the sale of assets, as compared with the purchase values and initial estimates of recovery have been analyzed.

The physical and financial assets under the control of FOBAPROA were analyzed and, using a sample, the valuations of the assets and their classification with respect to the information reported by the financial system as well as by the trust itself were analyzed. An analysis has also been provided of discrepancies between estimated fiscal costs as reported by FOBAPROA, and our estimate of fiscal costs. These discrepancies have been discussed with FOBAPROA.

In addition, a comparison has been made between amounts recovered from the sale of assets, purchase values, and initial estimates of recovery.

Block 4. Evaluation of the bank programs for capitalization and financial rehabilitation and of the regulatory monitoring and supervision of the bank programs

The objective of this block was to evaluate the capitalization and financial rehabilitation programs and CNBV's monitoring and supervision. The average condition of the banks and the economic climate in which they operated prior to their apparent need for recapitalization was reviewed, together with CNBV's monitoring and supervising role during such review period.

The evaluation included the efficiency of the CNBV audit of financial institutions operating loan portfolios, as well as the quality of the supervision of the recovery efforts of the banks regarding loans within the FOBAPROA trusts.

Block 5. Evaluation of the relief program for bank debtors

The purpose of this block was to evaluate the criteria and conditions for granting relief to bank debtors, the origin of the funding that was channelled into various programs, the fiscal cost resulting from this relief in relation to the goals and estimates, and to evaluate the results of these programs with respect to the goals proposed in terms of coverage, applied resources and estimated fiscal cost. In addition, the review consisted of determining whether the program was used for its intended purpose by the recipients.

The issue as to whether the banks absorbed the agreed upon proportion of the subsidy to debtors and the level at which debtors availed themselves of the re-structuring programs was also analyzed.

Block 6. Analysis of the liabilities which may be converted into public debt obligations

The purpose of this block was to categorize and specify the amount of inherent liabilities of the FOBAPROA operation, as well as its direct and indirect costs, which may be capable of being converted into debt of the federal government.

For the purposes of this review, the eligibility of the liabilities which may be converted into debt obligations of the government were evaluated, identifying those obligations with the commercial banks, the institutions involved and the transactions that generated them. Furthermore, the recipients and conditions upon which FOBAPROA granted the funding have been specified. In addition, the promissory notes for which the fund is obligated have been evaluated.

The question as to where, within the government, the obligations of FOBAPROA ought to reside is beyond the scope of this evaluation.

The use and application of funds distributed through FOBAPROA and the issues faced by those agencies responsible for supervising its activities cannot be understood without examining the economic and regulatory environment in which it operated and the conditions affecting those banks which relied on FOBAPROA for support. Accordingly, this report comments on the condition of the banks following their privatization in 1991, and the legislative and regulatory framework that existed at the time in order to assess their impact on FOBAPROA. This report also identifies many of the changes and improvements that have been made.

III METHODOLOGY

1. Introduction

To assist in the evaluation, experts were retained in the fields of financial institution restructuring, financial institution regulation, financial institution auditing, law, forensic accounting, real estate appraisal and economics. In conducting the review, a methodology was developed to cover the six blocks posed by the Hiring Committee, as previously described. This methodology was developed in two separate but related threads as follows:

Regulatory Thread Objectives

1. Document and analyze the Mexican regulatory framework in which FOBAPROA and the financial authorities operate and set the criteria to be used in evaluations.

2. Evaluate the actions taken by FOBAPROA, CNBV, SHCP and the Bank of Mexico with regard to the banks participating in FOBAPROA programs.

3. Evaluate the supervisory practices of FOBAPROA, CNBV, SHCP and the Bank of Mexico in place during the period 1995 – 1998.

4. Determine the sources of funds and estimate the fiscal costs and liabilities of FOBAPROA.

5. Assess the economic environment in which the various agencies operated during the period of the evaluation.

Bank Thread Objectives

1. Analyze information from the banks to assess the compliance with and the impact of the bank rehabilitation and debtor programs.

2. Analyze information from the banks to assess the supervisory actions of the regulatory agencies.

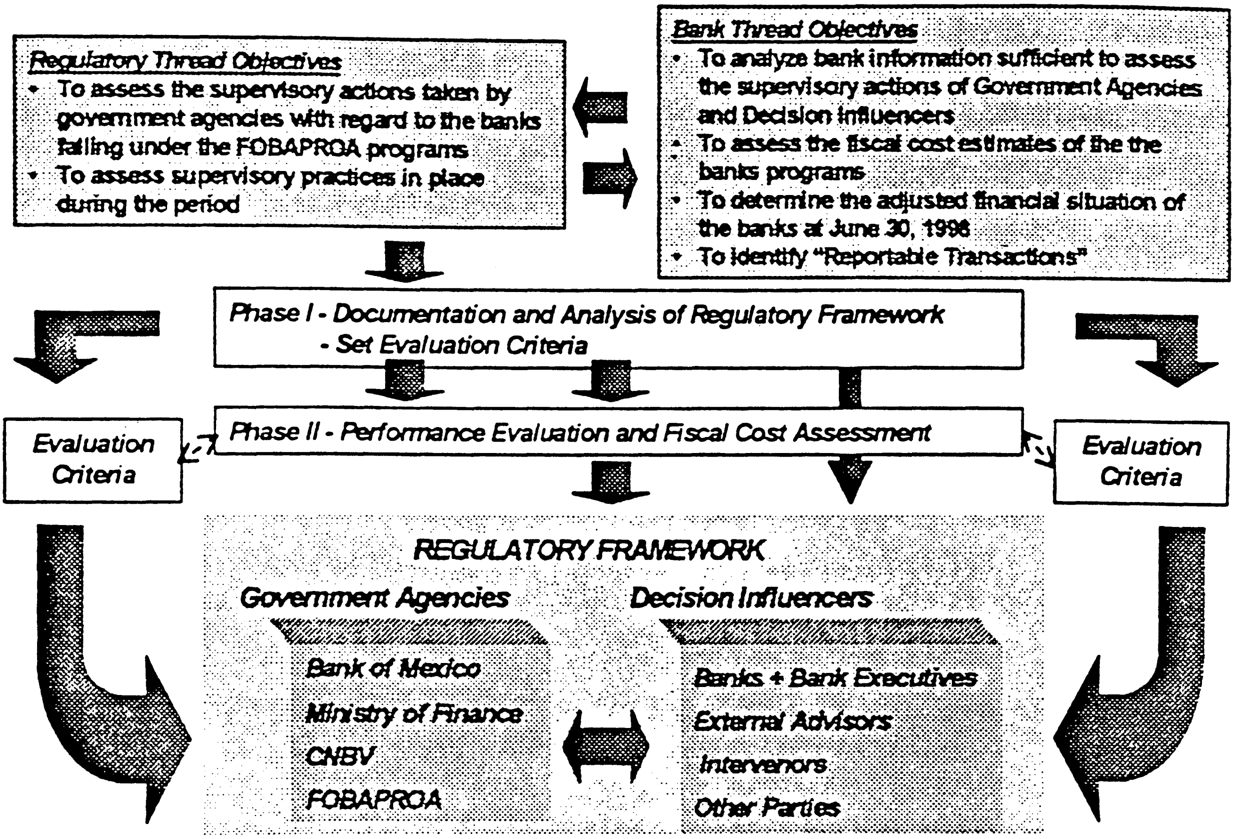
3. Assess the fiscal cost estimates of the programs at twenty-five individual banks to determine the adjusted financial situation of those banks at June 30, 1998.

4. Identify the potential costs of transactions that would be considered unusual in a commercial setting. These have been called "Reportable Transactions".

The two threads, and the objectives within each, are designed to address the six blocks.

Interaction of Threads

To ensure that all information was shared and that the efforts of the professionals working on the two threads of the engagement were co-ordinated, responsibilities and the flow of information were organized as follows:



As the arrows between the regulatory thread and the bank thread indicate, the findings of reviews are passed between the threads, which then compare that information to information provided by the banks and government agencies. This has enabled the actions of the government agencies to be evaluated against their own and international standards.

Evaluation criteria were established based upon an analysis (Phase I above) of documents relating to the regulatory framework. Phase II (above) involved an evaluation of the regulatory performance measured against these criteria.

2. Regulatory Evaluation

In conducting the regulatory evaluations, the regulatory team undertook, *inter alia*, the following tasks:

Documented and analyzed the Mexican regulatory framework in which FOBAPROA and the financial authorities operate and set the criteria to be used in evaluations:

- Documented the Mexican regulatory framework relying upon Mexican laws, CNBV, SHCP, FOBAPROA and Bank of Mexico circulars, internal documents, external studies and extensive interviews. In addition, interviews were conducted at the banks.

- Reviewed the history of Mexican banking from the time of the nationalization of the banks in 1982 through the privatization process to January 1, 1995, the commencement of the period of the review.

1. Evaluated the actions taken by FOBPROA, CNBV, SHCP, and the Bank of Mexico with regard to the banks participating in the FOBAPROA programs:

- Reviewed actions taken by the regulators regarding specific banks to determine whether the actions were timely, effective and consistent with the established objectives of the regulatory system as a whole.

- Reviewed the minutes of the Technical Committee governing FOBAPROA during the period, as well as the various sub-committees.

- Determined and evaluated the criteria used for the intervention process and the process followed by the intervenors.

- Reviewed the issues surrounding the debtor programs including the process involved in the implementation of the debtor programs.

- Reviewed the compliance by FOBAPROA regarding the agreements implementing the FOBAPROA bank programs.

- Reviewed related party transactions as developed from the records of the regulatory bodies.

2. Evaluated the supervisory practices of FOBAPROA, CNBV and SHCP and the Bank of Mexico in place during the period 1995 – 1998:

    - Developed an understanding of issues specific to Mexican banking including the protection of bank liabilities, bankruptcy legislation, credit collection issues, accounting rules, corporate governance guidelines, rules for capital adequacy and rules for financial groups.

    - Took steps to compare actions taken by the regulators within the regulatory framework, examining various standards, legislation and internal regulations governing their conduct.

    - Reviewed the quality and effectiveness of regulatory staff and their relationship with external advisors including external auditors.

3. Determined the sources of funds and estimated the fiscal costs and liabilities of FOBAPROA:

    - Documented and analyzed the regulatory framework in which FOBAPROA operated and set out the criteria to be used in its evaluation.

    - Identified the sources of funding for FOBAPROA.

    - Determined the method and assessed the calculation of fiscal costs, as well as reviewed the appropriateness of this methodology.

    - Estimated the total fiscal costs of the bank and the debtor programs, and performed a sensitivity analysis of the cost calculations of the debtor programs.

    - Analyzed the reported assets and liabilities of FOBAPROA as at June 30, 1998.

    - Identified contingent liabilities.

4. Assessed the economic environment in which the various agencies operated during the period of the evaluation:

    - Identified the impact that the international and domestic economic environment may have had on the success and costs of the bank and debtor programs during the period of the evaluation.

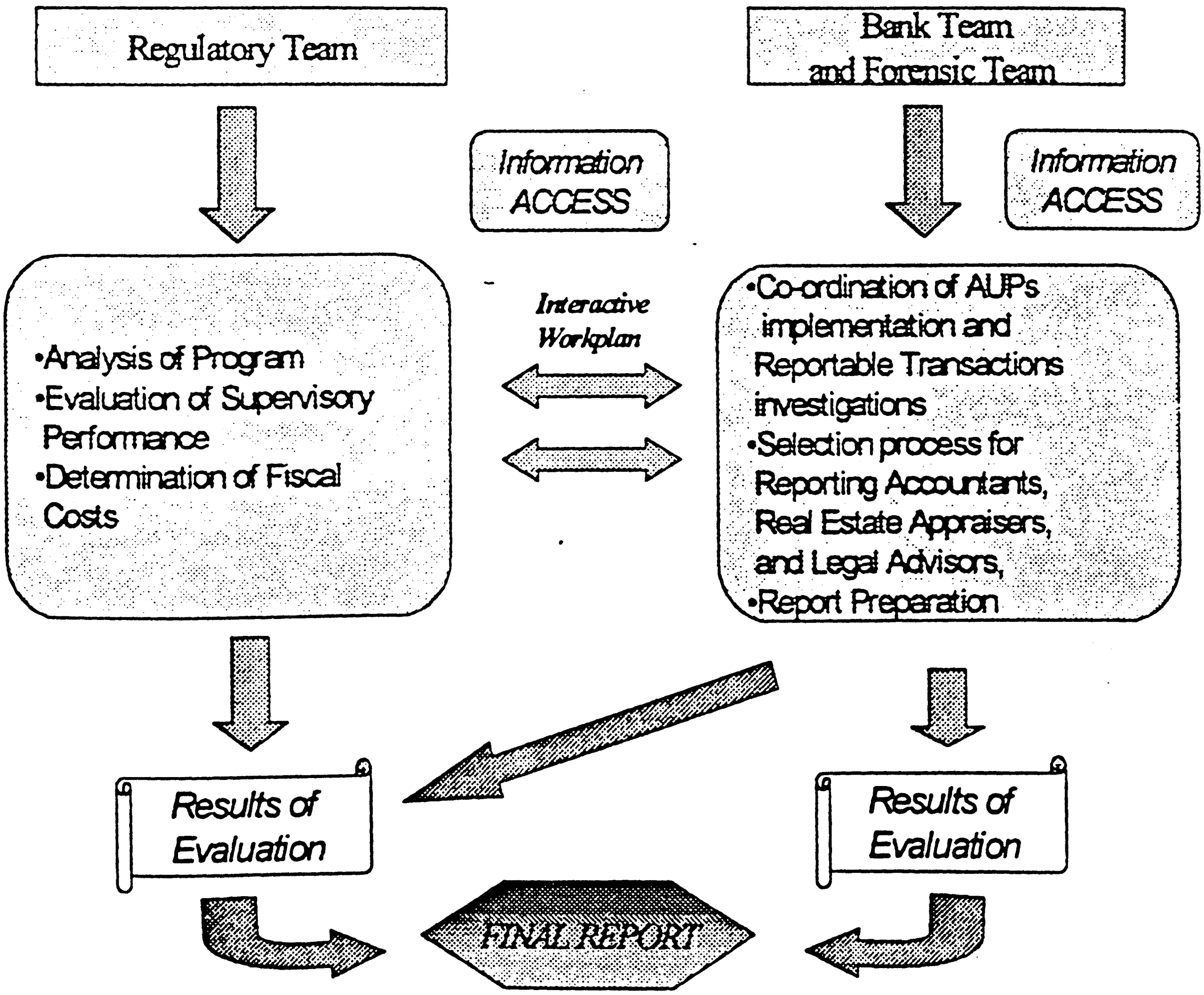
    - Identified the potential impact that the future international and domestic economic environment may have on the success and fiscal costs of the bank and debtor programs.

3. Bank Evaluation

The team charged with conducting the investigation of the banks involved in FOBAPROA included co-ordinators and a firm of Reporting Accountants assigned to each bank.

The bank team also utilized additional third party experts including local real estate appraisers and legal advisors.

To co-ordinate the various teams, a process was established whereby each team would initially gather information independently and would subsequently confirm and share such information with the other teams. Findings were shared and analyzed using the combined knowledge and perspective of each team. The following diagram sets out this process:



4. Reporting Accountants

The Reporting Accountants ("RA") were from five Mexican firms hired by the Hiring Committee following a lengthy selection process which was based on ensuring there were no conflicts of interest as well as ensuring appropriate capacity and capability.

The Reporting Accountants engaged by the Hiring Committee were charged with carrying out Agreed Upon Procedures ("AUPs") at each of the banks participating in the FOBAPROA programs.

These AUPs were provided to the Reporting Accountants in the form of forty–four individual specific work plans and included steps to complete the following objectives:

1. Analyzed information from the banks sufficiently to assess the compliance with and impact of the bank rehabilitation and debtor programs:

   - Evaluated the banks on their compliance with the agreements and programs implemented at the banks.

   - Provided comments as to the effectiveness and impact of the programs at the banks.

Analyzed information from the banks sufficiently to assess the supervisory actions of the regulatory agencies:

- Evaluated the effectiveness of the management information systems as they relate to assets and liabilities owned by FOBAPROA trust.

- Provided observations relating to the management of FOBAPROA assets including assets subject to intervention.

- Analyzed reports prepared by third party advisors including external auditors.

Assessed the fiscal cost estimates of the programs at twenty-five individual banks and determined the adjusted financial situation of those banks at June 30, 1998.

- Confirmed the source of funding for the FOBAPROA programs.

- Estimated the value of all assets related to FOBAPROA.

- Determined the level of liabilities.

- Performed a loan review analysis on all loans greater than MN $20 million, and a statistical sample of loans less than MN $20 million to achieve coverage of at least 50% of the portfolio.

- Identified off-balance sheet liabilities.

- Identified other alternatives to maximize realizations.

2. From the procedures performed by the Reporting Accountants, identified the potential costs of transactions that would be considered unusual in a commercial setting.

   - Identified "Reportable Transactions" (as defined in the section of the report entitled "Reportable Transactions").

   - Investigated selected related party transactions.

   - Investigated selected loans to common borrowers across the banks.

5. Communication

During the period of the evaluation (September 7, 1998 to June 30, 1999) meetings were held regularly with the Hiring Committee to keep the members informed of progress and preliminary findings.

During the period of the review, numerous meetings and discussions were held with senior officials of FOBAPROA, CNBV, SHCP, the Bank of Mexico and the banks. The findings and evaluations contained in this report have been discussed with the relevant party.

SCOPE LIMITATIONS

This report was commissioned September 7, 1998 and, at that time, it was expected the report team would enjoy the full co-operation of all the parties involved; specifically, the regulators and the banks. Unfortunately, that was not the case. Both CNBV and FOBAPROA initially were very reluctant to speak to us and considerable delays were experienced in September, October and November 1998. During that time, we were provided with cartons of documents by the Hiring Committee, however, no one was available to provide any context to the documents or even to explain their significance. Hence, the project took longer than necessary to advance beyond the preliminary stages.

Once the direction and context of the review became clear, issues were raised by the regulators regarding the legality of the review and the confidentiality of the information that was required to carry out the mandate. These questions were not resolved fully until Congress passed legislation in December, 1998 to clarify the issues related to access to information. In January 1999, similar issues were raised by the regulators in respect of the Reporting Accountants. The bankers also objected to permitting the Reporting Accountants access to customer files, an access that was fundamental in order to carry out the mandate. These access issues for the Reporting Accountants, who were engaged to do the fieldwork in the banks, were not resolved until March 1999. The combination of these delays caused this project to continue for a much longer period than could reasonably be anticipated.

Following a resolution of the issues that delayed completion, the level of co-operation from the parties involved improved. The assistance from CNBV and FOBPROA has been very helpful and most, but not all, of the banks have provided access to the files that have been requested, albeit through a very cumbersome and time consuming protocol which has inhibited the free flow of information and dialogue.

Notwithstanding that access to information was ultimately achieved, it should be noted that the mandate for this report included certain scope and access restrictions which must be acknowledged in order for the reader to understand fully the matters that are discussed herein. The mandate was focussed on FOBAPROA and the programs in which the various banks participated. As a result, we were not entitled to (and did not receive) access to those parts of the banks which were not connected to FOBAPROA. For example, if a bank participated in the loan purchase program, we were given access only to the portfolio of loans in which FOBAPROA had an interest, but no access was available to the other assets (or liabilities) of the bank. This restriction, while apparently reasonable in the circumstances, has reduced the precision with which comments can be prepared regarding the overall fiscal cost of the programs. Also, the compliance testing was prejudiced in selected areas; for example, the banks were obliged to collect the FOBAPROA loans with the same diligence and effort as they would use to collect loans for their own account, but no access at the banks was provided to such loans to enable us to see how the banks pursued them.

In addition, scope limitations were encountered with some of the bank intervenors who have been appointed by CNBV. In the cases of banks that had been intervened, it was clear that our scope extended to the whole bank, since FOBAPROA was responsible for all the liabilities in an intervened bank. In this context, two issues arose. First, in cases where only *de-facto* intervention had been undertaken, the intervenors took the position that no intervention had occurred, and access was denied to all aspects of the bank except those related to formal FOBAPROA programs. Second, in cases where management intervention had been undertaken, the intervenors took the position that trust accounts in the intervened banks were not part of the banks, with the result that access was denied to information regarding all trust accounts. These scope limitations were raised not only with the intervenors but also with CNBV and SHCP; however, no resolution of the issue was forthcoming, with the result that this report does not contain comment and information on certain matters that we believe were included in our mandate.

After most of our fieldwork was complete, it became clear that the restrictions in access were far more limiting to our scope than we believed initially. Because of the systemic nature of several of the issues that were identified, in order to assess the effectiveness of both the regulatory regime and the impact of the bank programs, we should have been provided full access to all banks which accepted funds from FOBAPROA, not just to those that had been intervened.

As set out more fully elsewhere in this report, the banks which have been formally intervened represent a definite fiscal cost for FOBAPROA. If there are banks which will soon be intervened, they also represent a definite fiscal cost to FOBAPROA. We had access to formally intervened banks, but the regulators restricted severely our access to *de facto* intervened banks. Such *de facto* intervened banks represent a larger portion of the system (and the potential costs) than do the formally intervened banks. Further, while we identified some *de facto* intervened banks, it is possible that there are additional banks which may soon be *de facto* intervened. As a result, we may have understated the ultimate fiscal costs and we may have reached too generous a conclusion regarding the effectiveness of the regulatory regime.

Lastly, it was a requirement of CNBV that we accept the involvement of a third party consultant to CNBV at fact finding meetings and to correspond with them in order to obtain access to individuals and documents. The participation of the third party consultant was agreed to in the procedures established by Congress and the executive branch; however, this process did not provide us with first hand assurance that we have received complete information.

IV BASIS FOR EVALUATION

1. *Regulatory Framework*

INTRODUCTION

The following section provides information regarding certain key aspects of the Mexican regulatory framework. The items selected for discussion are essential in order to understand the regulatory evaluation contained elsewhere in this report.

This section begins with a brief description of significant aspects of the regulatory system, including relevant aspects of the judicial system, and also describes the primary regulatory agencies, their mandates and the role that each played in regulating and supervising the financial system during the period under review.

BACKGROUND TO REGULATORY FRAMEWORK

In Mexico there are three financial authorities with influence over the banking system: Secretaria de Hacienda y Crédito Público (The Ministry of Finance - SHCP), Comisión Nacional Bancaria y de Valores (The National Banking and Securities Commission - CNBV), and Banco de México (The Bank of Mexico/Central Bank).

The Ministry of Finance is the senior authority within the Mexican financial system and is charged with planning, coordinating, evaluating and overseeing the banking system.

The Central Bank is an autonomous agency and its primary objective is to procure the stability of the purchasing power of the domestic currency, to promote the sound development of the financial system and to ensure the proper functioning of payment systems.

CNBV is an agency of SHCP. CNBV, together with SHCP and the Central Bank, supervises and regulates financial entities in order to promote their stability and the proper conduct of their business and to maintain and enhance the sound and stable development of the financial system as a whole while protecting the public interest. Its objective is to supervise and regulate individuals and entities engaged in activities included in the financial system.

FOBAPROA is not a financial authority. FOBAPROA is a trust constituted by the federal government. The Central Bank acts as trustee and a Technical Committee is charged with making decisions with respect to support to be provided to the banks. When the term FOBAPROA is used in this report, it refers to the trust unless otherwise specified. The FOBAPROA trust was established to carry out preventative operations to avoid financial problems that commercial banking institutions might face and to adopt measures to ensure their compliance with the obligations imposed by their liabilities.

The following series of explanations and diagrams set out the lines of authority and reporting for FOBAPROA, its Technical Committee and various government agencies.

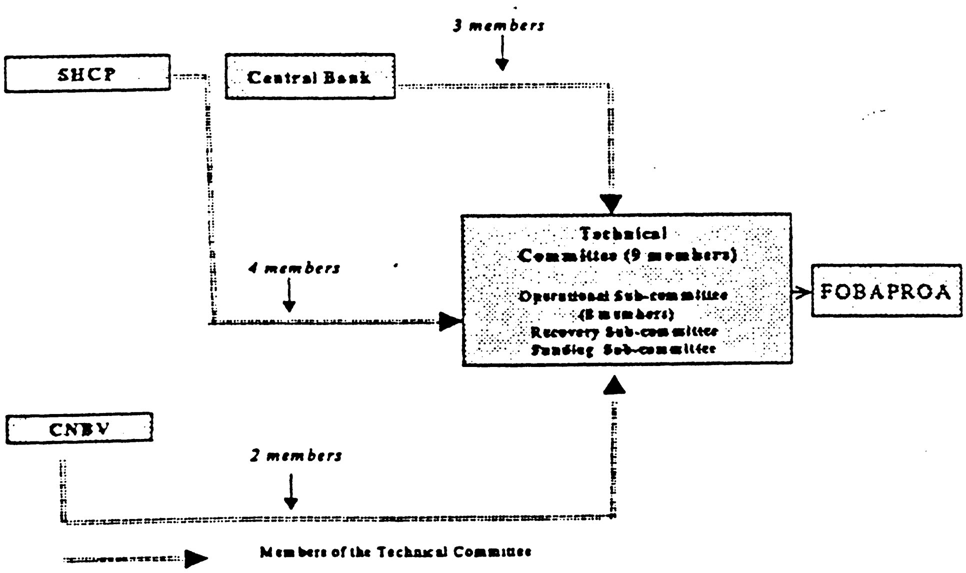
The President of Mexico appoints the governor of the Central Bank, with the approval of the Chamber of Senators. The President also designates and removes the head of SHCP.

The Minister of Finance, having been appointed by the President, appoints the president of CNBV. The Technical Committee of FOBAPROA is made up of nine members of whom four are from SHCP, three are from the Bank of Mexico and two are from CNBV. The chairman of the Technical Committee is from SHCP and has the deciding vote.

To carry out its responsibility, the Technical Committee passes resolutions which the Bank of Mexico, as fiduciary trustee, is responsible to execute.

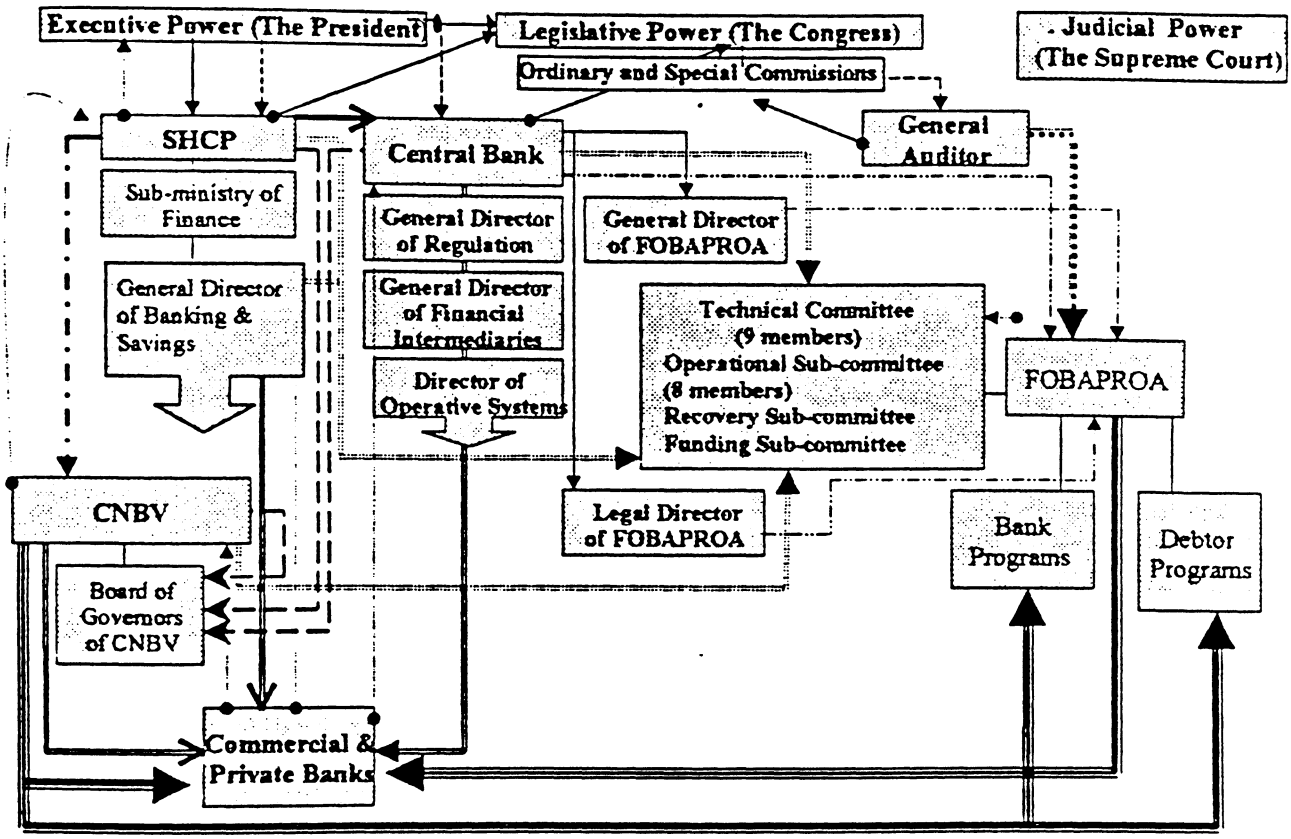
The following diagram sets out the relationship of FOBAPROA to the Technical Committee.

FOBAPROA and the Technical Committee



The following diagram sets out an overview of the reporting relationships, lines of authority, supervisory responsibilities and other inter-relationships among the various regulatory authorities and FOBAPROA. Responsibility for decisions made regarding the FOBAPROA trust rests with the Technical Committee

Overview of the Mexican Regulatory Environment as of June 30, 1998



Legend

- Report upon request
- Report in the authority line
- Subordinated Agency
- Supervision upon request
- Members of the Technical Committee
- Appointed by
- Managed by
- Authority Line
- Supervision of the FOBAPROA programs
- Supervision of the Financial System
- Members of the CNBV Board of Governors

ROLE OF THE REGULATORY AGENCIES IN THE BANK PROGRAMS

Ministry of Finance (SHCP)

SHCP is the agency with the most voting power of the Technical Committee of FOBAPROA. Four members of the Technical Committee are drawn from SHCP, one of whom is the Technical Committee's chairman who casts, when necessary, the deciding vote. While the implementation and design of each bank program involved the other regulatory agencies, SHCP was the principal decision-maker, was responsible for the concept, and underwrote the funding for the programs.

Bank of Mexico

The Bank of Mexico is the trustee of FOBAPROA trust, and is responsible for the execution of the resolutions of the Technical Committee. The Bank of Mexico participates in the decision-making process as a member of the Technical Committee. As the trustee of FOBAPROA trust, the Bank of Mexico is a signatory to all agreements through which financial support from the FOBAPROA trust was provided.

CNBV

Formally, all the regulatory agencies (CNBV, Ministry of Finance and Bank of Mexico) involved with the bank programs took part in the decision-making process, either through their representation on the Technical Committee, or as signatories to various agreements and circulars, or through the board of governors of CNBV. In practice, however, it was CNBV that was central to the design and implementation of the Capitalization and Loan Purchase of Bank Portfolios Program while the Bank of Mexico was central to the design and implementation of the Liquidity and PROCAPTE programs.

CNBV's wide-ranging mandate enabled it to control the development and implementation of the programs. In addition, CNBV has been the only authority with full access to bank information and it has, therefore, been in the best position to make judgements regarding the necessity to take, in any particular instance, corrective measures, including intervention.

Whenever CNBV intervened, FOBAPROA had an obligation under its mandate to assist the bank financially as necessary. The manner in which an intervention was carried out, as well as its timing, had a direct impact on the costs incurred by FOBAPROA.

Once the programs were established, CNBV's access to bank information gave it incremental influence on the decision-making of the Technical Committee. Although CNBV provides only two members to the nine-member Technical Committee, it is primarily CNBV, assisted by FOBAPROA staff, that prepares the technical documents that serve as a basis for many of the decisions of the Technical Committee.

ROLE OF THE REGULATORY AGENCIES IN THE DEBTOR PROGRAMS

SHCP

The Ministry of Finance actively participated in the design of the debtor programs, and issued operational rules for CNBV to supervise and enforce.

Bank of Mexico

The Bank of Mexico, in its role as financial agent for the federal government, both designed and created operational rules for several debtor programs as well as managed the payment process for these programs. As it does not have direct supervisory obligations (which lie with CNBV), its role has been very limited. The involvement of the FOBAPROA trust with the debtor programs was negligible in that it only served as a conduit for subsidy transfers from the government to some banks for a limited number of debtor programs.

CNBV

CNBV actively participated in the design of the debtor programs (together with SHCP and the Mexican Bankers Association). CNBV issued operational rules as well as procedures for the implementation of these programs. In addition, CNBV has been in charge of the operational supervision of the debtor programs, ensuring that banks comply with the rules and guidelines regarding such programs.

Overview of Development of Reforms to the Regulatory Framework

The following table sets out in chronological order the significant developments to the regulatory framework from June 1988, the beginning of Mexico's financial liberalization. Details of such developments are described elsewhere in this report.

Mexican Regulatory Framework – Chronology of Significant Reforms

Date	Reform
June 1988	Risk diversification rules established, financial liberaliztion initiated
July 1990	*Law to Regulate Financial Groups* established
	Law of Credit Institutions established
October 1990	FOBAPROA established.
August 1991	Loan portfolio qualification methodology issued by CNBV
June 1992	SHCP no longer required to approve foreign ownership of banks and financial groups
July 1993	External auditors required to audit annual balance sheet of banks
	Credit bureaus established
December 1993	Amendments to requirements to becoming a foreign subsidiary
	Individual ownership limited
April, 1994	Independent appraisal experts by CNBV
November 1994	Regulation of external auditors by CNBV
February 1995	Restrictions relaxed on becoming a foreign subsidiary
	Aggregate foreign ownership limitations increased
	Credit bureau rules established
May 1995	CNB and CNV merged to become CNBV
	Management and administrative intervention powers defined
July 1995	Related loan limit rules changed
November 1995	Foreign ownership rules amended
	Prevention and detection of criminal activity rules established
	CNBV decided to review mergers
December 1995	Accounting rules revised to take effect January 1, 1997
April 1996	Ownership rules relating to FOBAPROA established
July 1996	SHCP rules for the capitalization requirements of commercial banking institutions established
March 1997	Documentation and information requirements for credit files issued by CNBV
	Concentration risk reporting requirements issued by CNBV
October 1997	Additional reporting requirement timelines for banks reporting to CNBV established
February 1998	Guidelines established for the granting of credit – issued by CNBV and Bank of Mexico
October 1998	100% provision requirement established for loans not checked through credit bureau
January 1999	Risk management guidelines issued
January 1999	Foreign ownership rules relaxed.
	IPAB created (replaces FOBAPROA)
	Bankruptcy and suspension of payments revisions made within LCI

SHCP (Secretaría de Hacienda y Crédito Público – Ministry of Finance and Public Credit)

Objectives and Responsibilities

SHCP, a branch of the federal executive, is the senior regulatory body of the Mexican financial system, in charge of issuing administrative rules stated in *the Law of Credit Institutions* and regulating various aspects relating to the operation and structure of the Mexican banking system.

The purpose of the *Law of Credit Institutions* is to regulate banking and credit services, to oversee organization and operation of credit institutions, and the activities and operations they carry out, the sound and balanced development of credit institutions, the protection of the public's interest, and the conditions under which the state may exercise supervision over the Mexican banking system.[1] The federal executive, through SHCP, may interpret, for administrative purposes, the provisions of the *Law of Credit Institutions*[2] and the *Law to Regulate Financial Groups*.[3] In making its decisions regarding the *Law of Credit Institutions* and *Law to Regulate Financial Groups*, SHCP considers the opinions of the Bank of Mexico and CNBV.

Article 31 of the *Public Administration Act* outlines the responsibilities of SHCP. Among its responsibilities are national development planning, the estimation of federal revenues and expenditures, the collection of taxes and other revenues, the determination of the amounts of fiscal incentives, the handling of the public debt, the licensing of commercial banking activities, the preparation of the federal public expenditure program, and the supervision of fiscal provisions to ensure compliance.[4]

Role of SHCP in the Banking Crisis

SHCP, in its role as Mexico's senior regulatory body, was responsible for the manner in which the privatization was implemented. SHCP was responsible for the concept of privatizaton, the transfer of bank authorizations, the privatization selection process, and the licensing of new banks.

The Mexican government, faced with a systemic crisis and a potential run on the banks, published during December, 1995, confirmation that it would protect bank liabilities and use fiscal resources to achieve that objective. A decision had been reached by SHCP to use FOBAPROA to carry out this objective. FOBAPROA was not designed to deal with a crisis of such proportions and its resources were already depleted from the 1994 intervention of Union and Cremi banks.

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[1] *Law of Credit Institutions*, Article 1
[2] *Law of Credit Institutions*, Article 5
[3] *Law to Regulate Financial Groups*, Article 5
[4] Public Administration Act, Article 31

The funding for the debtor programs was provided directly by SHCP through the federal budget. Funding for the bank programs was provided by SHCP through its direct support of FOBAPROA.

The stated objectives that SHCP endeavoured to fulfill during the bank crisis may be summarized as follows:

1. reduce the risk of a run on the commercial banking system and the resulting collapse of the financial system;
2. protect the depositors and bank creditors;
3. maintain the integrity of the system of payments;
4. support the solvency and liquidity of institutions;
5. promote a culture of loan repayment by providing support to debtors;
6. minimize the current fiscal impact by distributing it over time; and
7. encourage the participation of first level foreign banks in order to improve the competitiveness of the banking system.

The Sub-Ministry of Finance and Public Credit and its Responsibilities

SHCP has a Sub-Ministry of Finance and Public Credit that is organized into six departments, one of which is the Department of the General Director of Banking and Savings responsible for providing oversight to the banking system. The Departments of the Assistant General Director of Multiple Banking, Financial Analysis and Savings Protection Policies, and Systems for Retirement Savings report to the Department of the General Director of Banking and Savings.

The significant responsibilities of the Department of the General Director of Banking and Savings, include:

- Creating, for senior approval, policies for the promotion, regulation, and supervision of financial groups, commercial banking institutions, credit information companies and savings and loan corporations. In addition, it participates in the evaluation of the operation and performance of these entities.
- Providing, for senior approval, recommendations for the authorization to operate as financial groups, commercial banking institutions, credit information companies, and savings and loan corporations, as well as making recommendations to revoke the aforementioned authorizations.[5]

One of the major responsibilities of the Department of the Assistant Director of Multiple Banking is to participate in the formulation of policies and measures to promote, regulate,

[5] Internal Regulations of the SHCP, Article 27

and supervise financial groups containing a commercial banking institution, foreign affiliated financial institutions, retirement fund administrators, credit information corporations, and savings and loans corporations. In addition, it participates in the evaluation of the operation and performance of these entities.[6]

The responsibilities of the Department of the Assistant General Director of Financial Analysis and Savings Protection Policies include participating in the evaluation of the operation and financial performance of the entities mentioned above and of the banking and savings activities, as well as the introduction, design and co-ordination of the application of management control mechanisms in these organizations. [7]

LAWS ISSUED BY SHCP REGARDING SUPERVISION OF THE BANKING SYSTEM

SHCP is responsible for issuing and implementing rules with respect to the *Law of Credit Institutions* and the *Law to Regulate Financial Groups*. A summary of relevant sections of this legislation follows:

Loan Portfolios

SHCP determines the basis for evaluating the loan portfolios of credit institutions and the documentation such institutions are required to request at the time of granting or renewing credits. The methodology to be followed in grading loan portfolios has been established by CNBV and is documented in the CNBV section of the Regulatory Framework of this report, entitled "Loan Qualification and Rating.[8]"

Access to Banking Information

The Department of the General Director of Banking and Saving requests information from the credit institutions in order to evaluate such institutions and to obtain the necessary information to carry out its regulation and co-ordination functions with respect to the banking system.

Capital Requirements

Commercial banking institutions are required to maintain minimum capital reserves as stated in the *Law of Credit Institutions* enacted July 1990. The minimum capital of each commercial banking institution is 0.12% of the amount of the aggregate net capital of all such institutions on December 31 of the immediately preceding year. In the first quarter of each year, CNBV publishes the amount of minimum capital that each institution must attain by the last day of the same year.

The minimum capital must be completely paid in by the commercial banking institution. In addition, capital stock in excess of the required minimum must be at least 50% paid.

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[6] Internal Regulations of the SHCP, Article 28
[7] Internal Regulations of the SHCP, Article 29
[8] *Law of Credit Institutions*, Article 76

Institutions are required to disclose their paid capital at the same time as they disclose their capital stock.[9]

According to Article 49 of the *Law of Credit Institutions*, commercial banking institutions are required to invest the resources they acquire from the public in a manner that allows them to maintain sufficient liquidity and security. SHCP determines the classification of assets and operations that produce contingent liabilities. It also determines the maximum percentages of enforceable liabilities and contingent liabilities that may be represented in the various groups of assets and operations resulting from such classifications.[10]

The *Law of Credit Institutions* also establishes a minimum requirement for net capital. Article 50 states that credit institutions must maintain a minimum net capital consisting of 6% multiplied by the sum of its assets and operations which produce contingent liabilities. SHCP may also take into account operations it determines expose the institution to significant risk, and may consider international banking practices with respect to determining capital adequacy[11].

Investment Limits

The *Law of Credit Institutions* establishes limits on investments that are charged against the paid up capital and capital reserves.[12]

Risk Diversification

Assets

Effective June 1, 1998, SHCP issued the rules for the diversification of risk in asset operations. These rules state that the:

- Financing that a financial institution grants to an individual cannot exceed 10% of the financial institution's net capital, or 0.5% of the total net capital of all financial institutions.
- Financing that an institution grants to a company cannot exceed 30% of the financial institution's net capital, or 6% of the total net capital of all financial institutions.
- Financing between financial institutions may add up to 100% of the net capital of the creditor.
- Limits do not apply to those loans granted or guaranteed by the federal government.

[9] *Law of Credit Institutions*, Article 19.
[10] *Law of Credit Institutions*, Article 49.
[11] *Law of Credit Institutions*, Article 50.
[12] *Law of Credit Institutions*, Article 55.

The Bank of Mexico annually publishes the maximum financing limits to individuals and companies, that are determined using the net capital of all financial institutions in the March and September Official Gazettes.

Financing granted to a group of individuals that have common risks due to their capital or responsibility links must be treated as financing to a single entity and the financing limits established above still apply. Groups that are considered to have common risks are as follows:

- Groups formed by people related to each other through guarantees or credits representing more than 50% of the net capital of the guarantor or creditor.
- Groups integrated by people with capital links representing more than 50% of the net capital of any of these people.

Liabilities

According to Article 51 of the *Law of Credit Institutions*, commercial banking institutions are required to diversify their risks. SHCP determines, through the application of general rules, the maximum percentage of liabilities of an institution that may represent obligations to a single person or entity, and the maximum limits on the amount of direct or contingent liabilities that represent the capital of the same person or entity. These limits may also refer to entities or segments of the market that represent a concentration of risk.[13]

A group of separate liabilities must be considered to be a single liability when the group of creditors have capital or responsibility relationships such that the financial situation or stability of the liabilities payable to one party affects the financial situation or stability of the credits payable to other parties. When these liabilities are identified, they are treated as single liabilities and subject to the limitations stipulated above.[14]

The Responsibility Agreement

According to Article 28 of the *Law to Regulate Financial Groups* enacted July 1990, the controlling company and each one of the financial entities which are members of the financial group, must execute an agreement in accordance with which:

The controlling company shall be liable, secondarily and without limitation, for fulfilling the obligations incurred by the financial entities who are members of the group.

1. The controlling company will be liable without limitation for the losses of all and each one of such entities. In the event that the assets of the controlling company are not sufficient to satisfy the obligations of two or more financial entities which

[13] *Law of Credit Institutions*, Article 51.
[14] SHCP Circular Number 101-467

are members of the group who are in need of capital at the same time, such obligations shall be paid on a pro rata basis until the assets of the controlling company have been exhausted.

Holding companies of financial groups are responsible for the members of the financial group. Each financial group must have a responsibility agreement in place in order to form the financial group.

Controlling companies of financial groups are subject to the inspection and oversight of the Commission that supervises the financial entity (i.e. Insurance Commission, CNBV) that SHCP determines to be the dominant member of the group.[15]

Foreign Ownership

The acquisition of the shares of the Mexican commercial banks or controlling companies of financial groups by foreign financial institutions is regulated by the North American Free Trade Agreement ("NAFTA") or the applicable international treaty or agreement, the *Law of Credit Institutions* and the *Law to Regulate Financial groups*.[16]

With the approval of SHCP, foreign financial institutions may purchase an unlimited series of shares for the purpose of converting the company to a foreign owned subsidiary[17]. As of July 18, 1990, foreign ownership of the voting capital of Mexican banking or financial groups was limited to an aggregate of 30%.

As at December 23, 1993, individual foreign investment was limited to owning 20% of Class "C" shares of the common stock so long as the investing foreign institution is widely held. Since February 15, 1995, the foreign aggregate ownership limit on voting capital of a Mexican bank or financial group increased to 49%.[18]

[15] *Law to Regulate Financial Groups*, Article 30.
[16] *Law of Credit Institutions*, Article 45-B and *Law to Regulate Financial Groups*, Article 27-B.
[17] *Law of Credit Institutions*, Article 17 Section VII and *Law to Regulate Financial Groups*, Article 20, Section V.
[18] Official Gazette of the Federation, February 15, 1995, Article 11 of the *Law of Credit Institutions*.
[19] *Law of Credit Institutions*, Article 17 Section VII, and *Law to Regulate Financial Groups*, Article 20, Section V

CNBV (Comisión Nacional Bancaria y de Valores – The National Banking and Securities Commission)

CNBV is the agency primarily responsible for regulating banks, brokerage firms and auxiliary credit institutions. The purpose for creating CNBV was to consolidate supervision for virtually all financial holding companies as well as banks and brokerage firms.

History of Supervision

In 1988 the financial liberalization of the Mexican banking system began with the lifting of restrictions on interest rates for borrowing and lending. This began a period of explosive growth in commercial and individual lending practices.

In 1990 the Mexican Congress enacted legislation (*the Law to Regulate Financial Groups*) that changed the legal and regulatory framework governing the banking and financial system, allowing for the existence of financial groups.[20] This law was the beginning of the process of regulation and supervision of banking groups in Mexico.

According to CNBV, the supervisory mechanisms and powers of the former CNB remained the same between 1991 and 1994 (between state and private ownership).

In 1995 the merging of CNB and the National Securities Commission was a significant step in the process of strengthening the supervision of the banking system.

On March 26, 1998, new legislation was presented to Congress which will strengthen the Bank of Mexico's autonomy and permit CNBV greater autonomy and powers for banking supervision. The initial proposal was to change the reporting structure of CNBV, from being subordinate to SHCP to being a decentralized agency within the Bank of Mexico. However, this proposal underwent some changes and the current proposal is that CNBV will remain subordinate to SHCP, but will enjoy more autonomy.

The new legislation clearly organizes the authoritative powers among CNBV, the Bank of Mexico, and SHCP. The specific powers to be transferred to CNBV from SHCP are the power to license financial entities in Mexico and the power to issue additional prudential regulation (such as capital ratios). Currently, CNBV is only authorized to issue prudential regulation in respect of risk management registration and accounting rules.

In accordance with the new legislation, the president of CNBV will be appointed by the President of Mexico for a term of six years, with one renewable term provided

[20] Anatomy of Mexico's Banking System Following the Peso Crisis, the World Bank, December 1996

authorization is given by the Chamber of Senators. Currently, the president of CNBV is appointed by the Minister of Finance.

The intention of the new law is to provide greater independence to CNBV, ensuring that actions are based on technical, rather than political, decisions.

Objectives of CNBV

CNBV's objective is to supervise and regulate financial entities in order to ensure their stability and proper performance, and to maintain and enhance the sound and stable development of the financial system as a whole, in the protection of the public interest.[xii] In addition, its objective is to supervise and regulate the activities of individuals and corporate entities as they pertain to the financial system. To do this effectively, CNBV has technical autonomy and executive powers granted by its own law, and other laws governing the financial system including the *Law to Regulate Financial Groups*, the *Law of Credit Institutions*, the *Organizations and Auxiliary Credit Activities Law*, the *Securities Market Law* and the *Mutual Funds Law*.

CNBV is responsible for inspecting and monitoring banking institutions and advises and reports to SHCP on such matters. The principle duties of CNBV with respect to the banks include the issuance of regulations governing banks, supervision of banks, approval of bank's reserves, approval of individuals elected by shareholders as senior officers of banks, advising SHCP and imposing fines on banking institutions which do not comply with existing laws.

CNBV's Relationships with Other Regulatory Authorities

According to CNBV, the supervisory areas within CNBV communicate with the Bank of Mexico on issues such as operations in exchange and money markets, and on the liquidity and soundness of the financial entities. Both authorities have recently established mechanisms of coordination through which they share most of the printed and/or electronic statistical information provided by the supervised entities, making it easier for these entities to comply with their information requirements.

Informal sharing of information takes place by virtue of the composition of the Board of Governors of CNBV.

CNBV's Responsibilities

The following list sets out a number of significant responsibilities of CNBV:

1. authorize or approve the appointment of directors, statutory auditors, attorneys, general directors and officers of banks;
2. act as a consulting body to the federal government on financial matters;
3. ensure that the operations and services carried out are performed in an efficient manner under agreed upon terms and condition;

4. authorize the minimum capital requirements that the institutions must hold by the last working day of the year (to be announced during the year's first quarter);
5. determine or recommend management continuance, suspension, or removal, and if applicable, the disqualification of the councillors, directors, officials, fiduciary delegates, attorneys and other individuals who may bind the institutions;
6. order the suspension of operations of certain financial entities in accordance with the law;
7. administratively, or managerially intervene the institutions, with the purpose of suspending, normalizing or resolving the operations that put their solvency, stability or liquidity at risk, or actions that violate the laws that govern them;
8. investigate those acts by individuals and corporate entities who carry out operations which violate the laws that govern the financial entities, and order the inspection of the responsible entities; and
9. intervene in the liquidation procedures of the entities which fall under the terms of the *Law of CNBV*.[21]

Inspection, Surveillance and Intervention

CNBV is also the inspection and surveillance body of the institutions that make up the financial system in Mexico. Such institutions are subject to the *Law of Credit Institutions*, *Securities Market Law* and *Mutual Funds Law* and the *General Law of Organizations* and *Auxiliary Credit* Activities and are subject to the inspection and surveillance powers of CNBV.[22]

Oversight consists of ensuring that the institutions comply with the provisions of the *Law of Credit Institutions* and provisions arising from the law, and that they comply with the comments and directives of CNBV resulting from the inspection visits conducted.[23]

Corrective Measures under Inspection and Surveillance

When CNBV considers that the operations of any of the entities subject to inspection and surveillance are not carried out under the terms of the applicable provisions, or that there are irregularities, the president of CNBV, with the consent of its board of governors, will define the measures necessary to normalize the situation. If the entity has not normalized the situation within the specified period of time, the president of CNBV may order the suspension of operations of the institution which has contravened the law. If necessary, the board of governors may order the administrative or management intervention of the entity.[24]

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[21] *Law of CNBV*, April 28, 1995, Article 4.
[22] Regulation of the National Banking Commission on Matters of Inspection, Surveillance and Accounting, November 24, 1988, Article 1.
[23] *Law of Credit Institutions*, Article 134
[24] Regulation of the National Banking Commission on Matters of Inspection, Surveillance and Accounting, November 24, 1988, Article 40-42.

The board of governors may declare an administrative intervention of the holding company, and appoint an intervenor for the purpose of suspending, normalizing or resolving the irregular acts.[25] Such administrative intervention shall be carried out directly by the intervenor, who shall carry out such acts as may be necessary to fulfill the objectives indicated in the corresponding order, and within the terms of the inspection regulations and internal regulations of CNBV[26].

In addition, we are informed by CNBV that, with the agreement of SHCP and Bank of Mexico, it may carry out an informal *(de facto)* intervention in which senior management of the bank is replaced by CNBV management appointees who report to CNBV, or the bank is manged by another bank with CNBV's approval.

A management intervention is declared when irregularities are discovered by CNBV which may affect the institution's stability and solvency, and where the interests of the public or of depositors is endangered. The purpose of the intervention is to protect the interests of depositors and creditors of the intervened institution and to restore its operations to normality. The president must obtain the consent of the board of governors to proceed with the management intervention, then appoints an individual to manage the company as the intervenor-manager.[27]

The intervenor manages the business and affairs of the intervened institution on behalf of CNBV, in lieu of its board of directors and its chief executive officer. As of the date of the management intervention, and until such time as it is terminated by CNBV, the elected board of directors of the financial institution exercises no authority or control over the business and affairs of the institution, although it may continue to meet to discuss the business and affairs of the institution. The management intervenor is not subject to the authority of the shareholders or the board of directors.

CNBV may request, from the court, a suspension of payments or the issuance of a declaration of bankruptcy.

Prudential Regulations

Under CNBV banking *Circular 1222*, external auditors are required to submit reports to CNBV in addition to the annual audited financial statements. These reports include commentaries by the external auditor regarding irregularities observed in the review of the commercial banking institution that have not been corrected, causing exceptions to the audit report. A description of the variations between the annual December 31 financial statements provided to CNBV and those published by the commercial banking institution, as reported by the external auditor, is required.[28] The purpose of the additional information is to obtain an opinion on specific topics, such as mark-to-market

[25] *Law to Regulate Financial Groups*, Article 30-A and the *Law of Credit Institutions*, Article 138.
[26] *Law of Credit Institutions*, Article 137
[27] *Law to Regulate Financial Groups*, Article 30-B and the Law of Credit Institutions, Article 138.
[28] CNBV Circular 1222, November 14, 1994, Article 14.

of financial instruments, internal control systems for credit, derivatives, securities, foreign exchange and market risks, loans granted to purchase equity, the internal audit function, and management suggestion reports provided to the institution, as detailed in *Circular 1222*, Article 14. The information must be filed with CNBV within sixty calendar days from year-end.[29]

Accounting Rules for Banking Institutions

In December 1995 CNBV issued Circular 1343 which introduced new accounting rules that banks were required to follow, commencing in 1997. Prior to December 1996, the accounting rules in place in the Mexican financial system were not codified and/or consistent with standards issued by other national or international accounting bodies.

Loan Qualification and Rating

SHCP, in conjunction with the Bank of Mexico and CNBV, determines the rules for evaluating loan portfolios of credit institutions and the level of precautionary reserves to be maintained for each level of loan classification. SHCP is also responsible for determining the documentation and information the institutions must request at the time of the granting or renewal of loans, given with or without security, the requirements the documentation must contain, and the time period in which it must be obtained.[30] CNBV determines the methodology for the qualification of the loan portfolio, oversees that the methodology is followed, and makes recommendations as required.[31]

The results of the portfolio quality assessment are submitted to CNBV, which determines whether the institution's reserves are adequate.[32]

Related Party Lending

According to Article 73 of the *Law of Credit Institutions*, multiple banking institutions require the consent of a majority of directors (appointed by series "A" or "F" shares) to enter into a transaction by which the following persons may become debtors of the institution:

1. individuals and companies that directly or indirectly own 1% or more of the outstanding capital stock of the bank or of the holding company which owns the bank;
2. regular and alternate members of the board of directors of the institution;
3. spouses of or persons related with such persons by blood, marriage or civil adoption;

[29] CNBV Circular 1222, November 14, 1994, Article 14.
[30] *Law of Credit Institutions*, Article 76.
[31] Rules to Qualify the Loan Portfolio, Articles 10 & 11.
[32] CNBV Circular 1128, August 15, 1991, Article 12.

4. any individual, other than bank directors or employees, who may bind the institutions with their signatures;
5. companies, as well as their directors and officers, in which the institution controls directly or indirectly at least 10% of the instruments representing capital;
6. companies whose officers and directors are the officers and directors of the financial institution; and
7. any corporation in which any of the aforementioned corporations and individuals, as well as the bank's employees, statutory auditors, external auditors or their relatives own directly or indirectly 10% or more of its outstanding capital stock.[33]

In addition to approval by the board of directors, loans granted to the above parties must have the prior recommendation from the institution's credit committee. If authorization is granted, the institution must present CNBV with a certified copy of the resolution in which the board's approval is stated, and inform it of the granting or renewal as well as the manner of payment or cancellation of such loans, within the terms that may be established by CNBV. In the case of loans granted to leasing and factoring companies which are members of the same holding company, CNBV does not consider such loans to be related party loans.

BANK OF MEXICO

Objective and Organization

The Bank of Mexico's autonomy was strengthened on April 1, 1994.[34] Prior to this, the Bank of Mexico was a decentralized body of the federal government.[35] The primary objective of the Bank of Mexico is to ensure the stability of the purchasing power of the domestic currency, promote the sound development of the financial system and to ensure the proper functioning of the payment system.[36] Article 28 of the Mexican Constitution adds that the responsibility of the Bank of Mexico is to ensure that economic development is consistent with the State's objectives.

The Bank of Mexico is entitled to issue regulations for the sole objective of exchange control, the sound development of the financial system and of the payment system, or the protection of public interest, and must indicate its reasons for doing so.[37]

In December of each year since 1992, the Bank of Mexico, on the instructions of the Technical Committee, has published in the Official Gazette[38] of the federation those liabilities that FOBAPROA is intended to protect.

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[33] *Law of Credit Institutions*, Article 106.
[34] *Law of the Bank of Mexico*, Fifth Transitory Article.
[35] *Law of the Bank of Mexico*, Thirteenth Transitory Article.
[36] *Law of the Bank of Mexico*, Article 2.
[37] *Law of the Bank of Mexico*, Article 24.
[38] December 26, 1997, Official Gazette of the Federation

Authority and Responsibilities

As outlined in the *Law of the Bank of Mexico*, the Central Bank is required, amongst other things, to perform the following functions:

- regulate the issuance and circulation of currency, foreign currency exchange, financial intermediation services and the payment systems; and
- operate as a reserve bank and lender of last resort for credit institutions.[39]

Supervision of the Banking System

The regulations issued by the Bank of Mexico apply to the operations in which credit institutions become creditors or debtors. In addition, service operations and granting of credit, loan and repurchase agreements effected by stock exchange intermediaries must adhere to these regulations. These regulations also apply to trusts, mandates and commissions of stock exchange intermediaries and insurance and bonding companies.[40] Credit institutions, brokers, stock exchange intermediaries, foreign exchange firms, and other intermediaries that belong to a financial group are also subject to the regulations issued by the Central Bank.[41]

Supervision of Banks

The financial institutions must provide all information required by the Bank of Mexico to adequately perform its functions. This includes providing information regarding operations and data sufficient to assess their financial situation. At the request of the Bank of Mexico, the supervisory commissions for the financial system such as CNBV will perform visitations at the institutions' facilities and conduct examinations.[42] The Bank of Mexico may suspend all or some of an institution's operations that infringe the Law or the resulting regulations.[43]

The specific provisions regarding banking secrecy are outlined in Article 117 of the *Law of Credit Institutions*. This Article stipulates that a credit institution may not provide news or information concerning deposits, services, or any other type of operation, except to the parties to which they pertain, or when ordered to do so by a judicial authority. However, this does not affect the credit institutions' obligation to provide CNBV with information and documentation regarding the operations carried out and services provided by the credit institution that CNBV requires to exercise its duties of inspection and oversight.[44]

[39] *Law of the Bank of Mexico*, Article 3.
[40] *Law of the Bank of Mexico*, Article 26
[41] *Law of the Bank of Mexico*, Article 32
[42] *Law of the Bank of Mexico*, Article 36
[43] *Law of the Bank of Mexico*, Article 37
[44] *Law of Credit Institutions*, Article 117

Department of FOBAPROA

The Bank of Mexico is the fiduciary trustee of the FOBRAPRA trust, and is responsible for the execution of the instructions of the Technical Committee and the general administration of the trust.

FOBAPROA TRUST

Laws and Bylaws regarding FOBAPROA

According to Article 122 of the *Law of Credit Institutions*, the Bank of Mexico shall administer a trust which shall be called FOBAPROA, whose purpose shall be to conduct operations of a preventative nature to avoid situations whereby a bank would default on its financial obligations. The creation of the fund by the federal government does not give it the character of an entity within the federal public administration and consequently, it is not subject to the provisions applicable to such entities.[45]

Supervision of FOBAPROA

The internal regulations of the Bank of Mexico, provide that there are two departments within the Bank of Mexico with FOBAPROA supervisory responsibilities. The Department of the General Director of Analysis of the Financial System was responsible for activities related to the performance of FOBAPROA.[46] When the department of the General Director of FOBAPROA was created in April 1997, the responsibility for the performance of FOBAPROA was no longer with the department of the General Director of Analysis of the Financial System. The Controllership Directorate, a department of the Bank of Mexico, is responsible for auditing the operations carried out by the banks, even when acting as fiduciary.[47]

FOBAPROA Trust Agreement

Article 122 of the *Law of Credit Institutions* appoints the Bank of Mexico as the administrator of the FOBAPROA trust.[48] The *FOBAPROA Trust Agreement* outlines the fiduciary's responsibilities with respect to this trust.

The trust agreement states that the fiduciary does not have any responsibilities toward the settlor (SHCP) or to third parties provided that the guidelines established in the trust agreement or the written instructions provided by the Technical Committee are followed.[49]

The Bank of Mexico and Debtor Programs

The operating rules for some of the debtor support programs were issued by the Bank of Mexico. The programs, program budgets and operation guidelines are not in its jurisdiction since they were not the institution implementing these programs.

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[45] *Law of Credit Institutions*, Article 122
[46] Internal Regulations of the Bank of Mexico, Article 14
[47] Internal Regulations of the Bank of Mexico, Article 27 X
[48] *Law of Credit Institutions*, Article 122, Section I
[49] Modifications to the FONAPRE Trust Agreement, October 18, 1990

Remuneration

The Bank of Mexico, as fiduciary trustee receives an annual management fee of 20% of the fund operating expenses for the year. The fee is to be paid to the fiduciary in January of the following year for services rendered.[50]

BANKRUPTCY (INSOLVENCY) LAWS

Background

The *Law of Bankruptcy and Suspension of Payments* ("Bankruptcy Law") was enacted in 1943, and subsequently underwent one minor revision. In 1988, the Bankruptcy Law was revised. Among other changes, special courts were created to hear only insolvency cases and specific rules were established for two separate procedures that could be implemented in order to resolve insolvency conflicts: the suspension of payments and bankruptcy procedures. Both procedures are long and complex.

Commercial insolvency falls under the jurisdiction of federal law in Mexico. Business bankruptcies are controlled by the Bankruptcy Law. This law governs the insolvency process for corporations and individuals engaged in business in Mexico. Personal non-business insolvencies are outside of the scope of this law and are governed instead by the relevant provisions in the state civil code.

Bankruptcy

As a result of their diverse needs, specific bankruptcy rules have been created for banks, auxiliary credit institutions, insurance companies, public corporations and bonding institutions. A number of federal statutes have been created specifically to deal with business bankruptcy proceedings including the following:

- *Federal Labor Law;*
- *Tax Code of the Federation;*
- *Law of Credit Institutions;*
- *General Law of Mutual Insurance Institutions and Societies; and*
- *New Federal Law of Bonding Institutions.*[51]

Bankruptcies in Mexico are to be categorized as either inadvertent, the result of bad management, or the result of fraudulent activities. The latter two categories may result in criminal prosecution for those responsible for the administration of the business concerned.

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[50] Modifications to the FONAPRE Trust Agreement, October 18, 1990

[51] Barrett, John A. "The Insolvency Process in Mexico", Latin American Law and Business Report, World Trade Executives Inc. 1995.

Suspension of Payments

Suspension of payments is a procedure provided by Mexican legislation to avoid bankruptcy. Debtors may request a judge to order a suspension of payments. The judge can authorize the debtor to suspend payments during a specified time period, provided the creditors are in agreement with this decision. In such a case, the debtor is permitted to continue to conduct its business, however, this is done under the supervision of an individual appointed by the court.

Creditors

The principle of dividing assets equally among creditors of a similar nature is fundamental in an insolvency legal process. The Bankruptcy Law provides for creditors to be categorized as either secured (those having security as collateral for a debt) or unsecured. Provisions exist for priority payments to be made to certain unsecured creditors where funds are available.

2. FOBAPROA

FOBAPROA (Fondo Bancario de Protección al Ahorro - Fund for the Protection of Bank Savings)

History of the Protection of Bank Deposits in Mexico

The *Bank Act* of 1897 established the legal possibility for the bankruptcy of credit institutions. Until 1981, there was no specific mechanism in place for protecting depositors under Mexican legislation. However, in practice, the federal government would grant full protection to bank depositors through the use of public funds by either taking control of the institution or by paying all of its liabilities.

The Credit Protection Fund was established in 1981. This organization was to be funded through commercial bank contributions to avoid the burden of protecting bank depositors through the exclusive use of public funds. The fund was not created with the intention or the resources to handle a systemic crisis, but rather to contain isolated problems in commercial banks.

On November 10, 1986, the federal government formed the Preventive Support Fund for Various Banking Institutions (FONAPRE). It operated throughout the period in which the commercial banking system was government owned. FONAPRE received contributions from commercial banking institutions in accordance with clause three of the FONAPRE Trust Agreement dated November 10, 1986, and Article 77 of the *Law to Regulate the Public Service of Banking and Credit*, published January 14, 1985. The resources of FONAPRE were intended to be available to carry out financial operations to support the financial stability of institutions, and to avoid circumstances that could impact on the timely repayment of their obligations.

During 1990, and in order to replace FONAPRE, the *Law of Credit Institutions* legislation established that all banking institutions would participate in the regime known as the Fund for the Protection of Bank Savings (FOBAPROA). FOBAPROA was a trust established in 1990 by the federal government with the Bank of Mexico as fiduciary trustee. The fund was directed by a Technical Committee comprised of members from SHCP, the Bank of Mexico and CNBV.

The document, entitled Modifications to the FONAPRE Trust Agreement, creating FOBAPROA was signed on October 18, 1990[52]. This agreement established the fiduciary trustee of the Fund as the Bank of Mexico and the settlor of the fund as SHCP.

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[52] Modifications to FONAPRE Trust Agreement, October 18, 1990

In general terms, the purpose of the FOBAPROA trust was to carry out preventative operations to avoid financial problems that commercial banking institutions might face and to adopt measures to ensure compliance with the banks' liabilities.[53]

OVERVIEW OF FOBAPROA

The FOBAPROA trust is administered by the Bank of Mexico. Representatives from each of SHCP, CNBV and the Bank of Mexico are placed on the Technical Committee. The Technical Committee passes resolutions which govern the trust and the FOBAPROA department within the Bank of Mexico. Specifically, the FOBAPROA Technical Committee forwards its resolutions to the governor of the Bank of Mexico who acts on behalf of the bank, in its character as fiduciary trustee, as its legal representative and fiduciary delegate[54]. The governor has at his disposal the FOBAPROA department that executes all of the Technical Committee resolutions.[55]

Two main committees exist to direct the FOBAPROA trust; the Technical Committee and the Operating Sub-Committee. The principal function of the Technical Committee is to define the terms and conditions for support that would be awarded by FOBAPROA. The function of the Operating Sub-Committee is determined by the Technical Committee. The Operating Sub-Committee is active in the determination of the characteristics necessary to grant support to the banks. Each decision was presented to the Technical Committee.[56]

FOBAPROA's Responsibilities

In addition to the purpose of the trust, as outlined in the trust agreement, the FOBAPROA Strategic Plan documented in the Technical Committee Meeting minutes of meeting of October 9, 1996, includes the following objectives:

- determine the strategy of and follow up with each FOBAPROA bank;
- appropriately administer the FOBAPROA banks, the trust portfolios and other assets;
- accelerate the credit restructuring process;
- assist in determining the best way in which debtor companies and those capitalized by FOBAPROA, may be intervened;
- prepare the credit portfolio and other assets for sale in co-ordination with the Valuation and Sale of Assets ("VVA");[57]
- accelerate the sale of FOBAPROA banks; and
- minimize FOBAPROA's cost of financing.

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[53] Modifications to FONAPRE Trust Agreement, October 18, 1990
[54] *Law of the Bank of Mexico*, Article 47, Sections IV and X
[55] Internal Regulations of the Bank of Mexico, Article 14bis.
[56] Technical Committee Minutes, April 29, 1997
[57] Valuation and Sale of Assets (VVA) is a subsidiary of FOBAPROA created April 26, 1996 to manage, value and sell the assets that FOBAPROA may acquire in its dealings with the banks.

In the Modification to the FONAPRE Trust Agreement of October 18, 1990, Antecedent II, the trust fund entitled FONAPRE was changed to FOBAPROA. With that, the support operations of FONAPRE, published on December 24, 1986, were adopted by FOBAPROA. The nature of the support that was to be provided by FONAPRE, and hence FOBAPROA, were as follows:

- provide financing to the banking institutions through the use of deposits, credits or loans;
- acquire subordinated debt issued by the institutions;
- acquire series "B" shares according to the laws;
- acquire loans, securities and other assets from the banking institutions;
- provide non-recoverable contributions, when strictly necessary, to cover financial imbalances in the institutions; and
- other similar related activities established by the Technical Committee according to the type of support required.[58]

Modifications to the FOBAPROA trust Agreement were made on May 3, 1996 which specified operations that could be undertaken by the trust as follows:

- provide financing to financial institutions or their holding company, through loans, credit lines, or other transactions established in the markets legislation;
- acquire stocks, subordinated debt, or other debt instruments issued by the institution or its holding company;
- acquire and sell assets or property titles to provide financial improvements to the institutions;
- subscribe for debt instruments, grant collateral, and assume liabilities on behalf of institutions;
- participate in the capital stock ownership in those entities which assist FOBAPROA in achieving its objectives, including the companies that provide complimentary or secondary services. In addition, the fund can create trusts and establish joint ventures which would provide assistance to the fund;
- obtain financing; and
- arrange complimentary or secondary services to perform the operations of the fund.[59]

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[58] FONAPRE Operating Rules, December 24. 1986.
[59] Modifications to the FOBAPROA trust Agreement, May 3, 1996, Clause 3.

FOBAPROA's Organizational Structure

FOBAPROA's Technical Committee

Article 122, Section IV of the *Law of Credit Institutions* provides for the creation of a Technical Committee. This committee is to establish the terms and conditions of support granted by the fund; the amounts of deposits, credits and other obligations that will be protected; the time periods in which ordinary contributions must be made; and other powers as may be set forth in the trust agreement.[60]

Responsibilities of the Technical Committee

According to the Trust Agreement of October 18, 1990, the Technical Committee exercises the following responsibilities:

- issues the operational rules that the fiduciary must follow;
- determines the terms and conditions of the support to be provided to the institutions;
- determines the deposits, credits and other obligations, and their amounts that must be protected or supported;
- authorizes the amounts, terms and conditions of the payment programs proposed by the Operational Sub-Committee in order to protect the obligations covered by FOBAPROA; and
- approves budgets and annual programs, their modifications, and the balance sheet provided by the fiduciary [61].

Operations of the Technical Committee

The Technical Committee generally met once or twice a month during the period 1994-1998. The topics of discussion were generally divided into two main types; issues related specifically to the FOBAPROA trust itself, and issues related to specific banks.

Items presented to the Technical Committee related to the trust's results included financial statements and budgets for the operation of the FOBAPROA trust prepared by the FOBAPROA department of the Central Bank and organizational issues relative to the FOBAPORA department. The reporting of the trust to the Technical Committee is described further under the topic of FOBAPROA Trust Accountability.

Issues discussed by the Technical Committee relating to specific banks included virtually every aspect of a bank's involvement in a bank program to be administered by the FOBAPROA department of the Central Bank. These included individual bank problems and requests for assistance, detailed aspects of an agreement, alternatives to, or different scenarios regarding an agreement, results of auditor's reports regarding loan portfolio agreements, non-compliance issues with a bank (i.e. related party loan inclusion in loan

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[60] *Law of Credit Institutions*, Article 122, IV

[61] Modifications to FONAPRE Trust Agreement, October 18, 1990

purchase portfolios, lack of capital injection), legal considerations and approvals thereon. Information presented to the Technical Committee was prepared by whichever financial authority had access to it (usually CNBV with the assistance from FOBAPROA department). While every important decision was presented to the Technical Committee, the FOBAPROA department could make some decisions of an administrative nature without consulting the Technical Committee. The financial authorities did agree and sign some letters of intent with third parties (i.e. regarding bank purchases) which were subject to Technical Committee approval.

FOBAPROA's Operational Sub-Committee

In order to assist the Technical Committee in its duties, an eight member Operational Sub-Committee was created on October 18, 1990, consisting of three members from SHCP, three members from the Bank of Mexico, and two members from CNBV. Each sub-committee member is required to name a substitute. The Operational Sub-Committee is chaired by a member appointed by SHCP.[62]

The Operations Sub-Committee would propose methods to support the credit institutions, subject to the confirmation of the resolutions by the Technical Committee[63].

Central Credit Committee

The Central Credit Committee was an unofficial forum created by FOBAPROA in October 1996 to review and approve the restructuring of loans greater than MN $50 million acquired by it or that were encountered during intervention. The objective was to ensure the highest return was received for the assets and to authorize new financing to improve debtors' repayment ability.

The Central Credit Committee supervised the analysis of the credits. This function replaced the analysis initially carried out by the credit committees of the banks administering the loans. This committee would authorize institutional restructuring when awarding new credits to debtors if it is determined to be suitable to attain the maximum recovery on the debts. Each credit committee of each bank's respective trust, consisted of eight members (three from SHCP, one from CNBV, two from the bank in question, one from FOBAPROA and one from VVA) who met regularly to make decisions regarding the creditors under the administration of the bank they represented.

The need for the Central Credit Committee came from the bank administrators and intervening management of banks who were unwilling to assume the responsibility for restructuring and related decisions. In addition, there was a need to derive the best strategy to maximize recoveries. This committee, while a forum for restructuring loans

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[62] Modifications to FONAPRE Trust Agreement. October 18, 1990.
[63] Technical Committee Minutes, April 29, 1997.

with the financial authorities involved, was not part of the Technical Committee, did not formally report to it, and operated independently of the Technical Committee.

FOBAPROA's Recovery Sub-Committee

The Recovery Sub-Committee was created by agreement of the FOBAPROA Technical Committee on April 29, 1997, replacing the Central Credit Committee which had never been formalized.[64] This sub-committee is comprised of six appointed members; two from SHCP, two from the Bank of Mexico, and two from CNBV. The priority of the committee is to maximize the recovery of those assets in the portfolios that FOBAPROA has acquired through the portfolio purchase program or the acquisition of the shares of the institutions. The sub-committee establishes the policies to be followed in respect of the administration, recovery and collection of the loans.[65] The restructuring of credits with amounts in excess of MN $50 million is co-ordinated by FOBAPROA, with reviews conducted by the Recovery Sub-Committee, once the restructurings have been approved by the credit committees of the affected banks.[66] In addition, in cases where there are several creditor banks, the committee co-ordinates the collection strategy to be implemented in order to ensure the highest overall recovery. The participation of CNBV on the committee allows the sub-committee to consider the recovery of assets in the intervened banks.

The Valuation and Sale of Assets

Valuation and Sale of Assets ("VVA"), a subsidiary of FOBAPROA, was created on April 26, 1996,[67] to manage value and sell the assets that FOBAPROA acquired in its dealings with the banks. The selling of acquired assets was intended to be done first, prior to the granting of any new bank support by FOBAPROA.[68] VVA's objective was to design, negotiate and implement an adequate mechanism to sell, transfer or assign properties or property rights.[69]

The mandate of VVA was to maximize realization through the sale of the financial assets, fixed and non-fixed assets that FOBAPROA had acquired from the various banks; to design sale strategies that support the recovery of viable entities; and to encourage the development of a mechanism designed to sell bank debt and other assets in the open market.[70]

There were several obstacles which impeded the performance of VVA. First, FOBAPROA had no legal rights to collect bank loans or credits because FOBAPROA had only an interest in the cash flow, not an interest in the loans themselves. Second, transferring assets from the banks to FOBAPROA had minor adverse tax implications. If the loans were transferred from the banks, FOBAPROA would have been required to

[64] Technical Committee Minutes, April 29, 1997.
[65] Technical Committee Minutes, April 26, 1996.
[66] Technical Committee Minutes, April 29, 1997.
[67] Technical Committee Minutes, April 26, 1996.
[68] Technical Committee Minutes, April 29, 1997.
[69] Technical Committee Minutes, April 26, 1996.
[70] Technical Committee Minutes, April 26, 1996.

register for and pay transfer tax. Third, Mexico does not have a sufficiently liquid secondary market for loans. Finally, under the terms of the portfolio purchase program, if FOBAPROA were to assume ownership of the loans, the banks would no longer have responsibility for sharing the losses.

As a result of these obstacles, VVA was prevented from carrying out its mandate and now exists as a shell entity in legal form only. The banks are directly responsible for selling their own assets, although the procedures related to the sale of these assets must be presented to the Technical Committee if FOBAPROA has an interest in the proceeds.

FOBAPROA's Departments

The FOBAPROA trust was created in 1990, and in 1993, thirty-three people were assigned from the Bank of Mexico. This number was considered sufficient to administer its responsibilities. In August 1993, the organizational structure and operations manual for the FOBAPROA department were created and authorized, being a part of the Monetary Planning and Financial System Analysis Department of the Bank of Mexico.

The first organization chart was composed of three sub-departments: Preventative Diagnostic, Technical Evaluation and Operative Evaluation, each with corresponding managers. The Operative Evaluation department was responsible for supervising the status of financial intermediaries, to research benchmarks like the standards and best practices issued by the Basle Committee on Banking Supervision, as well as to keep in contact with regulatory authorities. Its other primary responsibilities were to account for and control the FOBAPROA trust's transactions, and to assess the efficiency of all the operating departments of the banks through information gathered from the Mexican Bankers Association, or direct visits.

The Technical Evaluation department was responsible for participating, when requested, in the Technical Committee meetings. Otherwise its functions were similar to the Operative Evaluation department: to assess the strategy of bank management to determine whether the inflows were sufficient to cover the minimum capital and reserve requirements.

The Preventative Diagnostic department was to monitor and prevent problems in areas of financial intermediaries such as credit, securities, international transactions, administration, branch profitability, global risks etc. In doing so, it would compare indices issued by SHCP, CNBV and the Bank of Mexico, with banking figures such as credit concentration, geographic dispersion, etc.

The Technical Evaluation department and Preventative Diagnostic department had responsibilities which duplicated other regulatory agencies (i.e. CNBV). These departments did not have the resources or the legal authority to access the information required to perform these functions. The Operative Evaluation department and the Technical Evaluation department also had overlapping responsibilities.

The FOBAPROA department of the Bank of Mexico was staffed to administer and account for simple transactions. This may have been sufficient during normal periods when only accounting for deposit insurance proceeds and ongoing administrative expenses was necessary. However, the expansion of the number and complexity of transactions created difficulties for the department to effectively control its operations.

RESTRUCTURING OF THE FOBAPROA DEPARTMENT OF THE BANK OF MEXICO

In October 1996 a strategic plan was presented to the Technical Committee highlighting issues and problems the department was experiencing, adding objectives to the FOBAPROA trust's mandate and proposing resource needs to achieve the new objectives. In April 1997 the proposed resource changes were made substantially according to the original strategic plan. In broad terms, this involved increasing the human resources of the FOBAPROA department, its technological resources, and the use of specialized consultants where appropriate. Appointing a general director to be responsible for the department's operations heightened the importance of the FOBAPROA department. The general director of FOBAPROA department would also supervise the following:

- a controllership function (with two areas, financial and processes control);
- a general investigation and development directorate (with two areas, strategies and investigation and analysis), and;
- four further directorates known as:
  - the operation directorate (with six areas: bank support and supervision of intervened banks, trusts' supervision, portfolio sales, goods, furniture and buildings, treasury and securities and systems);
  - the corporate assets directorate (with eight main areas: evaluation, recovery, intervened banks, commercial banks, office of cases (i.e. situations/issues), office of companies, office of sales and technical support;
  - the legal directorate (with six areas: financial system support, litigation, fiduciary, real estate, corporate assets and internal judicial administration); and
  - the administration directorate (with three main areas: human resources, accounting and budgeting and service and installation).

The structure was designed to align specific departments with various types of assets under the trust's supervision and the functions for which the trust was responsible. It also provided infrastructure and support to the significant trust operations including:

- loan portfolio management;
- monitoring intervened and non-intervened institutions in which FOBAPROA trust was a shareholder;
- foreclosed assets and payments in kind, including real estate and other goods;
- information systems;

- valuation issues;
- legal agreement requirements; and
- accounting, record keeping and controllership functions.

With this structure, the FOBAPROA department experienced growth to approximately 300 employees. FOBAPROA's structure was modified on at least two occasions in September and November 1998, in order to equip the institution with the appropriate resources.

PROCESS FOR REQUESTING SUPPORT FROM FOBAPROA

In order for the commercial banking institutions to receive support through FOBAPROA, the institution must guarantee repayment of the support by pledging shares of the institution, government securities, or other assets the Fiduciary trustee believes satisfies the required guarantee.[71]

All limitations and restrictions to participation in the programs of FOBAPROA were determined on a case by case basis in the Technical Committee meetings. No general guidelines were formalized providing restrictions to program participation.

FUNDING AND EXPENSES OF FOBAPROA

Financing

Article 7 of the *Law of the Bank of Mexico* permits FOBAPROA to receive financing from the Bank of Mexico. The FOBAPROA trust Agreement also empowers FOBAPROA to obtain financing, and contains no restrictions.

Bank Contributions

Section III of Article 122 of the *Law of Credit Institutions*, states that commercial banking institutions are required to pay contributions, as determined by SHCP, which shall take into account the amount of liabilities and capitalization levels of each institution.[72]

Obligations to be Protected

The Bank of Mexico will publish, in December of each year, the maximum amount of obligations that will be protected by the fund in the following year, according to the agreements executed by the Technical Committee.[73] In practice, the actual statement

[71] *Law of Credit Institutions*, Article 122, II.
[72] *Law of Credit Institutions*, Article 122, VI.
[73] Modifications to the FONAPRE Trust Agreement, October 18, 1990, Clause 5(c).

published in the Official Gazette was not quantitative but rather a statement of the nature of the liabilities that will be protected as indicated below.

Each year in the December Official Gazette from 1992 to 1997, statements as follows were published, in lieu of a quantitative amount which would be protected by the fund, for the years 1993 to 1998.

The following was published in 1993 to 1994:

> "Based on Section IV of Article 122 of the *Law of Credit Institutions*, and considering that it has been a tradition that the Mexican financial authorities try to protect investors from any loss in case of insolvency of Credit Institutions, the FOBAPROA's Technical Committee has decided to continue with such tradition, for this reason it has been agreed that FOBAPROA, will endeavour to honor all of the liabilities charged to financial institutions that participate in the fund, provided that they are derived from their operations, excluding, liabilities arising from subordinated debentures liabilities resulting from illicit, irregular or bad faith operations"... [74]

The following was added to the above publication in 1995 to 1997:

> "and liabilities derived from loans granted between banking institutions participating in funds transfer systems administered by the Bank of Mexico, to back up obligations chargeable to the Bank of Mexico, as well as liabilities in favour of intermediaries belonging to the same financial group as the bank."[75]

[74] December 29, 1993 and December 28, 1994 publication in the Official Gazette of the Federation.
[75] December 26, 1997 publication in the Official Gazette of the Federation.

3. Privatization

In 1991, ten years after nationalization, the Mexican government commenced privatization of the commercial banking system in order to promote an open economy.

The bank authorizations (which included the approval of the transfer of existing banking licences or authorizations) were auctioned off to the highest bidder. This auction process resulted in revenue for the federal government of over MN $38,000 million (US $12,500) million at the then prevailing exchange rates that were used mainly to reduce public debt. Eighteen banks were auctioned to financial groups that were represented by eleven securities/brokerage houses and seven industrial groups or individuals. Offers within 5% were considered a second time, at which time other attributes were considered. See below (Table 1) for details of the prices paid for the eighteen banks.

Table 1

Banking Privatization – The Auction Results

Bank	Auction Date	Buyer	Region	Number of Shares Auctioned (thousands)	Percent of Total Shares of the Bank	Price per Share (Pesos)	Total Price Paid (thousands of pesos)	Multiple Price to Book Value	Multiple P/Profit (times)
Mercantil	Jun 14-91	Probursa	Mexico City	66,800	66.00	9.15	611,200	2.66	8.84
Banpais	Jun 21-91	Mexival	Mexico City & Northeast	32,344	100.00	16.85	544,989	3.02	22.23
Cremi	Jun 28-91	R. Gomez	Guadalajara	41,496	66.70	18.03	748,291	3.40	17.92
Confia	Aug 9-91	Abaco	Monterrey	15,736	78.70	56.70	892,260	3.73	8.60
Oriente	Aug 16-91	G. Margen	North and Centre	128,510	66.00	1.73	223,221	4.00	12.83
BanCrecer	Aug 23-91	R. Alcantara	Toluca and Leon	28,380	100.00	14.97	425,131	2.53	12.12
Banamex	Aug 30-91	Accival	Mexico City	505,000	51.00	19.22	9,744,982	2.62	13.90
Bancomer	Nov 8-91	G.F. Monterrey	Monterrey	2,366,313	51.00	3.29	8,564,218	2.99	13.10
B.C.H.	Nov 18-91	C. Cabal	Tabasco, Campeche & Chiapas	55,202	100.00	15.91	878,360	2.67	24.68
Serfin	Feb 3-92	O.B.S.	Monterrey & Mexico City	350,625	51.00	8.06	3,045,485	2.69	14.77
Comermex	Feb 17-92	Inverlat	Mexico City	2,629,751	66.50	1.02	2,706,014	3.73	20.61
Somex	Mar 11-92	Invermexico	Mexico City	261,172	61.50	7.18	1,876,526	3.31	21.26
Atlantico	Apr 6-92	G.B.M.	Mexico City	56,000	68.64	26.23	1,469,160	5.30	17.81
Promex	Apr 13-92	Val. Finamex	Guadalajara	250,767	66.00	4.28	1,074,474	4.23	16.45
Banoro	Apr 28-92	Estrategia B.	Culiacan	367,500	68.83	3.09	1,137,811	3.96	11.28

Mercantil del Norte	Jun 22-92	Banorte	Monterrey	*	*	*	1,775,779	4.25	*
Internacional	Jul 6-92	Bital	*	*	*	*	1,486,916	2.95	*
del Centro	Jul 13-92	Multiva	*	*	*	*	869,381	4.65	*
Weighted Total (Excluding Mercantil del Norte, Internacional and Del Centro)				7,155,596	59.20	4.60	38,074,198	3.48	15.03
* Information not available									

The average percentage of shares held by the government and sold was approximately 59%. Prior to privatization some shares of certain banks had already been sold. The government retained 22.53% of Bancomer and 15.9% of Serfin (two of the three largest banks in the system). 100% of the shares of B.C.H., Cremi and Banpais were sold. The weighted prices of Atlantico and Banco del Centro were the highest paid, at 5.3 and 4.65 times book value, respectively.

While processes were in place to ensure the background of prospective owners and senior management of banks complemented the new banking requirements, subsequently, the complete inadequacy of these requirements became apparent. The laws dictate that information on potential shareholders must be obtained by SHCP. However, they do not provide specifics as to how the shareholders are to be evaluated, and what minimum criteria must be meet.

The purchasers of Mexican banks in the 1991-1992 privatization period were primarily related to industrial groups where brokerage companies controlled by them transferred their operations to a financial group, and the group acquired a bank. An exception to the concentration rules was provided for a period of five years, creating the potential for conflicts of interest. In most cases, controlling shareholders lacked the lending experience and technical expertise necessary for prudent banking and were unwilling or unable to hire competent management. Also, the privatization process was carried out in an environment of weak banking supervision. As a result of the auction a number of banks became very closely held and this resulted in an environment whereby the shareholder could conduct themselves with lesser scrutiny than those banks in which the shares were widely held.

In some cases, the majority of the purchase price was financed with borrowed resources. For example, in Inverlat and the newly incorporated Banco Union, most of the capital initially contributed was obtained through loans from other Mexican financial institutions. Further, when the current management of Banpais was questioned by us about the source of funds used for buying Grupo Banpais from the Mexican government in 1991, no information was provided to us.

While some due diligence processes were performed during the privatization process, the purchasers detected bank portfolio valuation concerns following the six-month claw back period. In some cases (e.g. Serfin), having completed additional due diligence, it became apparent that the viability of the bank was not clear.

Inadequate steps were taken by SHCP to ensure a smooth transition from state ownership to a privatized environment. External Advisors were retained to assist in the due diligence process. Loan reviews were performed as part of this process, however, many of the loans were new at the time of the review and, consequently, significant overdue loans issues were not identified. Effective internal controls, well structured credit departments, documented policies, independent and objective internal audit departments and up-to-date management accounting and reporting systems were some of the areas that were not considered.

The new owners inherited unprepared personnel, inadequate internal systems of credit analysis and weak controls resulting from the long period of government ownership. Most of the privatized institutions had inadequate internal control systems, insufficient separation of duties, non-existent credit procedures and policies, and inadequate market risk practices. Moreover, the new owners were under considerable pressure to record high earnings, having paid multiples of three and four times book value for their ownership interests.

In addition, *NAFTA* was later signed, effectively opening up the banking market to foreign competition, an additional challenge that bankers had to face. The concept of "moral hazard" was very significant at the time of the privatization. Moral hazard occurs when members of the financial system (for example, bank management or depositors) take on increased risk due to guarantees that they will be protected fully or partially from losses. This environment created an atmosphere that was vulnerable to unsound banking practices.

4. Peso Crisis

During December 1994, the peso was devalued resulting in interest rates increasing to in excess of 100%. Mexican banks immediately had their funding curtailed by international markets. Liquidity became an urgent issue as banks, already in fragile financial condition, scrambled to find short term funding.

Interest rates suddenly increased by more than five-fold from the second week of December 1994 (20% as measured by the average inter-bank rate) to the third week of March 1995 (110%). This rise, which affected all variable-rate debt, immediately reduced debtors' capacity to repay in an environment of deteriorating assets and declining real wages. Thereafter, payments in arrears significantly increased. In turn, banks were required to increase their provisions to account for the increase in non-performing loans. At the same time, real estate values became depressed. Consequently, banks became undercapitalized, and, in many cases, insolvent.

IMPACT OF THE CURRENCY DEVALUATION

As a result of declining financial returns, the currency devaluation and the weak supervisory environment that then existed, a significant negative impact on the financial condition of the Mexican banks occurred. The following consequences resulted.

Inadequate Reserves

The growth in the granting of loans in the period following privatization was not supported by an increased capacity for credit analysis, leading to a decline in asset quality, an increased exposure to risk and a steady increase in past due loans. In addition, there was an exodus of experienced bankers from the industry during the nationalization period. In this environment, the provisions for losses recorded by the banks was inadequate.

The rapid rate of growth of loan portfolios after privatization, coupled with the banks' inadequate credit culture and generally weak monitoring guidelines and procedures, and ineffective supervision resulted in a noticeable deterioration in loan portfolio quality. The Mexican banks, in general, had not allocated sufficient provisions to cover their actual and potential loan losses. Although aggregate loan loss provisions increased from 1991 through 1993, the ratio of provisions to past due loans actually decreased.

The ratios did not always mirror the true situation, especially since the ratio of past due loans to gross loans reflected the arrears rather than the full amount of the outstanding loans affected. Further, the published classifications did not represent accurately the true risk profiles of the banks' loan portfolios.

Capital Deficiencies

The return on equity for the banking system fell to 7.7% in 1994 from 26.8% in 1993 and 25.7% in 1992. The 7.7% in 1994 would appear to have been overstated due to a combination of the under-provisioning on loans and the taking into income of interest income on past due loans. The banks' capital adequacy ratios were overstated due to this overstatement of profits.

Other factors that contributed to eroding bank capitalization were significant new loan provisions and increased funding costs. In 1995, measured by international standards, the banking system was severely undercapitalized.

Concentration

As at December 1994 the assets of the twenty-six banks (twenty five in this report as a result the merge of BanCrecer and Banoro) represented virtually all the assets of the banking system. The total assets (in US $) of the Mexican financial system peaked in 1993 and then fell throughout 1994. From 1993 to 1994 the value of the Mexican peso decreased significantly; falling from approximately 3.1 pesos to the US dollar to 8.96 pesos to the US dollar in June 1998. From 1991 to 1998, the top three banks in Mexico (by total assets) were Banamex, Bancomer and Serfin representing approximately one half of the system. A table for the years 1991-1994 is as follows[76]

(US $ million)	1991	1992	1993	1994
Banamex	30,798	37,823	43,012	33,789
Bancomer	30,076	33,156	36,134	28,466
Serfin	22,198	20,989	21,390	19,849
Sub total	83,072	91,968	100,536	82,104
Remaining Banks	49,616	66,509	101,572	76,134
Total	132,688	158,477	202,108	158,238
Three largest	66.6%	58.9%	49.8%	52.0%

In addition, the largest nineteen banks constituted 97% of the system. Due to the high level of concentration in the system, the insolvency of any large bank directly affected other banks.

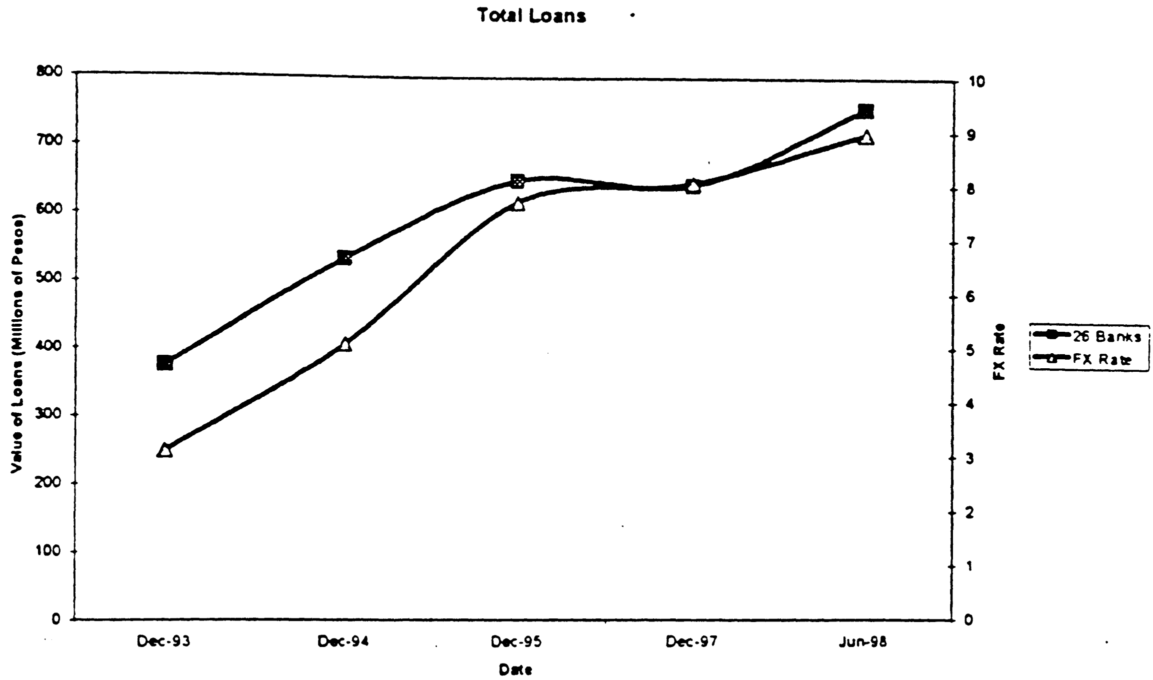
Total Assets

The size of the banking system also shrank because of the currency's devaluation. Total assets in US dollars at year-end 1994 were $158,200 million, down from $202,100

[76] Morgan Stanley, Latin America Banking, Mexican Banks: Fourth Quarter Results Point to a Bleak Future, March 24, 1995, page 3.

million in 1993. However, in peso terms, total reported assets increased to MN $842,600 million at the end of 1994 from MN $627,700 million at year-end 1993.

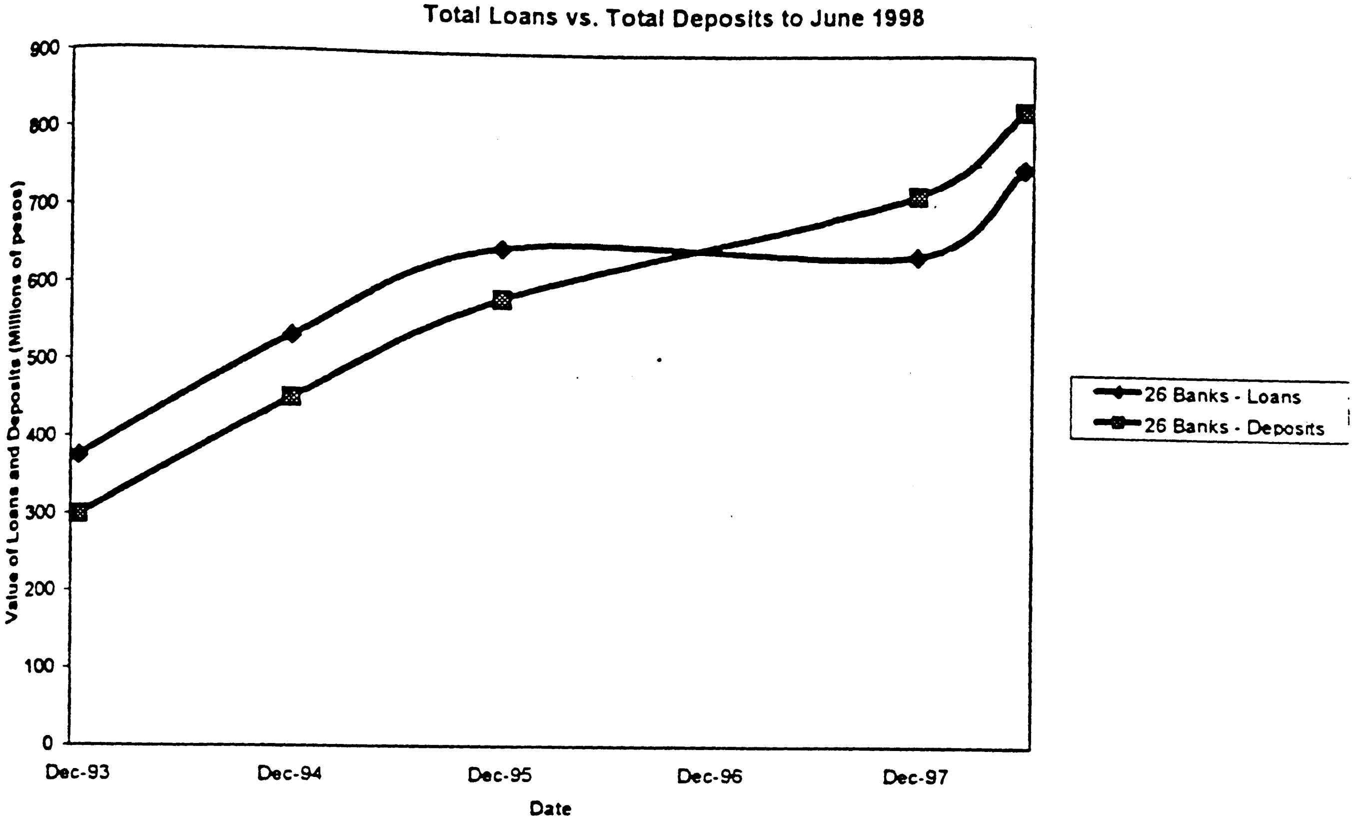
From 1991 to 1994, the Mexican banking sector experienced a sharp increase in the peso value of loan portfolios. The large capital inflows into Mexico during this period combined with an increase in competition among Mexican banks led to this increase in total system loans.



Source: CNBV

Several factors contributed to the leveling of increases to total system loans between 1995 and 1997 indicated on the graph above. Higher required loan provisions, more conservative accounting requirements, and a more cautious lending environment served to slow the growth in total system loans.

The graph below illustrates that although the value of loans granted exceeded the value of deposits (in pesos), the rates of growth were approximately equal from December 1993 to December 1995. From December 1995, however, the value of loans remained constant while deposits continued to grow.



Source: CNBV

Deposits

Mexico's banking system can be characterized as being "under banked" from the standpoint of total leverage in the system and the penetration rate, essentially being the percentage of the population having bank deposits. This is evidenced by the fact that 90% of system deposits are currently held by 5% of the population.

Although deposit mobilization increased significantly before the crisis, the rate of growth of loan portfolios outstripped that of deposits. Consequently, the ratio of loans to deposits increased steadily, placing banks in a negative financial margin position with low levels of liquidity. Thus loan books were largely funded through inter-bank lending with higher interest rates, predominately from foreign banks.

Undercapitalized Banking System

Capital declined in US dollar terms, to $8,400 million in 1994 from $12,700 million in 1993.

During the post-privatization period, the banking system was operating at capitalization levels that were below the levels suggested by international standards. Financial indicators revealed that there were capital and solvency problems for the whole system. In addition, the capital of the banks were often financed by loans from the same bank or other banks within the Mexican financial system.

5. Government Support Programs

As previously discussed, with the onset of the financial crisis in December 1994, SHCP determined that no bank would be permitted to default on its liabilities. This guarantee was restated and expanded in December 1995. Various support programs were developed to maintain public confidence and avoid a run on the banks. The situation facing the banks prompted SHCP to decide that FOBAPROA would be used to provide financial support to the institutions which required it.

Initially, the banks required immediate short-term liquidity funding, the needs of which the dollar liquidity program was designed to satisfy. As the crisis worsened and banks' loan portfolios deteriorated many banks required additional capital. As a result, temporary liquidity and then capitalization programs were offered to those banks willing to meet certain conditions. In some cases, the initial programs were insufficient and rehabilitation of the bank was required. Subsequent programs were intended to facilitate the sale of assets, the sale of branches, the procurement of additional capital from third party investors, bank mergers and sales of banks.

Commencing in 1995, several debtor programs were developed to assist and encourage debtors to repay their outstanding loans, in turn assisting the banks and the financial system in general. The following is an examination of the various government support programs.

2. Bank Programs

LIQUIDITY SUPPORT PROGRAM

Objective

Following the devaluation of the peso in December 1994, some credit institutions began to experience problems in renewing their foreign currency liabilities, principally for holders of certificates of deposit and inter-bank lines contracted abroad. In order to aid Mexican banks in meeting these obligations, short-term credits in dollars were granted to institutions that required it beginning from January 6, 1995. The objective of the dollar liquidity program was to help the banks face their liabilities denominated in foreign currencies and consequently, reduce the pressure on the exchange rate.[77] FOBAPROA used resources provided by the Central Bank to grant loans in US dollars to financial institutions.[78]

Characteristics

FOBAPROA financing was granted in two stages:

Stage 1

The financing in Stage 1, initiated in January 19, 1995, involved the granting of simple loans by FOBAPROA via a credit line to the banking institutions for a term of seven days.

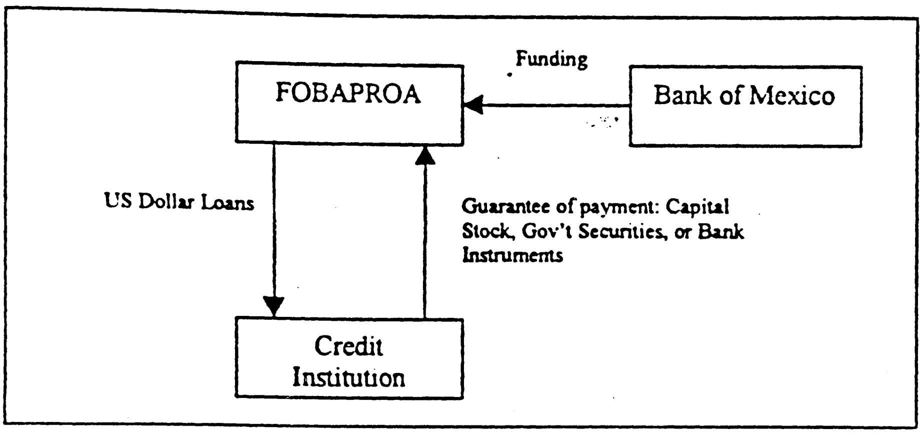
Stage 2

The second stage of financing was initiated on April 19,1995 and consisted of the opening of an overdraft line of credit with repayment terms of twenty-eight days. The interest rate for current loans was granted at 23% annually. Institutions making principal payments as of April 1995 received interest rate reductions as follows:

- the balance outstanding on the loan, once the corresponding payment was subtracted, was divided into two parts;
- the first part of the balance outstanding was equal to the difference between the new balance and that registered on April 1995. The amount was subject to an annual interest rate of 17.5%;
- the second part, was the remaining amount due, which was subject to a 23% annual interest rate; and
- interest was paid weekly according to a predetermined calculation.

[77] General Auditor Report, page 1/16.
[78] General Auditor Report, page 1/16.

The objective behind this interest calculation was to provide an incentive for the banks to reduce their debt with FOBAPROA, to the degree to which they could obtain alternative financing. The interest calculation rewarded institutions making larger principal repayments with lower interest rates. The financial institutions also provided a guarantee against the line of credit in the form of the capital stock of the institution, government securities and/or bank instruments. Ultimately, the banks repaid all loans:



The Bank of Mexico (and the FOBAPROA department) was keeping track of administrative details such as principal amounts and interest payments. The Bank of Mexico, through its monitoring of foreign exchange positions of each bank, had the capability to monitor the needs of the banks relative to this program and has indicated that it was active in this regard.

Fiscal Costs

Estimated Fiscal Cost of Dollar Liquidity Program

There was no fiscal cost as the banks repaid the loans received from the Bank of Mexico in full by September 1995. The rate of interest was high enough to cover the Bank of Mexico funding of foreign denominated loans. Total cash support to the banks under the scheme was MN $355,108 million, which was repaid together with interest of MN $24,091 million.

TEMPORARY CAPITALIZATION PROGRAM (PROCAPTE)

Objective

The objective of PROCAPTE was to temporarily capitalize the commercial banking system, while each bank was seeking additional capital, without incurring any fiscal cost. When reserve requirements were increased in March 1995, many banks were not able to meet the revised capital requirements. The financial authorities decided to implement a program of "temporary capitalization", called PROCAPTE, for those institutions that were not able to comply with the 8% capitalization requirement. This temporary capitalization program was to be in place until the banks could raise additional capital.

To aid in the process of recapitalization, Congress passed amendments to the *Law of Credit Institutions* in February 1995 eliminating some legal restrictions for injecting capital into multiple banking institutions. The program required all banks with capital ratios below the 8% threshold, to issue subordinated debentures to FOBAPROA.[79] These debentures were acquired and administered by FOBAPROA while utilizing financing granted by the Bank of Mexico.[80]

Characteristics

The request to join the program was to be completed in writing, by interested financial institutions.[81] The PROCAPTE program was to last for a period of five years. Shareholders of the participating institutions were required to adopt the necessary steps to issue convertible debentures and the agreements to participate in the program were to be approved by the shareholders and other authorities.[82]

The subordinated debentures were issued in accordance with Article 4 of the *Law of Credit Institutions*. FOBAPROA acquired these debentures using resources obtained from the Central Bank.[83] The subordinated convertible debentures issued by the banks were mandatorily converted into equity after five years. Until FOBAPROA had been repaid, banks could not issue additional capital debt, issue dividends, or issue additional mandatorily convertible subordinated debentures, unless issued in conjunction with the program.[84]

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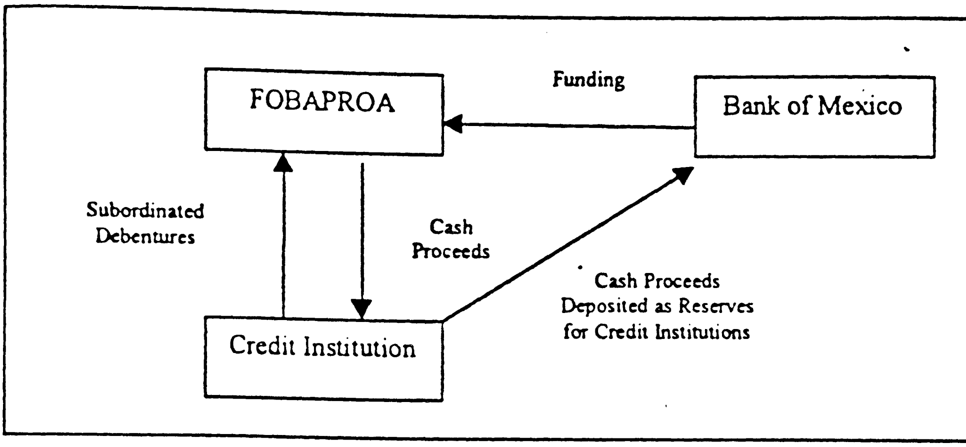
[79] The Hidden Costs of Mexican Banking Reform, Jan 1, 1997, William P. Osterberg, Economic Commentary (Cleveland), Page 1, Copyright 1997 Federal Reserve Board of Cleveland, page 4
[80] Technical Committee Minutes, April 7, 1995
[81] Technical Committee Minutes, April 7, 1995
[82] Technical Committee Minutes, April 7, 1995
[83] Bank of Mexico 1995 Annual Report
[84] *Technical Committee Minutes*, April 7, 1995

The following diagram illustrates the PROCAPTE mechanism:



The PROCAPTE program was designed so that FOBAPROA would take into account the financial situation of the institution, the amount of capital, the risks, and the institution's adherence to the established programs for capitalization before exercising its conversion option. If the financial situation of the institution showed improvement over the course of the program, conversion would not be exercised.[85]

FOBAPROA was entitled to exercise the right to early conversion if the net capital of the institution represented less than 2% of the assets subject to risk.[86] FOBAPROA reserved the right to compel the institution, with a year of prior notice, to reacquire all or some of the bonds where favourable conditions existed in the capital markets.[87]

The design of the program was intended to reduce moral hazard as previously defined. The banks were provided the opportunity and incentive to manage their bad debts or, alternatively, risk relinquishing control to the government.

[85] Technical Committee Minutes, January 6, 1995
[86] Technical Committee Minutes, Meeting 27
[87] Technical Committee Minutes, Meeting 27

Fiscal Costs

Estimated Fiscal Cost of PROCAPTE

All of the PROCAPTE advances were repaid, with the exception of the PROCAPTE funding to Inverlat of MN $1,400 million, plus accrued interest of MN $700 million. This was converted into shares of the bank; however the value of these shares is nil and the amount was written off and the losses were recognized by FOBAPROA.

CAPITALIZATION AND LOAN PURCHASE OF BANK PORTFOLIO PROGRAM

Objective

The Capitalization and Loan Purchase of Bank Portfolio ("CLPP") program was implemented to capitalize the banks whose financial situation was solvent but, due to the deterioration of their loan assets, risked not complying with minimum capital requirements.

CLPP was designed to support banks that, due to their importance and high concentration in the industry, could have put the Mexican banking system at risk.

The following principles were to be observed by the government during the capitalization of institutions:

If problem related to:	Solution was:
- Irregularities and lack of capital	- Intervention, recovery, sales and/or liquidation
- Severe lack of capital	- Restructuring and sale
- Lack of capital available from shareholders	- Purchases of portfolio

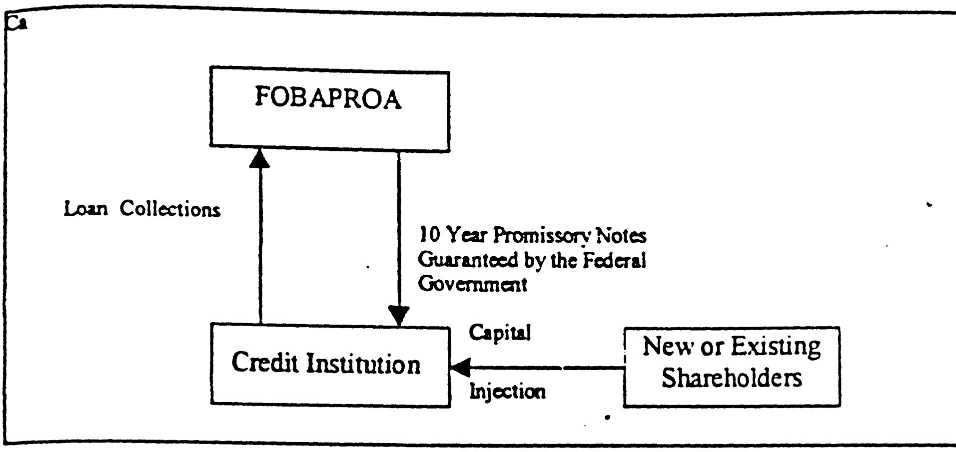
Characteristics

Under the CLPP program, FOBAPROA acquired an interest in the cash flows from a designated portfolio of loans identified by the bank. The bank would be responsible for the collection from its customers and for the administration of the loan portfolio.

The interest in the cash flows was transferred by the bank to a trust administered by the bank. The beneficiary of the trust was FOBAPROA. In exchange for its interest in the trust, FOBAPROA would issue ten-year promissory notes payable to the bank. The notes were backed by the government. Interest was payable on the notes, but accrued over the term and was payable only at maturity.

In exchange for FOBAPROA taking an interest in the designated loan portfolio, the bank was required to raise new capital, generally on the basis of one peso of new capital for every two pesos of loan portfolio designated for the trust.

The following diagram sets out the flow of the transaction:



Proceeds collected on the loan portfolio were to be held in the trust and used to liquidate the promissory note. The individual banks each had a loss sharing agreement with FOBAPROA, in which each agreed to pay approximately 25% of the losses on the loan portfolio. The actual loss sharing agreements between FOBAPROA and the banks varied slightly from institution to institution. The loss sharing cost is recognized only upon maturity of the notes, at which time the banks forgive the loss sharing percentage of the relevant promissory note.

The following example sets out the effect of the loss sharing arrangement on the banks and the trust:

For the purposes of the example, the following has been assumed:

- $1,100 loan portfolio;
- $100 reserve made by bank against the loan portfolio; and
- loss sharing arrangement, 75% FOBAPROA trust, 25% bank.

	Bank	**Trust**
Transfer net amount from bank to trust	1,000	1,000
Trust reserves its 75% share over ten years		750
Bank records reserves to cover its 25% share of the loss over ten years	250	
Assume alternative actual portfolio collections of:		
(i). NIL recovery		
Loss recorded	250	750

(ii). $100 recovery Loss recorded ($1,000 -$100) times loss sharing percentage (75%/25%)	225	675
(iii) $750 recovery Loss recorded ($1,000 -$750) times loss sharing percentage (75%/25%)	63	187

It should also be noted that if the actual portfolio collections exceed $1,000, such excess would all be retained by the bank. In such case the loss to the trust would be Nil.

Process of Finalizing Loan Portfolio Purchases

The value of the promissory notes issued by FOBAPROA at the transaction date was designed to equal the net book value of the portfolio. The net value was originally defined as the value of the portfolio less "preventative" reserves, or anticipated losses. The reserves would be determined by the bank in accordance with the general rules issued by authorities in 1991 for rating bank portfolios, and were to be reviewed by an external auditor. FOBAPROA and CNBV carried out a review process and proposed that, in most cases, reserve levels should have been higher than those determined by the external auditor. In most cases, however, the overall reserves were lower than required to reflect market value. This issue was dealt with through the loan loss sharing arrangements.

The loan portfolio purchases were carried out in two rounds during 1995 (the first round), and during 1996 (the second round). Due to delays in finalizing and closing agreements, none of the purchases were closed or finalized until the summer of 1997, and the results of these two rounds varied.

When the first program was instituted, the following loans were not accepted in the loan purchase program:

- loans rated "E" (loans past due);
- loans held by companies in bankruptcy or suspension of payments;
- loans discounted with development institutions;
- loans denominated in inflation-linked currency units (UDIs); and
- related party loans.

As the situation in the commercial banking system continued to deteriorate, the Technical Committee decided to adjust the criteria by accepting previously excluded types of loans.

The first round of loan portfolio purchase agreements underwent amendments, and variations were negotiated. Consequently, differing results occurred at each bank. To prevent this from occurring again, the process for the second round was adjusted. The process of negotiation for setting loan values was simplified, and the external auditors' figures (primarily based on CNBV criteria) were taken as definitive reserves. In at least two banks, mortgage loans were valued at 65% of face value. The external auditors were directed towards verifying the existence and validity of loans and were not directed towards valuation.

Insufficient Loan Reserves

The review carried out by FOBAPROA and CNBV on the first round of loan portfolio purchases indicated that required reserve levels were higher than could be absorbed by the banks while maintaining capital ratios exceeding 8%. Consequently, the process and criteria for evaluating loans was adjusted such that guarantees and collateral were considered in the evaluation process. This resulted in lower required reserves, though in some cases these reserves were still too high for the banks to absorb. The subsequent negotiations between the banks, FOBAPROA and CNBV resulted in the banks either adding or substituting additional loans, increasing the loss sharing percentage, or participating in an incentive arrangement. The incentive arrangements set out the lack of reserves the institutions had to cover over a certain period of time. The incentive schemes therefore became a function of the loan collections.

The Creation of "Loss Sharing Reserves"

To ensure the creation of reserves sufficient to pay the contingent liabilities resulting from the loss sharing agreements, an official communication was issued on February 25, 1998 to the banks establishing their obligation to create the contingent loss reserves. The institutions were entitled to select between two methods of creating the contingent "loss sharing" reserve. They were to establish contingent "loss sharing" reserves on a straight line basis over a term of eight years from July 1, 1998, or to establish these reserves over ten years from the start of the program at the bank.

Fiscal Costs

Estimated Fiscal Cost of Capitalization and Bank Loan Portfolio Purchase Program

The ultimate cost of the CLPP program will depend upon the recoveries from the various trusts, the timing of their settlement and the loss sharing contributions from the banks. The financial authorities have estimated this cost as MN $97,000 million, being the difference between the value of the outstanding notes and the value of associated loan trusts and loss sharing agreements with the banks, together with other associated flows.

INTERVENTION AND REHABILITATION PROGRAM (SANEAMIENTO)

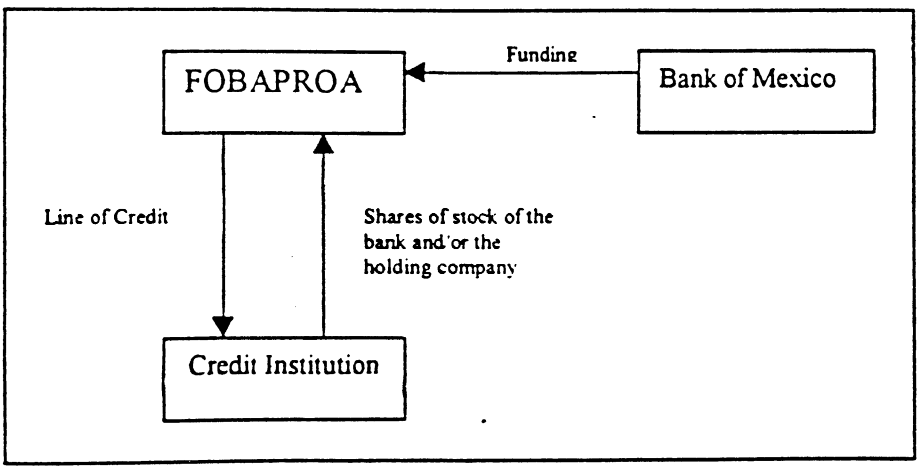
Origins of "Saneamiento"

The CLPP program was not sufficient to save some of the banks from the financial crisis. Where shareholders were unable to raise additional capital, the financial authorities launched the Saneamiento program consisting of further capitalization of the banks and the active pursuit of both domestic and foreign investors for the banks in hopes of aiding in their recovery. Saneamiento means recovery or healing. This program was implemented in all eligible banks including the intervened banks. The Saneamiento program would be implemented in the hopes of saving the bank from liquidation. The following sections explain FOBAPROA's role in the Saneamiento program.

Characteristics

Saneamiento manifested itself in three phases as follows:

In the first phase of the Saneamiento process, FOBAPROA granted the institution a line of credit allowing the bank to fulfill its obligations to depositors. As security, FOBAPROA received and held shares of stock of the bank and/or the holding company to which the bank belongs.



In the second phase of the Saneamiento process, FOBAPROA injected new capital by capitalizing loans granted in the first phase and/or providing additional resources. This allowed the bank to continue operating and meet its obligations to public depositors.

The third phase of the Saneamiento process involved two possible courses of action. If the bank is deemed viable as a going concern, then FOBAPROA may sell the shares it acquired to an eligible third party. FOBAPROA would provide support by allocating resources and/or purchasing loan portfolios and then selling the institution to international banks of prestige, or to viable Mexican banking institutions.

If the bank is deemed not to be viable as a going concern, then the branches of the bank would be offered for sale, staff reductions would occur and the remaining assets of the institution would be liquidated. In the liquidation process, the acquiring bank assumes liabilities of the selling bank in pesos. To compensate the acquiring bank for assuming these liabilities, the selling bank issues a promissory note in pesos and assumes a contractual obligation to pay in U.S. dollars an amount equal to the liabilities assigned.

Legal Process

The legality of FOBAPROA taking possession of the assets of insolvent institutions has been the subject of considerable scrutiny. The manner in which FOBAPROA obtained the shares of some banks has been challenged as unconstitutional. To date, the courts have not yet finally ruled on this matter.

Saneamiento Program and Bank Interventions

Intervention in the banks by CNBV is intended to protect the interests of public depositors, however, it is an ongoing responsibility of CNBV and is not to be mistaken for a "program" created as a result of the December 1994 financial crisis. It is CNBV's view that its responsibility is only to ensure it intervenes in those banks in which it detects "irregular operations" that could endanger the public's deposits. "Irregular operations" is defined as anything from fraud to banking law deviations, such as granting insider loans, or failing to maintain minimum capital and reserve requirements.

Interventions were conducted by CNBV, which determined on a case by case basis which bank was to be intervened and the manner in which the intervention was to occur. CNBV designed individual programs according to the characteristics of each institution and the environment at the time the intervention decision was made.

During the interventions, CNBV seized control of the banks and suspended shareholder rights, replaced the existing management of the institution, and designated a managing intervenor. FOBAPROA had no authority to initiate interventions in the banks and was not a participant in supervising the intervention process. FOBAPROA's sole responsibility to the intervened banks was to capitalize the banks, while CNBV appointed intervenors to lead the Saneamiento process.

Participants

Between 1994 and 1998, commercial banks with operating irregularities, serious financial problems or whose shareholders could not cover the capital requirements of the institution were intervened by CNBV. By the end of 1996, eight banks had been intervened due to irregularities detected in their banking operations and of these banks, Banca Cremi and Banco Union had been intervened prior to the devaluation of the peso.

The other intervened banks exhibited a combination of financial problems and/or operational irregularities.

The following, are the twelve intervened banks up to June 30, 1998:

- Anahuac
- Banca Cremi
- Banco de Oriente
- Banco Union
- Banpais
- Industrial
- Confia
- Banco Capital
- Banco Interestatal
- Banco Obrero
- Banco del Sureste
- Pronorte

For intervened banks, CNBV has indicated its ongoing supervisory responsibilities will include monitoring the performance of the intervenor, as well as reviewing administrative systems, internal controls, money market operations, capitalization, and deficient loan reserves. Loan recoveries will be reviewed on an overall basis. FOBAPROA department staff of the Bank of Mexico will be responsible for monitoring recoveries on these loans.

Third Party Review

Where value was an issue, third parties were hired to perform various analyses, including audits of portfolio values in preparation for sale, operational reviews of transactions, viability studies, and overall valuations.

De Facto Intervention

As the third largest Mexican bank at the time of the crisis, Banca Serfin presented a unique situation to the financial authorities. There were serious concerns about the effects of an intervention at a bank of this magnitude. In order to take control of the operation of the bank, CNBV initiated a *de facto* intervention which included the replacement of the bank's management and negotiations with third parties to invest in or acquire the institution rather than selling the branches and liquidating the assets. Inverlat was also *de facto* intervened in this manner.

BanCrecer is also under *de facto* intervention, and under the close scrutiny and supervision of CNBV. BanCrecer has had its loan portfolio purchase agreements reversed. The status of this bank's viability, and the ultimate costs required for its continued operations are uncertain at this time, as it will be IPAB's first time decision as to how to resolve known problems within this bank.

CNBV believed that by entering into a *de facto* intervention, it could avoid the perceived negative repercussions of earlier interventions (i.e. higher costs of liquidation, higher loan losses, loss of core deposits, and higher funding costs). It was expected that an agreement with the party interested in buying the bank would be reached whereby the purchasing institution would act as *de facto* intervenor until the purchase was finalized.

Fiscal Costs

Estimated Fiscal Cost of Intervention and Rehabilitation Program (Saneamiento)

The overall total fiscal cost of Saneamiento will only be known when all remaining assets, including loans, are liquidated, and the remaining sales of banks are closed with final closing prices. There is also uncertainty whether FOBAPROA's programs to date have provided the remaining operating banks sufficient capital to deal with any adverse economic conditions. This general issue is discussed as part of the evaluation of the government support programs. The costs of Saneamiento have also tended to increase as capitalization programs have been reclassified as Saneamiento expenses. Estimated total cost for these programs as at June 30, 1998 is MN $337,800 million.

3. Debtor Programs

Definition and purpose of debtor programs

Debtor programs were created primarily for small debtors, with the objective of assisting them in repayment of their outstanding loans. Small debtors suffered greatly from the financial crisis of 1994-95 by losing their purchasing power as a consequence of high inflation and volatile interest rates. It was widely accepted that these debtors had no significant role in the financial crisis and should not entirely suffer the burden caused by the crisis. Thus, it was considered necessary by the Mexican Bankers Association and the financial authorities to create support programs that would provide relief to such debtors. The banks also benefited from the programs because at least part of the discounts given to debtors was financed by the federal government.

The guiding principles of the support programs to debtors were to:

- avoid systemic risk;
- promote public confidence and credibility in the banking system;
- minimize fiscal and monetary impact resulting from the crisis; and
- promote a culture of debt repayment under existing market conditions.

Role of FOBAPROA

FOBAPROA's involvement in the debtor programs was minimal. It was limited to serving as a conduit for support payments between the federal government and the banks. Prior to August 1998, FOBAPROA made the support payments to banks and thereafter the information was sent to CNBV for analysis to confirm the accuracy of the amount. Since August 1998, this arrangement has changed and the payments by FOBAPROA to banks are now made after approval by CNBV.

Program Framework

Evolution of the debtor programs

Debtor programs evolved over a period of time. The first programs were created in early 1995 and new programs were gradually added until the end of 1998. This evolution occurred in response to the changing needs of the debtors whom the programs were intended to assist and the state of the economy characterized by inflation and declining real wages.

Process of creating and implementing debtor programs

The debtor programs were targeted to specific sectors of the economy. In some cases a program was aimed at more than one sector of debtors, while in other cases a single sector was targeted.

The development of the programs was a combined effort of the Mexican Bankers Association, Bank of Mexico, CNBV and SHCP. The banks identified the problems relating to a particular sector and through the Mexican Bankers Association presented them to the authorities, whereupon a mechanism to solve the problems was formulated. The cost of the programs, to be shared by the banks and the government, was estimated by CNBV and presented to SHCP for approval and financing. A basic accord was then drafted describing how the program would function. This accord was followed by a series of circulars issued by CNBV setting out specific operating rules for the program. The banks were then provided an understanding of the programs by means of presentations and other communicative measures carried out primarily by CNBV.

The programs and their benefits

Beginning in 1995, until the end of 1998, a number of different debtor programs were introduced. The significant ones are set out on the chart below. The sectors targeted by these aid programs were: Micro, Small and Medium Size Commercial Enterprises, Agriculture, Fishing, Livestock and Forestry, Low (FOVI – type) and Middle Income Residential Mortgage holders, and individuals with personal loans and loans for Acquisition of Consumed Durable Goods and Credit Card debt.

The following table sets out the various debtor programs in which FOBAPROA was involved.

Debtor Programs	Signing Date of the Agreement	End Date	Restructuring in UDIs with Fixed Rate of Interest	Interest Rate Discount	Payment Discount
Planta Productiva	Apr 24-95	Up to 12 yrs from restructuring	✔		
Residential Mortgages	Jun 22-95	Up to 30 yrs from restructuring	✔		
ADE					
ADE - FOVI	Aug 23-95	May31-96			✔
ADE - Residential	Aug 23-95	12 months from restructuring	✔		
ADE - Credit Card	Aug 23-95	Sep 30-96	✔	✔	
ADE - Personal and Consumer Loans	Aug 23-95	Sep 30-96	✔	✔	
ADE - Commercial Loans	Aug 23-95	Sep 30-96	✔	✔	
ADE - Agricultural Loans	Aug 23-95	Feb 28-97	✔	✔	
Additional Benefits for Residential Mortgages					
FOVI-type Housing Mortgages	May 16-96	Dec 31-00			✔
Mid-size Residential Mortgages	May 16-96	Dec 31-05	✔		✔
Minimum Payments Equivalent to Rent	May 16-96	6 years from entering	payment of rent with an option to reacquire		
FINAPE	Jul 23-96	10 year from restructuring*	✔		✔
FOPYME	Aug 16-96	10 year from restructuring*	✔		✔
Punto Final (subsequent event)					
Punto Final Mid-Size Residential Mortgages	Dec 16-98	up to 30 yrs from restructuring	✔		✔
Punto Final-Agricultural	Dec 16-98	Dec 31-01	✔		✔
Punto Final-Commercial	Dec 16-98	Dec 31-01	✔		✔

*Punto Final applied for 1999 and 2000 to loans before April 30, 1996. Reverts to FINAPE and FOPYME from 2001.

Debtors with loans granted prior to a certain date were eligible for three kinds of benefits:

reduced interest rates offered debtors relief from the soaring market interest rates during the crisis;
discounts on payments allowed debtors to make a reduced loan payment and have their balances credited for the full amount; and
restructuring of loans in UDIs protected debtors from the effects of real interest rates rising faster than real wages.

The type of support offered varied according to the program in which the debtor was enrolled. All types of support were conditional upon the debtor remaining current in its loan payments.

Additional Benefits Offered by Banks

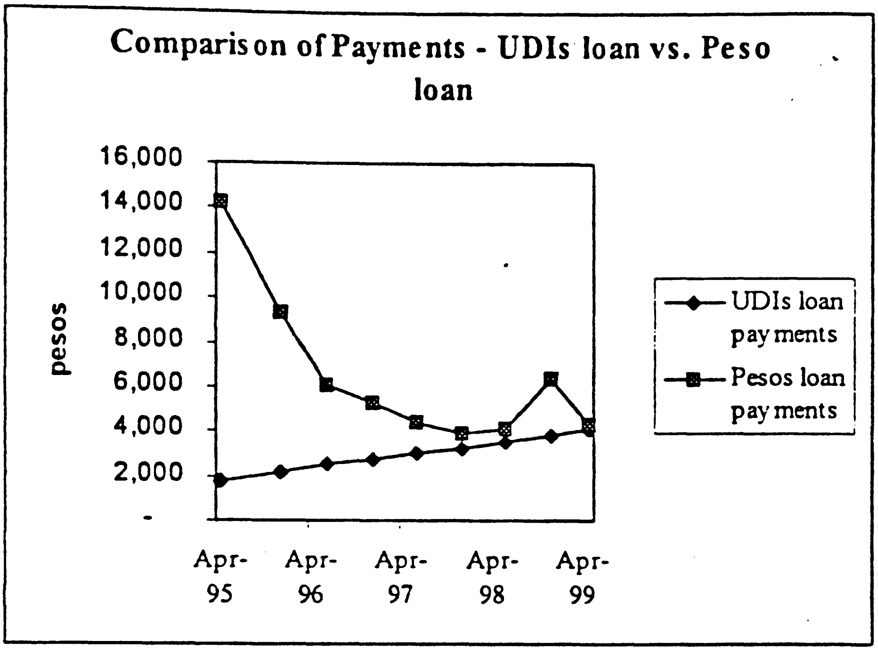
In addition to the benefits offered by the debtor programs, banks often offered their own additional benefits to debtors. Some of these were standard benefits available to all debtors, and others were negotiated with debtors on a case-by-case basis. Due to the difficulties involved in repossessing loan collateral, banks were willing to offer additional discounts to debtors. To settle a loan for a discounted amount was faster and easier than going to litigation.

UDIs

One of the main features and principal benefits of the debtor programs was the opportunity for debtors to restructure their loans in Unidades de Inversion or UDI, an artificial currency pegged to the consumer price index. Under this program, loans in pesos were restructured and denominated in UDIs with a fixed rate of interest. All the installment payments of restructured loans were also determined in UDIs. Since UDIs were an artificial currency and could not be used as a payment medium, the debtors concerned made their payments in pesos which was computed by multiplying the UDIs installment amount to the going rate of UDIs to pesos. UDIs were designed in such a manner that the debtors paid the real interest rate, while the government bore the cost of the difference between the nominal rate and real rate that is implied in the arrangement described in the section of this report below entitled Restructuring in UDIs and the Trust Mechanism.

The idea behind the use of UDIs was to alleviate liquidity pressure on debtors caused by the high and volatile interest rates, particularly during 1995-1996. In doing so, the current nominal cash flows were initially reduced, as lower fixed rates of interest were applied to loan values. However, with inflation over the years, future cash flows in nominal terms, stated in pesos, rose as the value of the UDIs to the peso increased.

The following example demonstrates the comparison of payments in nominal pesos, between an UDI restructured loan and a peso loan. The diagram indicates that initially payments denominated in UDIs were lower than those denominated in pesos. Later, with the decrease in interest rates on peso loans, the gap between the monthly payments between these two loans decreased.

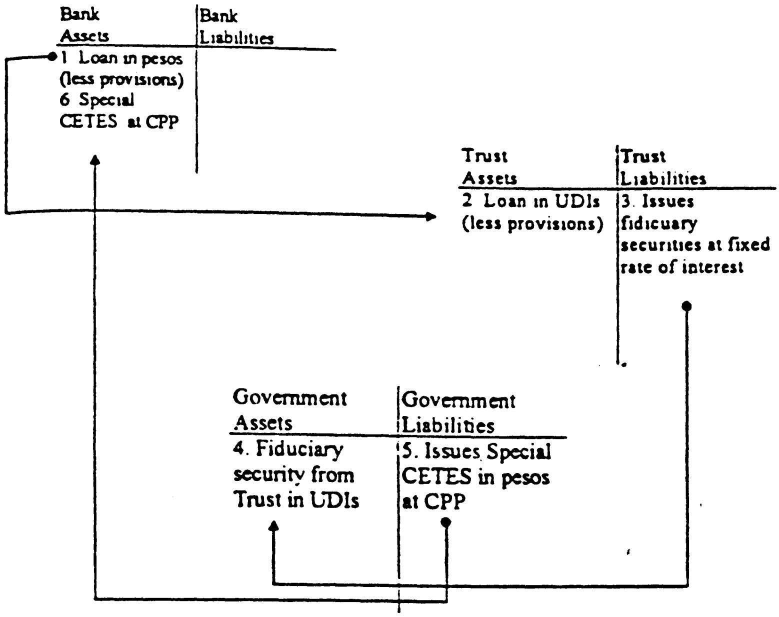


Restructuring in UDIs and the Trust Mechanism

A separate mechanism was created for effective control of the transactions resulting from the use of UDIs. Accordingly, once the loan was restructured in UDIs, it was transferred together with the required provisions to a trust managed by the bank. This trust was created as a vehicle for exchanging the UDIs and pesos between the government and the bank, in a way that the government accepted the risk between the real and nominal rate of interest.

Once the loan was transferred to the trust, the trust issued fiduciary securities in UDIs in order to finance the acquisition of such lóans, for an amount and term similar to the transferred loan. Alternatively, to finance the acquisition of the transferred loan, the trust may also have obtained loans from the federal government in UDIs. If the trust issued fiduciary securities, the government acquired these securities and accounted for them on their books. To finance the purchase of these fiduciary securities, the government issued peso denominated special Certificados Tesarios Especiales ("CETES") to the banks at the Costo Porcentual Promedio ("CPP") rate of interest, matching the amount and term of the fiduciary securities. Where the government loaned to the trust, it transferred the amount through the trust to the bank, which in turn acquired special CETES at CPP for that amount. The following diagram illustrates the trust mechanism.

Trust Mechanism



When a loan installment was paid by the debtor, the trust liquidated the corresponding amount of the loan and redeemed the fiduciary securities for that amount. Upon redemption of the fiduciary securities, the federal government in turn redeemed the Special CETES it issued to the banks. In cases where the trusts had not issued fiduciary securities and instead borrowed from the government to finance the acquisition of transferred debtor loans, the trust repaid the loan for the corresponding amount, to the government, which in turn triggered the liquidation of CETES held by the bank for the equivalent amount.

This mechanism applied to all support programs where the loan was restructured in UDIs except in cases of "Minimum Payments Equivalent to Rent", (which has its own mechanism) and FOVI-type housing programs.

Once the loan was restructured in UDIs, the provisions, along with the loan portfolio, were transferred into the trust as a book entry. These provisions are transferred at a minimum prescribed percentage according to the program (e.g. mortgages 2.5%-5%).

The debtor programs required a quarterly assessment of provisions by the banks to ensure that the provisions were adequate. If not, the bank supplemented the provisions in cash, to the trust. These provisions transferred in cash were to be invested by the trust in financial instruments at the rate equivalent to the rate of the fiduciary securities.

Credit risk and Collection

The banks were responsible for the collection of debts and credit risk whether or not the loans were transferred to the trust.

Accounting treatment

The circulars regarding debtor programs provided detailed accounting requirements to be followed by the banks in accounting for participation in a debtor program.

Support Payments to banks

The support offered to debtors was shared by the banks and the federal government, with the government paying its portion to the banks via the Bank of Mexico (UDIs cost) and FOBAPROA (discount on payments and interest rates). The support via the Bank of Mexico was covered in the form of government bonds, the term of which depended on the term of the restructured loan. FOBAPROA settled its share of support payments by obtaining a five-year credit from the banks.

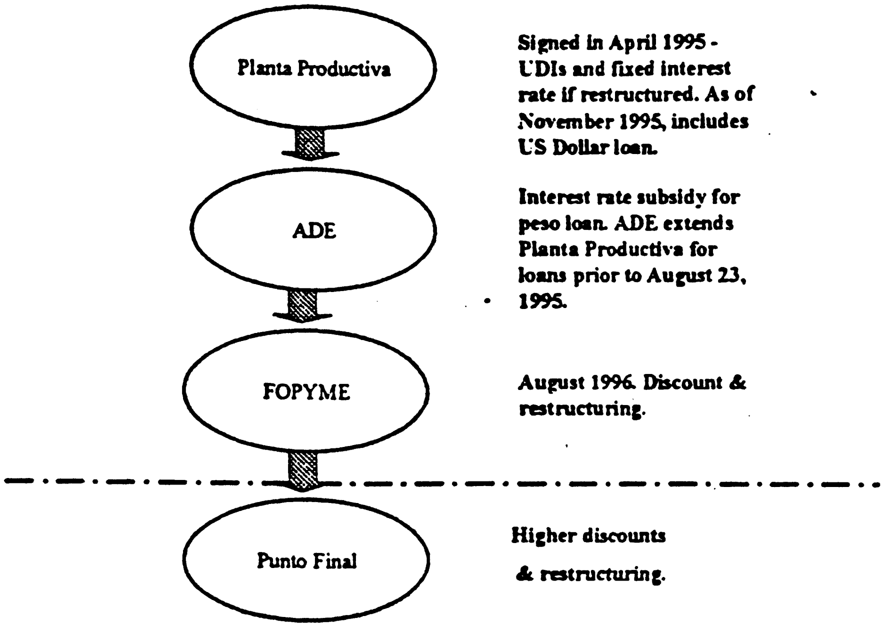
Evolution of Significant Programs

The following paragraphs and diagrams illustrate the evolution of significant programs and benefits provided to the key sectors of the economy.

Micro, Small and Medium Size Commercial Enterprise Sector

This sector received its first benefit with Planta Productiva in April 1995, which provided the option to restructure peso loans in UDIs at fixed rates of interest. Those who did not restructure under this program, could opt to restructure their loans in UDIs under the ADE program for the period and rates specified in Planta Productiva. Debtors who still decided to pay in pesos, received assistance by way of fixed rates of interest under ADE. After ADE, the commercial debtors, having loans in pesos, UDIs and U.S. dollars, received support under FOPYME by way of payment discounts and restructuring options. FOPYME was followed, by the final program, Punto Final, that offered deep discounts on payments starting in 1999. The following diagram sets out the progression of programs in this sector:

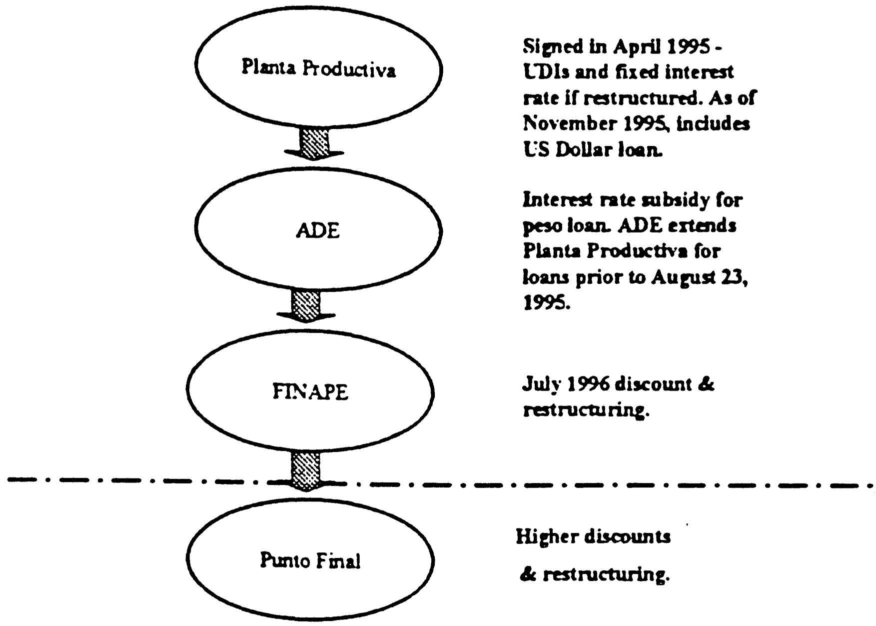
Micro, Small and Medium Sized Businesses



Agriculture, Fishing, Livestock and Forestry Sector

This sector received essentially the same benefits as were made available to the commercial debtors, from both the Planta Productiva and ADE programs. ADE was followed by FINAPE which again provided the option to restructure in UDIs for those having loans denominated in pesos and provided discounts on payments to debtors having loans in pesos, U.S. dollars or UDIs. Later in 1999, the debtors of this sector could opt for the Punto Final program and avail themselves of the benefits under it.

Agriculture, Fishing, Livestock and Forestry Sector

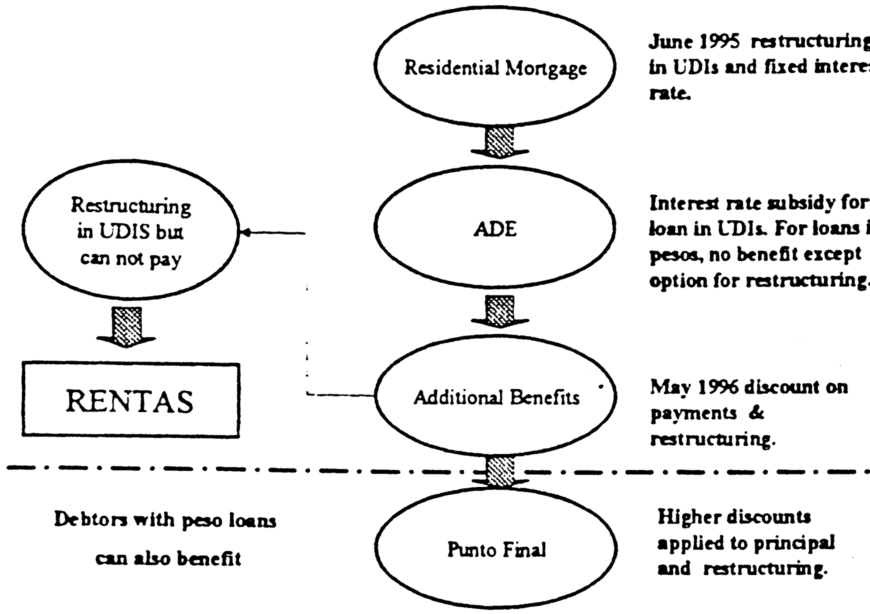


Residential Housing Sector

There were two types of residential housing mortgages that were targeted by the debtor programs. The first type is mid size residential mortgages. These were traditional mortgages based on the value of the home acquired. The second type is low-income, or FOVI-type housing mortgages. These mortgage loans were for minimum wage earners and were based on a debtor's income, not on the value of the home. The diagrams below illustrate the evolution and benefits provided by these two types of programs.

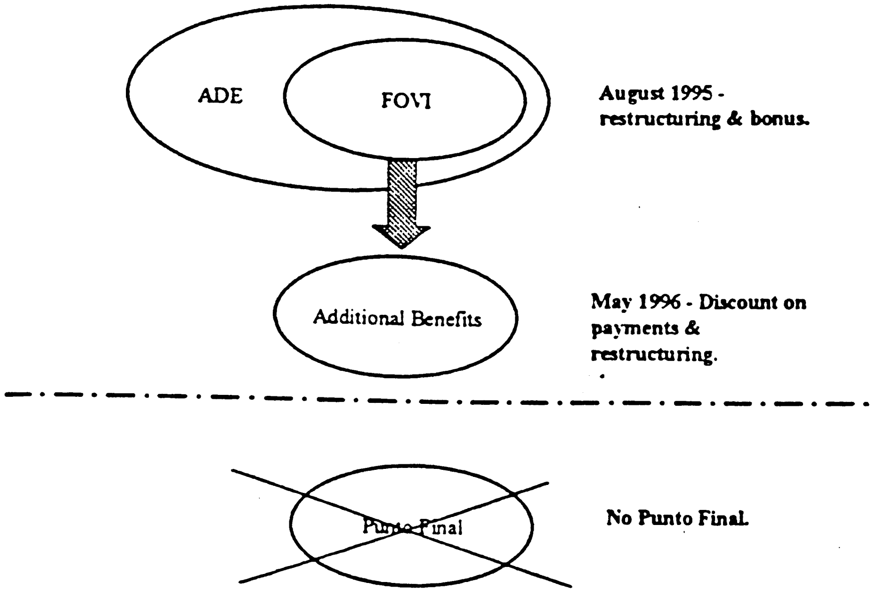
The first support program for the mid size residential housing debtors, was established in June 1995, and contained an option to restructure loans in UDIs at fixed rates of interest. This was followed by ADE, which again gave these debtors the same option though at lower rates of interest. After ADE, the Additional Benefits program offered payment discounts and restructuring options. Those debtors who, after restructuring their loans, did not have the capacity to service their commitments could opt for "Rentas" under which a monthly rental was to be paid for six years with an option to reacquire the house after that period. The last opportunity for assistance came in the form of Punto Final, in which, until September 1999, debtors could enroll and avail themselves of the benefits of Punto Final.

Mid-Size Residential Housing Support Program



With regard to FOVI-type housing mortgages, ADE offered bonuses on each payment for twelve months effective February 1996. By June 1996, this was replaced by the program for additional benefits which offered discounts on payments until Year 2000. As shown by the diagram below, FOVI-type housing loans did not receive benefits from Punto Final. According to CNBV, the FOVI-type debtors were already benefiting with interest rate subsidies and the waiver of the outstanding balance of the loan at the end of the loan term. This put them in a better position than the mid-size residential debtors with Punto Final benefits. For this reason, it was decided not to include the FOVI-type debtors under Punto Final.

FOVI-type Residential Housing Support Program



Individuals with Personal Loans, Loans for Durable Consumer Goods and Credit Card Debts

The ADE program provided relief to the credit card, durable consumer and personal loan debtors by giving an option to restructure in UDIs with a fixed rate of interest. If the debtors were current and chose to stay in pesos they benefited from the fixed rates of interest from September 1, 1995 to September 30, 1996.

Subsequent Events

Punto Final, the last debtor program, came into effect in January 1999, and replaced all previous programs for the agricultural, commercial and mid-size residential housing sectors. This program aimed to solve problems such as the discrepancy between mortgage and house values and provide further encouragement to debtors to pay off their outstanding loans by offering somewhat higher discounts than earlier programs. According to CNBV, Punto Final was packaged in a manner which made it evident that the program offered 'significantly higher' discounts than the earlier programs. Debtors were informed that this was the last opportunity to benefit from the programs. To increase the participation of residential debtors, the program opened itself to debtors with loans in pesos.

Punto Final did not involve a significant increase in costs to the federal government from the previous programs. The reason was that Punto Final had a cost sharing arrangement (for discounts on payments) between the government and the banks unlike the earlier residential programs where the cost was borne solely by the government.

CNBV indicated that the introduction of higher discounts on advance payments and outstanding debts under this program resulted in a significant increase in participation and repayment of debt.

PROGRAM SUPERVISION

Introduction

The progress and implementation of all the debtor programs was supervised by CNBV, with the exception of the States and Municipalities program, which was managed by SHCP.

The objective of this process was to:

- ensure that the programs were implemented by the banks in accordance with the agreements signed, and circulars issued by CNBV and SHCP;
- confirm the extent to which the programs have achieved their goals; and
- determine and verify the cost to the government and the banks.

CNBV supervised the debtor programs by:

- analyzing the information received directly from the banks in prescribed formats;
- initiating special audits of banks whereby external auditors performed agreed upon procedures; and
- reviewing the reports of the annual audit of the banks.

Analysis of Information Received From the Banks

The information received from banks was reviewed by CNBV to confirm the program costs charged by the bank to the federal government. The information also served to assess the impact of debtor programs to date, and provided input for future improvements in programs to make them more effective.

The methods for supervising the banks were developed as the programs evolved. When the programs were first implemented, the information relating to such programs was sent by banks via fax to CNBV. According to CNBV, the information was not delivered in a standardized format, and it was necessary to go through a process of sorting and grouping before an analysis could be performed.

Later, the process of sending information by fax changed to electronic spreadsheets. The information was sorted, classified and grouped by month for each bank in order to carry out the analysis. Several validation formulas were used on the electronic spreadsheets to confirm that the amounts submitted by the banks were in accordance with the agreements and circulars.

By August 1998, SAC, an electronic database system was fully functional and replaced the spreadsheets. The new system significantly reduced the resources spent on sorting and compiling the information. According to CNBV, the SAC was designed to receive the relevant information for analysis in a consistent and efficient manner.

Each bank entered information for the calculation of the subsidy into the SAC system. SAC's built-in validation formulae ensured the accuracy of calculations in such a way that support amounts which were incorrectly calculated were rejected by the system and not sent to the bank. There were, however, some instances where incorrect parameters were not caught, and for which CNBV carried out a specific review of the information. After validation of the information, it was analyzed by CNBV.

It should be noted that before the implementation of SAC, the Bank of Mexico made payments to the banks and then forwarded the information to CNBV for its analysis and confirmation of the support amounts. Any adjustments recommended by CNBV to the support amount would take place after such process.

With the implementation of SAC, the analysis by CNBV was carried out much earlier, and support amounts were approved and sent to the Bank of Mexico for payment. SAC thus ensured an improved payment process whereby the approval was given before payment was made by the Bank of Mexico.

Special Review by External Auditors

Since 1998, the external auditors of the banks have been carrying out a special review on the implementation of the debtor programs in accordance with the scope of work defined by CNBV. The intention was to provide assurance to the regulators that the banking institutions carried out the correct application of the benefits of different programs. The scope of the audit covered the following:

- reviewing the mechanism for tracking payments which banks received from debtors and reviewing the calculation of discounts and other incentives; and
- analyzing individual loans based on statistical sampling to determine whether debtors benefiting from the programs were current in meeting their obligations.

The auditors were not required to issue an opinion on the impact or success of the debtor programs.

General Audits of the Banks by External Auditors

The external auditors of the banks carried out their review of the debtor programs as part of their regular annual audit. CNBV reviewed the reports issued by these auditors to ensure there was no significant failure to comply with the debtor programs.

PROGRAM COMPLIANCE

CNBV, as part of its supervisory role, undertook to ensure that the banks complied with the statutory framework governing the debtor programs.

According to CNBV, the banks in general complied with the established regulations. Such advice was confirmed by our discussions with the banks and their auditors. While there were a few cases in which the banks did not adhere to the statutory framework, such inconsistencies were reported to the bank by CNBV and later rectified.

One instance of non-compliance identified by CNBV was a case in which it was discovered that Banco Inverlat misinterpreted the relevant statutory provisions, which resulted in the bank drawing support of more than MN $200 million from the federal government. This issue was detected by CNBV when it found that, in May 1998, Banco Inverlat reported 48.6% of support given to that date was attributable to the FOVI-type housing program. After conducting further research, and reviewing their findings with the bank, it was established that Banco Inverlat had reported to CNBV the individual discounts it had established for the FOVI type loan portfolio, as prepayments made by debtors. Inverlat granted further discounts by treating prior discounts as prepayments, for an amount of MN $520.8 million of which the fiscal cost was MN $209.4 million. Inverlat later admitted it had misinterpreted the governing legislation and reimbursed the amount with interest. CNBV imposed a fine of MN $1 million on Banco Inverlat for violating the statute.

Another example of non-compliance that was determined by CNBV related to Sureste in which one account was used for all debtors instead of applying benefits to individual debtor's accounts. As a result, it was not possible to determine if the debtors receiving benefits were current. The last audit revealed that Sureste had remedied the situation.

The Reporting Accountants' findings confirm the findings of CNBV and of the banks' external auditors in respect of compliance.

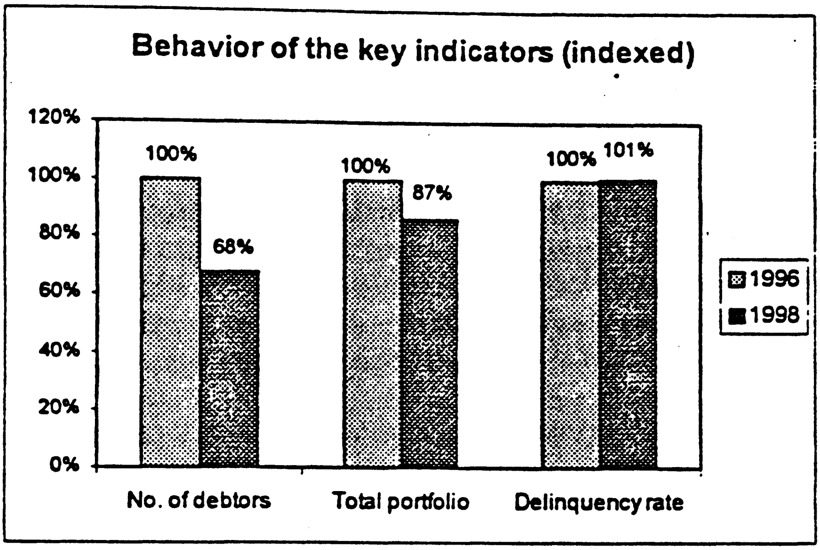
DEBTOR PROGRAMS FINDINGS

The debtor programs were created primarily to help the debtors repay their debts by offering certain benefits. The extent to which this objective was achieved may be determined by measuring the effect of the programs on the delinquency rates, the number of debtors and portfolio values. Other measures such as the extent of benefits provided to small debtors, and new loans granted, are also discussed as are key factors that affected the payment capacity of the debtors and the objectives of debtor programs.

These finding are based on the discussions held with and information provided by CNBV, for the periods beginning and ending during the third quarter of 1996 and 1998 respectively. The review covers only several significant debtor programs for the relatively larger sectors of debtors.

General Findings

The impact of the debtor programs is summarized by the chart below and sets out the aggregate percentage change in the number of debtors, portfolio values and delinquency rates for agricultural, entrepreneurial and residential sectors over a two year period. The behaviour of key indicators is summarized in the table below.



Source: CNBV

Notes to the chart

- The period covered by this chart begins with the 3rd quarter of 1996 and ends in the same quarter of 1998.
- The chart above includes statistics for agricultural, entrepreneurial, mid size residential and FOVI-type housing debtors. These together constitute a significant proportion of the banking system's debt for which the debtor programs were offered and therefore can be used as a measure to assess the impact of these programs.
- The key indicators in the chart above are indexed with the figures of 1996 as base.
- The involvement of debtors in Minimum Payments Equivalent to Rent program is relatively very low and therefore excluded from above.
- The number of debtors, portfolio value and delinquency index are net of the portfolio transferred to FOBAPROA.

The following comments may be made based on the chart above :

- The benefits offered by the programs including those offered by the banks encouraged debtors to liquidate their portfolios. A direct result of liquidation of portfolios was a reduction in the number of debtors compared to the number that initially entered the program.

- Liquidation of portfolios and part payments of their obligations by debtors due to the incentives offered, caused the total portfolio under the programs to decline in value.

- The decrease in the number of debtors by a higher percentage compared to the decrease in the total portfolio value indicates that a larger number of small debtors liquidated their portfolios. Consequently, the programs may have been of greater benefit to small debtors than to larger ones.

- The chart illustrates that the delinquency rate, which describes the proportion of the overdue portfolios to total portfolio, has not significantly varied. In other words, the overdue portfolio remains at the same relative level as it was at the time the programs were first implemented. This was largely due to the incentives offered by the debtor programs that encouraged a significant proportion of the debtors to stay current.

It is to be noted that the delinquency rate does not include the effect of the change in accounting policy that become effective in 1997. Under the new accounting policy, the entire value of the overdue loan was transferred to the overdue portfolio, while in accordance with the earlier policy, only the overdue portion of the loan was considered delinquent.

It is also noted that the portfolio transferred to FOBAPROA was not included in the chart and the findings summarized above . According to CNBV, most of the portfolio transferred to FOBAPROA was delinquent before the advent of the crisis, and any offer for incentives would not have increased recoveries. It was therefore considered appropriate not to include such amount when assessing the impact of the debtor programs. A significant part of the portfolio eligible for program benefits were "E" category loans, delinquent long before the crisis. Such debtors did not appear to have the intention to pay, even with the incentives offered. Consequently, the debtor programs did not affect this category.

The programs were also designed to provide incentives to the banks to provide new loans. Banks received a certain percentage of the subsidy from the government only if they granted new loans for the development of the sectors, especially the commercial and agricultural sectors. To some extent, the disbursement of new loans can be attributed to this policy. This amount of the new loans was MN $30,700 million to the agricultural sector and MN $13,591 million to the commercial sector.

Based on the performance of the debtor programs, CNBV is of the view that the programs achieved their objectives, especially with respect to the containment of overdue portfolios and the granting of news loans for development of the critical sectors of the economy. Had the programs not been implemented, significantly higher loan defaults would have occurred, increasing the risk of collapse to the banking system.

Sector Findings

A sector based, key program trend summary is set out in the table below. The notes to table on page 91 of this section also apply to this table.

		Agricultural sector – FINAPE	Entrepreneurial sector – FOPYME	Mid-size Residential housing – additional benefits	FOVI-type housing sector – additional benefits
No. of debtors	1996	906,992	198,040	243,200	398,056
	1998	458,145	112,038	261,186	346,993
Portfolio (million pesos/UDIs)	1996	56,521	55,009	46,826	35,756
	1998	42,420	42,098	45,984	37,687
Delinquency rate	1996	34.69%	44.10%	0.80%	4.73%
	1998	34.76%	39.87%	12.81%	7.78%

The following are the key findings based upon the analysis and discussion with CNBV:

- On a program basis, the decrease in the number of debtors and portfolio value has been higher for FINAPE and FOPYME programs than compared to the residential programs. It is to be noted that the residential loans are relatively long term and, therefore, the decrease in the portfolio value and number of debtors is expected to be lower than the other sectors. In the case of FOVI-type housing loans, this decrease is partly due to the transfer of delinquent portfolios to FOBAPROA.

- In the case of the commercial sector, the rate of delinquency actually declined while it increased for the residential sector. Overall delinquency has been contained. It is to be noted that the effect of the new accounting policy discussed earlier, is eliminated in determining the delinquency rates shown above. Had the effect of the new policy been considered, the delinquency rates would be 37.82%, 47.59%, 27.46% and 15.10% for agricultural, entrepreneurial, mid size residential and FOVI type housing sectors, respectively.

Minimum Payments Equivalent to Rent or Rentas, did not benefit a large number of debtors. Only five banks and less than 3% of all mortgage debtors participated in the program.

Advance Payments

Advance payments, that is, those payments received by banks ahead of their due dates, constituted a significant proportion of the aggregate repayments and, therefore, contributed to the achievement of the program objectives. For example, 22.70% of the total payments by the agricultural sector were advance payments. This was due to the fact that the programs offered substantial incentives to debtors to make such advance payments. In some cases, these benefits, or discounts, were equivalent to the discounts on regular monthly payments, while in other cases they were even higher.

Impact of UDIs on Payments

UDIs depended to a significant degree on future economic growth and low inflation in order to improve debtors' ability to make future payments. The initial payments of UDI loans were lower compared to peso loans. However, the trend of future payments will depend on inflation and the ability of wages to keep pace with it. If nominal wages increase at the same rate or greater compared to inflation, then debtors will have the capacity to service their debt payments and the objectives of UDIs will be achieved. At present, the federal government predicts inflation to be 13% and 10% for 1999 and 2000, respectively. The Mexican Consensus Forecast predicts it be higher for the same periods, at 16.2% and 13.9%, respectively. Such inflation rates, without a corresponding increase in wages, may result in increased defaults, given the public perception that the government program may be causing payments to increase while real wages decline.

Bank Results

As discussed previously, the debtor programs encouraged payments and contained the delinquency rate. This led to a positive impact on the banks as a larger proportion of their portfolios stayed current. In addition, the payments resulted in improvement to the banks' cash flows. According to CNBV, without the program benefits, debtors would have defaulted on a large scale which would then have required additional assistance from the federal government to maintain the banks' capital.

Factors Limiting the Debtors Programs

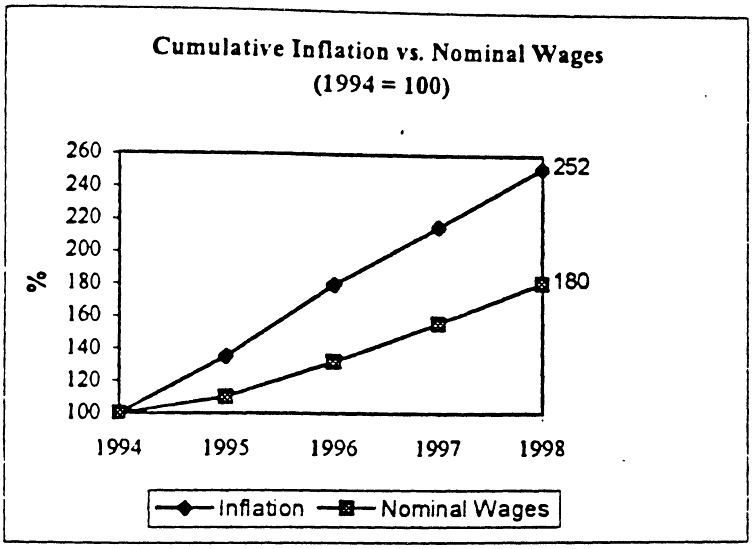
The following factors, among others, limited the debt servicing capacity of the debtors:

- inflation and wages;
- value of houses to loans;
- legal system;
- adverse publicity;
- environmental factors; and

The impact of each of the above factors is set out below.

Inflation and Wages

Since the peso crisis, Mexico's inflation has outpaced the increase in the nominal wage such that real wages and consumers' purchasing power have continued to decline. Real wages declined 28% between 1994 and 1998. This decline had a detrimental effect on the debt servicing capacity of the existing borrowers who realized that a larger proportion of their income was required to service their debts, affecting the success of the programs. The following chart indicates the upward rise and increasing gap between inflation and nominal wages:



Source: International Financial Statistics Yearbook INEGI and World Economics Outlook

Value of houses to loans

During the crisis there was an incorrect assumption that housing prices were increasing because of high inflation and an increase in the cost of construction materials. Excess supply resulting from a large inventory of housing and corresponding low demand caused the real value of houses to collapse in 1995, a trend that continued over the next few years. At the same time, however, mortgages grew rapidly because of high inflation and high interest rates causing the value of most mortgages to rise above the value of the houses that were pledged as security. This disparity served as a disincentive for debtors to stay current and participate in the debtor programs.

Legal system

Bankruptcy laws in Mexico were not supportive of the banks' efforts to realize on their security. Communities did not support residential evictions with the result that there were few consequences arising from a failure or refusal to pay. Those who were aware of these shortcomings in the judicial system, remained in their houses for years without making payments.

Adverse publicity

According to CNBV, there was considerable adverse publicity concerning the debtor programs. Groups were formed that enrolled debtors as members, and encouraged non-payment while promising waivers and protection against potential consequences.

Environmental factors

According to CNBV, the agricultural sector was affected by droughts and forest fires in the North that destroyed many crops in 1997 and 1998. This affected the payment capacity of debtors in those sectors and ultimately proved an obstacle to the success of the debtor programs.

Limitations on information

The information for ADE and Planta Productiva programs is consolidated in such a way that an analysis of the impact of these programs is not feasible. According to CNBV, SHCP audited these programs and did not find significant inconsistencies.

FISCAL COST

The following table sets out the CNBV estimates for the three components (at June 30, 1998) of the fiscal cost of the debtor programs. These amounts represent the present value of future payments anticipated from these programs. An analysis, along with our own estimate has been presented in the "Fiscal Cost" section of our report.

Program	Estimated Fiscal Cost (Thousands of Millions of Pesos)
UDIs Costs	35.2
Discounts in Payments	78.3
Interest Rate Discounts	6.2
TOTAL	119.7

V EVALUATION

1. Introduction

In accordance with the questions posed by the Hiring Committee and in response to its concerns, this section of the report contains an evaluation of, together with recommendations regarding, the regulatory framework in which FOBAPROA existed and the individual supervisory agencies responsible in some measure for its operation. The report then evaluates the banking and debtor programs that were funded through FOBAPROA.

In order to understand the findings contained in this section of the report, some general comments regarding the ownership of the banks following their privatization in 1991 and the general supervisory environment affecting their financial security are necessary and will assist in explaining the impact and challenges that faced FOBAPROA.

BANK OWNERSHIP SUBSEQUENT TO PRIVATIZATION

During the period of privatization, which began in 1991, the Mexican government received approximately MN $38,000 million (US $12,500 million) in exchange for its interest in the banks subject to privatization. From 1992 until 1994, an additional sixteen banks were created through the granting of authorizations by the government.

When the process of privatization began, a limit was imposed regarding the voting share ownership of banks and financial holding companies. Individuals and corporations were restricted to owning no more than 5% of such shares, subject to an increase to as much as 20%, with the approval of SHCP. These restrictions did not apply, among others, to institutional investors who were permitted to acquire, individually or collectively, up to 20% of the capital stock of a particular bank. Further transitional exemptions were granted to financial groups allowing them to hold more than 20% during the privatization process. This resulted in the ownership of many banks becoming heavily concentrated, and significant influence being exerted on such banks by a few shareholders. Although a number of the new and privatized banks were acquired by groups who evidently intended to operate them (and in fact did operate them) in an appropriate manner, there were others who viewed bank ownership as a means to gaining access to financing at favourable terms for related companies and enterprises.

The weak supervisory environment in which both the new and privatized banks found themselves, coupled with the implicit guarantee given by the government that all liabilities, including deposit liabilities, would be met, gave the banks the opportunity, and possibly the incentive, for excessive risk taking and removed the incentive to put in place proper management structures. The regulatory authorities have agreed that, in hindsight, the privatization process should have been conducted in a more prudent manner.

The concentration of ownership in a few hands, the involvement of financial groups in the ownership structure of the banks and the use of such banks for related party and non-arm's length transactions in many cases distorted the financial condition of the banks. In addition, the reliance on large transactions with related companies in financial groups placed a number of banks at substantial risk as a result of such exposure.

At the time of privatization and in part as the result of the concentration of ownership of the banks among a few financial groups, the capital structure of many of the privatized banks was weak and they were not in a position to easily weather changes in the economic climate. Loans to ownership groups to subsidize capital injections and the inclusion in Tier I capital of significant deferred income taxes substantially overstated the true capital of many of the banks. As will become apparent, this capital inadequacy contributed to the severe impact of the peso crisis on the banks.

In order to assess the exposure of banking institutions to financial groups, to diversify credit risk and to understand the impact that such groups may have on the financial condition of those banks in which they are involved, it is essential that those responsible for the supervision of banks be informed on a regular basis of the existence and nature of all such exposures and that they also be given access, for the purposes of assessing capital adequacy and ensuring that all transactions are completed on an arm's length basis, to the non-regulated members of all ownership groups. Consolidation of supervision and diversification of ownership and risk will contribute to a much healthier banking environment.

General Conclusions Regarding the Supervisory and Regulatory Environment

The weak and somewhat unfocused supervisory practices that were in place at the time that privatization began can be traced back to the nationalization of banks that occurred in 1982. At that time and during the next ten years, CNB was not viewed as essential for the purpose of securing a strong and active regulatory regime, as it was one government body overseeing another. This period clearly inhibited the development of the Mexican supervisory body.

An improvement in the regulatory environment did not immediately accompany privatization even though the need for rigorous regulation takes on greater importance in a privatized environment. Immediately following privatization, a period of general optimism blurred the need for improved supervision and control. The regulatory authorities were not given the necessary authority or autonomy to perform proper supervision and impose corrective measures, nor did they have the experience or the resources to regulate the newly privatized banks. The process of information gathering by CNB was outdated and involved a lag period that often made the information redundant when it was received. A lack of consistency in public reporting caused uncertainty about the banks' financial results. As there was no ability to compare information provided by each of the reporting institutions, the users of the reports interpreted them differently.

Due to a combination of poor regulatory supervision, the concentration of ownership, the ethics of some shareholders and a lack of internal controls in the newly privatized banks, some irregular operations were carried out. This was indeed the case with respect to the Cremi and Union banks, where criminal charges were ultimately laid against certain shareholders.

Following privatization of the banks in 1991, their assets continued to grow substantially during the next three years, reaching record levels in 1994. It is now apparent that many of the banks sought to boost their market share by granting loans in an aggressive and, in many cases, an imprudent manner. This expansion of loans paralleled Central Bank policy which, in 1993 and 1994, resulted in credit to the banking system being expanded at an increasing rate. Inter-bank borrowing through lines of credit from foreign banks to larger domestic banks was funding the loan portfolio growth with the result that much of the inter-bank borrowing was denominated in foreign currency.

As a result of the inherent fragility of many of the banks following privatization and their rapid growth through imprudent lending, they were, for the most part, not equipped to cope with the challenges posed by the peso crisis in 1994 and the impact that both inflation and high interest rates had on the quality of their loan portfolios. In addition, the legislative environment which protected the rights of debtors at the expense of creditors and a judicial system that was ill equipped to cope with creditors seeking to enforce their security made the position of the banks even more precarious.

In response to the peso crisis and as a result of its determination to use fiscal resources to protect depositors from the risks posed by the deterioration of capital within the banking system, SHCP adopted the following objectives and decided to use FOBAPROA to achieve them to:

1. reduce the risk of a run on the commercial banking system, and the potential collapse of the financial system;
2. protect depositors and bank creditors;
3. maintain the integrity of the payments system;
4. support the solvency and liquidity of institutions;
5. support the greatest possible number of families and companies by promoting a culture of payment;
6. minimize fiscal impact, distributing it over time; and
7. encourage the participation of first-level foreign banks in order to improve the competitiveness and solvency of the system, as well as reduce the county risk.

While the decision made by SHCP to subsidize banks that were either insolvent or whose continued viability was seriously in doubt may be subject to criticism, any evaluation of the role of the regulatory and supervisory agencies in the banking system must be considered in light of such decision. In the final analysis, the direction that FOBAPROA was to take and the costs it was to incur were the result of determinations made by SHCP which the other government agencies were obliged to respect. As a result of practices and policies of SHCP at and prior to the period of privatization, Mexico did not have the financial resources to pay out all creditors including depositors in full and to restructure the banking system.

When the banking programs administered through FOBAPROA were initiated, the solvency and viability of many of the banks that obtained assistance through these programs were serious issues. The general weaknesses in the supervisory environment that were inherent at the time of privatization, the reluctance on the part of the government to permit insolvent banks to fail and the delays that often followed the identification by the supervising agencies of significant problems, combined to increase substantially the costs of the banking programs administered through FOBAPROA.

In our opinion, had CNBV acted and been permitted to act more decisively with respect to information regarding the precarious financial condition of many of the banks, the costs that have since been incurred in maintaining insolvent institutions would have been substantially reduced. In order to secure the overall health of the banking industry, it is, in our view, essential that SHCP allow banks, once identified as insolvent, to be wound-up. In an environment where all depositors are protected (which is currently the case in Mexico), the potential impact of the winding-up of the operations of one or more banks on the viability of the financial system through runs on deposits is not a significant concern.

In order to permit the supervising agencies to respond more quickly to perceived problems with those banks whose affairs they supervise and in order to achieve public accountability, the roles of each of the agencies must be clearly defined and any overlap between them eliminated. If the mandate of each of the agencies is clear, then each will be better able to deal, in an expeditious fashion, with problems as they arise.

Ultimately, the consolidation of Mexico's banks through the liquidation and disposition of those that are not viable, improved capitalization (and the recognition of current capital inadequacies) and the improvement of the legislative framework in order to better protect the rights of creditors will contribute to the growth of a healthier and more stable banking system.

2. Regulatory Framework

Scope

The following is an analysis of the Mexican regulatory framework as it relates to the banking sector prior to and during the Mexican banking crisis. The analysis is divided into the following three sections:

I. Evaluation of the legislation and supervisory regime
- Bankruptcy Laws
- Exit Policy
- Protection of Depositors
- Supervision of Financial Groups
- Ownership
- Credit Bureaus

II. Evaluation of the regulatory agencies' mandates and powers
- Overlap of Powers
- Mandates and Accountability

III. Evaluation of prudential regulations
- Capital Adequacy Rules for Banks
- Prescribed Mexican Bank Accounting Standards
- Corporate Governance
- Credit Diversification
- Related Party Lending

The focus of the review has been the laws and regulations in place in Mexico with respect to supervising and regulating banking institutions.

A review of various laws such as the *Law of Credit Institutions*, the *Law to Regulate Financial Groups*, the *Law of CNBV* and the amendments to these laws since 1990 was performed. In addition a review of more specific regulations contained in various rules and circulars published in the Official Gazette of the nation during the same time period was undertaken.

Interviews were conducted with various regulatory agencies and consultations were held with our legal advisors and various other Mexican professionals as required.

All aspects of the Mexican regulatory framework have not been covered and comments have been restricted to those areas which have had the greatest impact on Mexico's financial system.

BANKRUPTCY AND SUSPENSION OF PAYMENTS

A review of the Mexican bankruptcy and insolvency legislation was performed and the following analysis will set out the strengths and weaknesses of that legislation which were observed over the course of the review.

Collection and Enforcement

While some degree of imprecision in bankruptcy law may be important to provide the flexibility required to efficiently resolve complex and unique cases, based on experience with Canadian bankruptcy law, the Mexican law appears to be too imprecise and as such fails to provide proper guidance, frequently causing the law to be misinterpreted and inconsistently applied by the courts.

A significant problem encountered during the peso crisis was the inadequate infrastructure of the bankruptcy court system itself, which was unable to handle the volume of claims that were made during this period. This was due to the fact that there were few judges in Mexico to hear bankruptcy proceedings, a problem that continues to exist to this day.

Bankruptcy court judges are obligated to pass resolutions on each objection presented to them by debtors. Debtors play on this weakness, deliberately delaying the recovery of collateral by creditors by raising unwarranted objections. These objections, in turn, contribute to the inability of the courts to deal expeditiously with the issues before them. Various organizations exist throughout Mexico whose purpose is to protect debtors and which prepare and sell "books of objections" which debtors merely have to sign and file with the court.

In addition to the bankruptcy legislation, recovery by the banks is impeded by the laws governing enforcement and collections. The process is cumbersome, with substantial delays, and when favourable judgements are rendered they are not always enforced. To attempt to recover a loan through the legal process often takes between three and seven years. Debtors will appeal decisions with the knowledge that the banks will often try to settle the issue out of court.

Rehabilitation Process for Debtors

The suspension of payments procedure is a process whereby a debtor, in an attempt to avoid bankruptcy, may solicit the court and submit a proposal with the aim of reducing payments or gaining time for repayment. In such a proposal, the debtor identifies those payments that are necessary to maintain the business.

The system is designed to give a debtor some incentive to pursue this form of rehabilitation for the following reasons:

approval of the suspension of payments process takes approximately one year. During this time, the debtor retains the administration of the business;
once this process is initiated, interest ceases to accrue on all loans except mortgage and pledge loans and the amount of the loan is frozen. While this is common practice among other countries, in Mexico, the length of time required for this process to be approved is far greater than most. Throughout this period, the debtor is required to make only those payments needed to maintain his business as a going concern and there is no enforceable maximum time limit for the completion of this process;
once approved, the debtor has merely to comply with the minimum payments listed in the proposal to be in compliance with the agreement. Thus, the debtor has full control over any excess cash that may remain after having paid the required minimum amounts; and there is no right of set off in Mexico.

Creditors' Rights

While the bankruptcy law contains provisions that are aimed at protecting the rights of secured creditors by allowing them to take possession of assets, in practice, such protection is minimized due to automatic stays on secured assets.

As the proceedings are time consuming and inefficient, a creditor usually only receives a small portion of the money owed. This is especially the case, as employees must be paid, whether working or not, throughout the period that the entity remains in the approval process and until the judge rules. In addition, regardless of the existence of a guarantee, secured creditors are only entitled to the residual amount after the other preferred creditors have been paid.

As debtors are currently protected by the legislative and judicial system, there is tremendous public resistance to bankruptcy reform. The latest proposal, from the Ministry of Commerce, maintains the current procedures but imposes a maximum time limit of 180 days for an agreement to be reached. Once this time has elapsed, bankruptcy can be declared and an entity can be sold either as a going concern or in selected pieces. Creditors and debtors are able to dispute the distribution of assets, if necessary, after liquidation takes place.[88] These reforms have not materialized to date.

The primary obstacles to reforming the bankruptcy law are social and political in nature:

- It is difficult to pass laws during a crisis due to the unfavourable ramifications it may have on the financial system. Mexico has been in and out of crises since 1976.
- The number of businesses and individuals that would be susceptible to bankruptcy are great and could trigger a recession or depression.

As a result, the government would be subject to intense political opposition if it were to propose new legislation.

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[88] Dr. Roberto del Cueto, Director of the Center for Private Legal Studies at the Autonomous Technological Institute in Mexico (ITAM).

Other Weaknesses

There is no mention of a trustee licensing process whereby the trustee's credibility can be measured, other than that trustees for financial institutions should qualify to act as receiver. In addition, through the course of the review, it was determined that numerous locations existed where bankruptcy information could be filed (municipally, regionally, etc.), making it difficult to locate a particular filing. In some cases bankruptcy filings could not be found for known bankruptcies.

Attempted Reforms

In 1995 a restructuring process outside the bankruptcy law was attempted, called A Co-ordinating Unit for Bank-Enterprise Agreements (UCABE). UCABE was an informed orzanization that attempted to lay the foundation for the financial restructuring of the largest "syndicated" corporate loans, by furthering negotiations between debtors and banks to avoid bankruptcy and to expedite the process. Loans in Mexico are not syndicated, but in the case of a common debtor, UCABE tried to co-ordinate all lenders in order to maximize the available recoveries. In 1997 UCABE was disbanded.

Impact on the Financial System

The lack of adequate judicial resources and deficient bankruptcy laws have had a significant impact on the financial system:

- It appears that banks may be unwilling to lend due to the difficulties they encounter in collecting on collateral, creating a credit scarcity problem.
- Bank credit losses and the cost of borrowing for firms has become abnormally high.
- Market discipline is being undermined and a culture of non-repayment of loans is developing, furthering the problem of moral hazard. (Moral hazard occurs when members of the financial system, for example, bank management or depositors, take on increased risk due to guarantees that they will be protected fully or partially from losses).
- Banks tend to seek out of court settlements with debtors and the debtors have high leverage.

Conclusions and Recommendations

Creditors' rights require greater protection so that in practice, they are able to recover reasonable amounts on their secured loans. If creditors' rights are strengthened, a balance must be sought between these and debtors' rights especially in the transition period to avoid a bankruptcy epidemic.

The number of bankruptcy courts and judges should be increased to allow for bankruptcy and suspension of payments cases to be processed on a timely basis. Time limits should be placed on the length of time in which a debtor may be permitted to suspend payment of his obligations so that foreclosures are facilitated when necessary.

Restrictions should be put on the number of objections that can be brought forth by debtors in order to reduce the impact that such objections have on the timely resolution of court proceedings. Further restrictions could be put on the use of cash by a debtor in the suspension of payments status.

A trustee licensing process could be put in place to enhance a trustee's credibility before the courts. The number of locations in which bankruptcy information can be filed should be reduced in order to facilitate access to bankruptcy filings.

In addition, foreign ownership laws have become more relaxed in recent years, causing an increase in foreign ownership. Therefore, international insolvency issues and their co-ordination among other countries must also be considered.

EXIT POLICY

One of the obstacles in containing the costs of the financial crisis was the inability to effectively wind-up insolvent banks while sustaining and supporting illiquid but solvent banks. Much of this was due to the lengthy and costly re-organization procedures that resulted from the ineffective bankruptcy laws.

Exit policy is the closing or winding-up of a bank, either voluntarily or through the force of a regulatory authority, through its liquidation. Neither a voluntary wind-up policy, nor a formal exit policy for forced closure exists in Mexico.

In Mexico, the term liquidation is used in more than one circumstance, as follows:

(1) Liquidation refers to the selling off of assets for cash, and does not necessarily refer to the liquidation of the entire entity. CNBV has the power to conduct this type of liquidation, according to Article 40 of the *Law of CNBV*, which activity will be referred to as selling off of assets.

(2) Liquidation also refers to complete liquidation and closure, including the removal of an entity's authorization to operate. This form of liquidation will be referred to as closing a bank. CNBV is not authorized to perform this type of liquidation, however, SHCP has the power to withdraw a bank's authorization.

Major Issues

According to the International Monetary Fund, an effective exit policy requires a supervisory authority that has an adequate and effective legal framework and the will, autonomy and powers to implement a firm policy.

In Mexico, the principal impediment to conducting an efficient exit policy is the government's reluctance to allow banks to fail. In addition, despite its power to liquidate assets and suspend operations of an institution under management intervention, CNBV policy was to perform a management intervention only as a last resort. Finally, Mexico does not have an effective judicial and legal framework with respect to the bankruptcy of financial institutions, bankruptcy in general, and the suspension of payments.

Adequate and Effective Legal Framework

CNBV is only permitted to request the suspension of payments or bankruptcy from the bankruptcy courts. It does not have the authority to force the bankruptcy of an institution without the prior consent of the courts. Although this process is standard practice in industrialized countries, the approval process is lengthy in Mexico, and impedes CNBV's ability to conduct bankruptcy proceedings in a timely fashion.

FOBAPROA was effectively limited in its ability to approve settlements on debts that the management intervenors of certain banks were attempting to collect. This authority was transferred to IPAB before IPAB's board of governors was established. This left a period in which the ability to pursue the collection of assets and the merger strategies being developed were delayed due to a legal void in the system. This contributed to the prolonging of the management intervention process and has resulted in a number of banks remaining in a suspended status.

The law does not provide immunity to government agencies or individuals in carrying out their functions. According to CNBV's legal counsel, supervisors can be held individually responsible for loss or damage that may be caused due to intervening a bank that may not have warranted management intervention. Supervisors may be restricted in the nature of decisions they are willing to make, given a fear of potential legal repercussions.

Government Policy

SHCP has stated that it fully supports the policy of not allowing banks to fail or close. As a result of this policy, insolvent banks were not forced to exit the system. Restructuring was attempted and management intervention was used as a last resort. The restructuring process encompassed one or more of the following:

a) capitalization by FOBAPROA;
b) merger with solvent banks;
c) the sale of the banks and/or branches to foreign investors; and
d) the realization of the bank's assets.

The regulators supported this government policy and viewed management interventions as the most costly form of support. This view is the subject of comment in other sections of this report.

Powers of CNBV

CNBV has the power to:

- managerially intervene in an institution and seize control of its operations;
- sell off the assets, and
- suspend operations.

This implies that, despite the absence of a formal exit policy, CNBV is able to wind down a bank by stripping it of its assets and liabilities.

Conclusions and Recommendations

As previously mentioned, the International Monetary Fund was used as a benchmark to evaluate exit policy. In its opinion, an effective exit policy must have an adequate and effective legal framework and a supervisory authority with the will, autonomy and powers to implement a firm policy. Also, supervisors must have the authority to act outside the standard bankruptcy procedures and without the need for political approval on a case-by-case basis.

Mexico not only has an insufficient formal exit policy, but also does not have essential elements which allow for effective winding-up of institutions in the absence of formal legislation. The absence of an adequate winding-up policy for banks has had a significant impact on the health and progression of the financial system and is one of the reasons the regulatory framework remains deficient despite advances that have been made in areas of supervision. In order for the regulatory framework to be effective, all components of the system must be enhanced.

Despite the external obstacles mentioned, which hampered CNBV's ability to carry out an effective exit policy, CNBV has the necessary authority to seize control of an institution and proceed with the sale of assets and the suspension of its operations.

CNBV has the power to develop an exit policy and should ensure that one is established for national banks, as it is currently developing an exit process for foreign bank subsidiaries. This policy could be flexible enough to adapt to the various individual situations as required, providing guidelines on the management of closures.

The International Monetary Fund suggests that supervisors "should not be held personally liable for damages caused by actions legitimately performed in the course of their duties" and should only be liable for decisions which are obviously unreasonable and damaging. Such legislation should be sought.

System in Place Prior to and During the Banking Crisis

FOBAPROA's mandate was to cover the liabilities of the banks and, therefore, protect the depositors. FOBAPROA's liability coverage has been very broad and essentially, it ensures coverage of all bank liabilities except subordinated debt.

This type of blanket coverage may have resulted in increasing moral hazard in the banking system. The presence of moral hazard reduces the effect of market forces that provide incentives for all members in the financial system to evaluate the risks of the actions they take.

With the onset of the banking crisis, the Mexican government presumably could not remove its guarantees of the bank's liabilities without risking a run on the banks. According to the World Bank, past experience shows that reversing earlier pronouncements during a crisis might cause panic and capital flight, damaging economic recovery and financial development. The International Monetary Fund suggests extending coverage temporarily during a crisis.

Ideally, the Mexican government should have had a system of limited deposit insurance in place before the onset of privatization. The introduction of IPAB and the phasing in of limited deposit insurance will, in the future, remedy this situation.

New System of Deposit Insurance

In 1998, the government passed new legislation to create IPAB (Institute for Protection of Bank Deposits). The purpose of IPAB is to provide the financial institutions with a system for the protection of bank savings and to manage the financial recovery programs. This indicates that the government is moving in the direction of other international communities with respect to deposit insurance systems.

Effective deposit insurance schemes are aimed at protecting relatively small depositors from loss. The following two tables illustrate the characteristics of an effective deposit insurance scheme under normal times and in times of crisis:

Typical Practices for a Successful Deposit Insurance Scheme Under Normal Conditions[89]	
The scheme should: - Be explicitly defined in law and regulation - Resolve failed depository institutions promptly - Impose limitations on coverage - Have wide membership base - Pay deposits quickly - Have adequate sources of funding to avoid insolvency	- Offer risk-adjusted premiums (when risks can be accurately measured) - Have accurate information and disclosure of an insured bank's financial condition - Grant no decision-making authority for bankers within the deposit insurance scheme - Take prompt remedial actions - Have close relations with the lender of last resort and the supervisor

Typical Practices for a Successful Deposit Insurance Scheme in Systemic Crises[90]
The scheme should: - Extend coverage temporarily - Obtain government backing

The highlights of Mexico's new deposit insurance agency versus FOBAPROA are listed below:

Institute for Protection of Bank Deposits (IPAB)	FOBAPROA
Insurance covers –Presently: all bank liabilities except subordinated debt and liabilities derived from irregular operations. Coverage decreases in stages and IPAB should only cover bank deposits by the end of 2004.[91]	Insurance covers – all bank liabilities with the exception of subordinated debt and liabilities derived from irregular operations.
Guarantees limited to 400,000 UDIs (effective 2005).	No limits established.
A framework for bank bankruptcy and liquidation whereby IPAB assumes payment of the guaranteed obligations of the failed institution.	No provisions in previous law providing guidance on the management of a bank in bankruptcy.
The amount of financing that IPAB can obtain from the Bank of Mexico, in the excess of bank contributions, must not exceed 6% of total liabilities of all banks every three years. Additional funding from the Bank of Mexico must have government approval.	No limits established.
Allowance for risk based premiums.	Contributions not to exceed, respectively, 0.5% and 0.7% annually of the maximum amount of obligations the fund will explicitly protect.
A twelve month time limit is put on the provision of liquidity support. The institutions are charged an inspection fee so that IPAB can ensure the funds are properly utilized.	Limits regarding the period of financing were not formalized under the old legislation.
In return for granting support, the IPAB may impose terms, measures and operational restrictions on the bank including the demand for the dismissal and hiring of officers and employees.	These measures could be implemented by CNBV during their management intervention. FOBAPROA was not given this power.
IPAB is responsible for financial support compliance, may request information from banks and may accompany CNBV to on-site inspections.	Procedures for FOBAPROA to fulfil its mandate of compliance were unclear.

[89] Toward a Framework for Financial Stability, International Monetary Fund, January 1998
[90] Toward a Framework for Financial Stability, International Monetary Fund, January 1998
[91] The Bank Savings Protection, Chapter I, Article 6, Chapter II, Article 11, Transitory Article 11

Institute for Protection of Bank Deposits (IPAB)	FOBAPROA
IPAB assumes ownership of all bank and debtor programs.	FOBAPROA retains ownership of the portfolio purchase program
IPAB and the banks will agree on a formula that will force the banks to pay more attention to the collection and management process of the loans in the trust.	Incentives for loan collection were not sufficient
- IPAB can obtain financing from 3 sources in the following order: 1) 4/1000 pesos per year from each bank based on deposits are collected; 2) the Central Bank may grant financing up to 6% of the bank liabilities, published by the CNBV, one every three years; 3) In times of emergency, the Congress may approve a special expenditure budget item, in order for IPAB to fulfil its obligations.	- FOBAPROA obtained financing from: 1) initial, ordinary and extraordinary contributions of financial institutions, and 2) from the Bank of Mexico as permitted by Article 7 of the Law of the Bank of Mexico - FOBAPROA's financing of bank programs did not required approval by the legislature

International Comparisons

The following table illustrates that there are various coverage limits and pricing schemes for the implementation of deposit insurance, most of which are capped thereby protecting smaller unsophisticated depositors and leaving large creditors at risk allowing market forces to prevail. As indicated by the table, many countries have had deposit insurance schemes in place for decades. According to the International Monetary Fund, a formal deposit insurance scheme that offers limited coverage can reduce government outlays when political considerations would otherwise compel the authorities to protect all the depositors of failed banks[92].

Country	Year Established	Insurance Coverage Limit	US $ Equivalent (as of July 1/93)	Premium Pricing Scheme[93]
Canada	1967	Cdn$ 60,000	48,806	0.1 percent of insured deposits
Denmark	1987	Dkr. 250,000	38,075	Max. 0.2 percent of total deposits; starting in 1989, total annual contributions of all members is kr. 700 million until fund reaches kr. 3 billion
France	1980	FF 400,000	69,512	Collected as needed; assessments based on deposits
Germany	1966	30 percent of the "liable capital of bank concerned per depositor"	N/A	0.03 percent of total deposits
Italy	1987	100 percent of first L 200 mil., 75 percent of next L 800 mil.	516,000	Unfunded arrangement

[92] Toward a Framework for Financial Stability, International Monetary Fund, January 1998
[93] Financial Regulation in the Global Economy, Richard J. Herring and Robert E. Litan, 1995, Washington D.C., page 54

Country	Year Established	Insurance Coverage Limit	US $ Equivalent (as of July 1/93)	Premium Pricing Scheme[94]
Japan	1971	Y 10,000,000	93,370	0.012 percent of covered deposit balance
Mexico	1990	Unlimited deposits, credits and loans	Unlimited	0.5% and 0.7% annually of the maximum amount of obligations the fund will explicitly protect in a given year all bank liabilities. bad faith transactions and subordinated debt.
	1999	400,000 UDIs as of 2005	97,087	0.4% per year from each bank based on deposits.
Norway	1961	Unlimited	Unlimited	0.015 percent of total assets
Switzerland	1984	SF 30,000	19.803	Unfunded arrangement
United Kingdom	1982	75 percent of deposit balance up to L 20,000	22,373	Progressive levy with the effective rate not to exceed 0.3 percent of domestic sterling deposits
United States	1933	$100,000	100,000	0.23 percent of deposits (and higher depending on risk. up to 0.30 percent)

Conclusions

Mexico's new deposit insurance laws represent a significant reform and are a positive step towards the achievement of an effective regulatory framework for the supervision of financial institutions. Protection will be capped once IPAB regulations are fully phased into the system creating a market discipline on banks. Especially noteworthy is the new law's provision for risk based premiums such that banks having a greater risk may have to pay higher premiums. The capping of the deposit insurance at 400,000 UDIs by 2005 is a positive move and earlier adoption, if possible, is encouraged. However, IPAB for the time being, continues to protect all bank liabilities, except subordinated debt and liabilities derived from irregular operations.

SUPERVISION OF FINANCIAL GROUPS

The *Law to Regulate Financial Groups* of 1990 introduced the possibility of financial groups in Mexico. In 1995, the CNB and CNV merged in an attempt to move toward consolidated supervision. With the advent of financial groups in any country, certain issues arise that must be managed by the supervisory authorities. The Tripartite Group (an internationally represented group of supervisors and regulators set up at the beginning of 1993 specifically to consider ways of improving the supervision of financial groups) identified the major issues to consolidated supervision, some of which are listed as follows:

- the overall approach to the supervision of financial groups;
- the assessment of capital adequacy;

[94] Financial Regulation in the Global Economy, Richard J. Herring and Robert E. Litan, 1995, Washington D.C., page 54

- contagion, in particular the effect of intra-group exposures;
- large exposures at the group level;
- problems in applying a suitability test to shareholders and a fitness and propriety test to managers;
- the transparency of group structures; and
- the rights of access to information about non-regulated entities.

Overall Approach to the Supervision of Financial Groups

The Tripartite Group agreed that supervision of financial groups cannot be effective if individual components of a group are supervised on a purely solo basis. Solo supervision means that the banking supervisor supervises, in isolation, the bank within the financial group, the insurance supervisor supervises, in isolation, the insurance company within the financial group, and so on. CNB was merged in 1995 with the CNV in order to consolidate supervision of the banking and securities industries. The insurance industry is still being supervised by a separate agency.

According to the Tripartite Group, consolidated supervision is defined as follows:

> Consolidated supervision is a supervisory approach that focuses on the parent or holding company, although, individual entities may and should continue to be supervised on a solo basis according to the capital requirements of their respective regulators. In order to determine whether the group as a whole has adequate capital, the assets and liabilities of individual companies are consolidated; and capital requirements are applied to the consolidated entity at the parent company level; and the net result is compared with the parent's (or group's) capital.

According to the *Law to Regulate Financial Groups*, controlling companies of financial groups are subject to the inspection and oversight of the Commission that supervises the financial entity that, in the opinion of SHCP, is the dominant member of the financial group. Currently, in Mexico, CNBV supervises all groups that contain a bank. The controlling company must accept the on-site visits of the Commission and provide all necessary reports and information.

Rights of Access to Information about Non-Regulated Entities

An important element in supervising financial groups is access to non-regulated members of the group. This access is important in assessing the capital adequacy of the group as a whole and in ensuring that inter-group transactions are done on an arm's length basis. There are no non-regulated companies allowed in financial groups in Mexico.

The Assessment of Capital Adequacy

Mexico does not require financial groups to maintain a specific capital adequacy ratio; they do so only on an individual entity basis. It is important that capital adequacy be monitored on an individual basis but be complemented by an examination of the capital of the financial group as a whole, as problems faced by one of the group members can affect the other members in the group.

Large Exposures at Group Level

Although Mexico has in place risk diversification rules for individual financial institutions, there are no rules in place to assess large exposures at a group level. Large exposures at the group level can lead to contagion of financial problems throughout the group. It is essential for supervisors to be informed on a regular basis of the existence and nature of all such exposures. One approach, as suggested by the Tripartite Group, would be to have the lead regulator responsible for obtaining the necessary information to assess the group wide exposure and identify suitable trigger points for concern that would lead to discussions between the various supervisory agencies. However, although there may be a lead regulator, there is no mention in the laws as to how regulators are to supervise large exposures at the group level.

Contagion, in particular the Effect of Intra-Group Exposures

The solo supervisor best controls intra-group exposures. CNBV issued a circular in 1997 that established the obligation for credit institutions to identify the groups of individuals and companies, which due to their capital or responsibility links constitute common risks. Each financial institution is to keep a listing of all identified related parties and submit the list to CNBV semi-annually.

Transparency of Group Structures

SHCP, through the *Law to Regulate Financial Groups*, authorizes the establishment, organization and merger, acquisition, or withdrawal of an entity, from a financial group. SHCP has issued rules regarding the requests for authorization of financial groups, which include information regarding bylaws, rules for avoidance of conflicts of interest, listings of shareholders, officers and directors and other documentation, as SHCP deems necessary. As of 1999, any person, and/or entity, that acquires or transfers more than 2% of the capital stock of a commercial banking institution or financial group must notify SHCP.

Suitability Tests for Shareholders and Fitness and Propriety Tests for Managers

Shareholders that have material influence over a financial group should meet fit and proper criteria as determined by the supervisory authority. Such standards would require information about the identity, professional qualifications, experience, competence, honesty, integrity, and personal financial status of the shareholders. This information should be corroborated with such things as law enforcement agencies, court records, credit agencies and interviews with previous business associates. Information detailing business or personal relationships among directors, large shareholders and counterparties of the bank or financial group should also be collected. Mexico does not have standards that shareholders with material holdings must meet. This insufficiency of formal standards for the determination of the suitability of shareholders contributed to the problems created upon privatization.

Fit and proper criteria should also apply to senior bank officers of the bank at the group and bank level. As banking, insurance and securities businesses become more integrated, it is possible that the decision making process will be shifted away from the individually regulated entities to the parent thus enabling managers of an unregulated company to make decisions over the regulated entity. Supervisors should thus have access to and be evaluating the managers actually making the decisions relative to the regulated entity.

Conclusions and Recommendations

Although the Mexican regulatory framework has allowed for the existence of financial groups since 1990, it was only on May 1, 1995, that CNB and the CNV were merged to become CNBV. Although a merger of the supervisory authority is not required for effective consolidation, the merger of the Commissions facilitates this process. Thus, the merger of the supervisory authorities was a positive step towards supervision of financial groups.

The Mexican supervisory authorities could consider putting in place a system to supervise the financial groups that make up the Mexican financial system in accordance with the principles stated above. If the laws permit such groups to operate, the groups should be adequately supervised. CNBV has been aware of the need for consolidated supervision since 1996. In that year, CNBV signed a resolution of the President's Committee of IOSCO (International Organization of Securities Commissions) agreeing that certain principles should form the basis for the risk assessment of financial groups and should be used, as far as possible, to guide the development of regulatory practice and regulatory co-operation in the area of financial groups.

General Ownership

During the period from nationalization (1982) to privatization (1991), Mexican banks continued operating as commercial banks. However, credit extended to the private sector began to decline and during the period from 1985 to 1987, the government used the commercial banks mainly to finance the public sector deficit. Supervision of the banks was not effective due to the power held by the heads of the banks during this time.

The International Monetary Fund recommends that state-owned banks operate according to commercial criteria and conform to the same prudential rules as private banks and fully and transparently transfer all their quasi-fiscal undertaking to the government budget. This does not appear to have been the case during the period of nationalization. Were it the case, the banking system would probably have been more prepared to deal with the realities of operating in a privatized banking system.

Foreign Ownership

Many banking systems are open to foreign ownership and Mexico has gradually been opening up its banking system. As of July 1990, foreign investors as a group could acquire up to 30% of the voting shares of a Mexican controlled commercial bank or financial group. Amendments made in 1995 permit foreign individuals and companies as a group to hold as much as 49% of the voting capital of a Mexican-controlled commercial bank or financial group. Restrictions on non-voting shares (eligible to be held by both foreigners and Mexicans) were raised from 30% of the voting capital of the institution to 40%.

Prior to *NAFTA*, in order to establish a foreign owned financial subsidiary, foreign investors were required to invest in at least 99% of the share capital of the commercial bank. As a result of *NAFTA*, a financial institution may be deemed a foreign financial subsidiary when as little as 51% of the share capital is owned by a foreign financial institution.

According to a study done by the Bank of Mexico, global participation in the Mexican banking system increased from 1.5% in 1993 to 25% in 1996.

The following table shows the foreign component of the banking systems of other countries as published in the Bank for International Settlements, Economic Paper No. 46, October 1996.

Foreign-Owned Banks' Percentage Share of Total Assets

Country	Percentage	Country	Percentage	Country	Percentage
India	7.3	Thailand	7.1	Venezuela	1.2
Hong Kong	78.0*	Russian Federation	2.2	Israel	0.0
Korea	5.1	Argentina	21.7	South Africa	3.3
Singapore	80.0	Brazil	9.4	United States	22.0
Taiwan	4.7	Chile	21.4	Japan	1.8
Indonesia	3.7	Colombia	3.6	Germany	3.9
Malaysia	15.9				

* Refers to all overseas-incorporated authorized institutions
Note: Figures refer to latest available year as at October 1996
Sources: OECD, central banks and Ministries of Finance

At 25% foreign ownership in Mexico as of 1996, Mexico's foreign ownership component is greater than most of the countries listed in this sample. Mexico's foreign ownership component seems to be consistent with that of the United States and with Latin American countries such as Argentina and Chile.

Conclusions

Had the nationalized banks been operating more in accordance with commercial banking criteria (i.e. proper credit granting policies and supervisory oversight) during the period of nationalization, they would have been more prepared for privatization and their solvency problems during the banking crisis may have been lessened.

With the exceptions of the five year exemption given to brokerage houses who transferred into a financial group and purchased a bank, maximum ownership limits on Mexican banks and financial groups, while sufficient to reduce undue influence over the banks management, were suspended during the time the banks were privatized. The ineligible owners were then grandfathered by SHCP when the suspension was removed.

Given the substantial increase in foreign investment in Mexico (1.5% to 25%), it seems the changes to foreign ownership rules have been successful in increasing foreign participation in the system.

In 1993, amendments to the *Law to Regulate Financial Groups* established the provision for the foundation of credit bureaus. The legal infrastructure had not been set up to facilitate the implementation and use of credit bureaus before the crisis. It was not until 1995, that the SHCP published the "General Rules That Credit Bureaus Must Follow" in the Official Gazette.

In 1996 and 1997, stronger information systems were put in place to help establish the credit bureau system for individuals. These bureaus record all relevant lending information.

Recently, on October 15, 1998, CNBV issued a circular requiring financial institutions to set up additional loan provisions if the institution fails to access a credit bureau to obtain the credit record of the borrower. Loans where the credit record of the borrower is not checked must be provisioned 100%. If the institution accesses the credit bureau and the borrower has a poor credit record, and the loan is nevertheless granted, the institution must also provision the loan at 100%. The issuance of this circular puts in place a strong incentive for credit institutions to utilize the credit bureaus.

The banks have reported that the establishment of the credit bureaus have resulted in significant improvement in their credit granting process, since they now have a third party source of information. It has led to inaccurate credit applications being refused by the banks, and, therefore, is an effective addition to the banks' credit risk management process.

Conclusions

The use of credit bureaus in Mexico has been slow to develop. The *Law to Regulate Financial Groups* had been amended in 1993 for the establishment of credit bureaus, "General Rules That Credit Bureaus Must Follow" were not issued until 1995 and strong incentives for the use of credit bureaus were not established until 1998.

Given the effectiveness of the credit bureaus as reported by the banks, their absence during the period of rapid loan book expansion, especially post privatization, has contributed to the overall lack of credit quality within the system.

EVALUATION OF THE AGENCIES' MANDATES AND POWERS

The following table lists legal responsibilities of the financial authorities in respect to the banking system. It is the basis for our analysis of the overlap of powers, mandates and accountability of the financial authorities.

Synopsis of Legal Responsibilities of the Federal Authorities that constitute the Regulatory Framework for Financial institutions

Responsibility	CNBV	SHCP	Bank of Mexico	FOBAPROA	IPAB
Implementation of public policy objectives:					
• Consumer protection	♦	♦	♦		♦
• Stability, soundness and functioning of the financial system	♦		♦		
• Competitiveness of the financial system	♦				
• Public confidence in financial system	♦		♦		
Co-ordination mechanisms:					
• FOBAPROA's Technical Committee	♦	♦	♦	♦	
• Governing Board of IPAB	♦	♦	♦		
• Board of Governors of CNBV	♦	♦	♦		
Supervision of financial institutions :					
• Creation of supervision policies/rules		♦			
• Internal and external annual examinations	♦				
• Evaluation of financial institutions	♦	♦			
• Compliance with regulations	♦	♦			
• Monitoring and assessing banks for the purpose of					
- Communicating findings to regulatory authorities	♦		♦		
- Levying penalties and sanctions for administrative and/or legal infractions identified	♦		♦		
Handling of troubled institutions:					
• Preventative measures	♦			♦	♦
• Corrective action and recovery process	♦			♦	♦
• Compliance with programs	♦			♦	♦
• Provision of liquidity support			♦	♦	♦
• Liquidation – Sale of assets and suspension of operations	♦				
• Liquidation – closure of failed institutions					♦
• Management interventions of failing institutions	♦				♦
• Recovery of assets of portfolios acquired				♦	♦
• Reporting troubled institutions to the SHCP	♦				
Specific to 1994 Mexican Crisis					
• Bank Programs	♦	♦	♦	♦	
• Debtor Programs	♦	♦	♦	♦	
Best Management practices in financial institutions:					
• Issuance of Prudential Regulations	♦	♦			
• Promotion of standards of sound business and financial practices	♦				
• Guidelines and regulations for financial institutions (operational and administrative)	♦	♦	♦		
New licenses/Mergers/Foreign Entry:					
• Regulatory approval		♦			
Payments System:					
• Oversight of clearing and settlement system			♦		
• Issuance of regulations.			♦		
Other					
• Issuance of deposit insurance policy		♦		♦	♦
• Recovery of assets of deposit insurance agency				♦	♦

General Observations and Overlapping Responsibilities

As evidenced in the previous table, there are numerous areas of overlap in the responsibilities of the regulatory authorities and related agencies that comprise the financial system.

Coordination and Decision Making Among the Various Regulators

Presently there are two arenas for co-ordination between the various regulatory authorities.

The first arena is the Technical Committee of FOBAPROA whereby members from SHCP, CNBV, and the Bank of Mexico participate in decisions regarding recovery and support of failing financial institutions. Representatives of the FOBAPROA department can attend but cannot vote at such meetings and as result had little influence over decisions surrounding support provided to banks. This highlights the fact that the FOBAPROA department, contrary to general perception, did not participate in formal decision-making with respect to the support provided to the banking system.

The second arena is the board of governors of CNBV on which members from CNBV, the Bank of Mexico and SHCP sit. In this arena, the Bank of Mexico and SHCP have access to information on the various financial institutions under CNBV's supervision.

Various informal agencies exist, however, what is lacking is a prominent mechanism, whereby the financial authorities can convene on macro and micro economic issues, financial system regulations and performance of the overall system.

Supervision of Financial Institutions

The *Law of Credit Institutions* sets forth the obligation for credit institutions to submit financial information and documentation as requested by SHCP, Bank of Mexico and CNBV. Bank representatives have indicated that historically, they have been overburdened with information requests from the various regulators. As a result of reports from the Reporting Accountants, some banks still feel this burden. It appears that there is room for improvement in the area of sharing of information between the regulatory bodies.

The CNBV, SAF database, initiated in 1994, was substantially complete by 1998. This is an improvement in this area of co-ordination in the gathering of information. FOBAPROA has on line access to financial information through the use of this system. According to CNBV, the other regulatory authorities (SHCP and Bank of Mexico) also have access to the database. With the effective use of the SAF system, the requests for information from the financial institutions will subside.

Compliance Measures

CNBV and FOBAPROA's Technical Committee are currently responsible for ensuring compliance with corrective measures. In the future, IPAB will also perform this function.

CNBV has statutory authority, to implement and ensure the compliance of corrective measures. Its powers include conducting special examinations to assess the effectiveness and achievements of recommended corrective programs and administrative or management interventions of the entity, in the case of non-compliance. Credit institutions are legally bound to implement corrective action in response to CNBV's observations.

FOBAPROA was responsible to ensure the compliance with corrective programs developed by the financial institutions, which were required in order to receive support from FOBAPROA. However, no specific procedures are outlined in the law or the Technical Committee minutes and it is unclear as to how FOBAPROA was to achieve this mandate. FOBAPROA did not have sufficient mechanisms and regulations to ensure compliance ensued.

In the new law, IPAB is responsible for ensuring compliance with the conditions of financial support. IPAB is given a detailed statutory authority and guidelines on how this will be carried out, which includes access to required information from the banks and assistance from CNBV, as required, to ensure that compliance is sufficient. IPAB has not yet had the opportunity to carry out this mandate, but it appears that it may have sufficient legal power to do so.

It seems appropriate that both IPAB, as the insurer and provider of funds, and CNBV as the supervisor, be able to assess compliance with support programs. However, in order to avoid duplication of functions, IPAB and CNBV could take steps to ensure that this function is formally coordinated.

Management Intervention

CNBV, and currently IPAB, have the mandate to perform, for practical purposes, management interventions in troubled institutions.

In FOBAPROA's strategic plan, established by the Technical Committee, FOBAPROA was given the mandate to assist in determining the best way in which debtor companies and those capitalized by FOBAPROA, may be intervened. However, by law, CNBV is granted management intervention powers and the Technical Committee's resolution cannot override a statute. As a result FOBAPROA has no management powers over the institution.

Unlike FOBAPROA, the new law that governs IPAB gives it the power to perform a management intervention in those institutions to which it provides monetary support, while CNBV is able to managerially intervene in institutions in which irregular operations have been detected. Despite the apparent distinction there are no regulations which stipulate which agency has a right or precedence to management interventions in the event that both CNBV and IPAB are eligible (i.e in the case that an institution has both irregular operations and has received assistance from IPAB). The regulatory authorities have indicated that, in practice, this is not a problem because the decision makers on the board of governors of CNBV and those of IPAB are made up of the same individuals. Thus, there would never be a case where there were two simultaneous management interventions. In addition, it has been stated that, in practise, CNBV would always take precedence over IPAB in this case. However, this is not clearly set out in the governing legislation.

Issuance of Prudential Regulations

Currently, both SHCP and CNBV have the authority to issue prudential regulation. However, each agency is responsible for specific areas of prudential regulation such that their responsibilities do not overlap. By law, CNBV is only entitled to issue prudential regulation in the areas of risk management and accounting standards; SHCP on the other hand is responsible for issuing all other prudential regulation, such as capital adequacy requirements. The SHCP has many other responsibilities for the Mexican financial system and as such, it may be more efficient to leave the issuance of prudential regulation to the supervisory authority.

Mexico appears to be progressing in this direction, as legislation is currently pending that will give CNBV statutory authority to issue all prudential regulation.

Issuance of Deposit Insurance Policy

Although Mexico did not have a true deposit insurance agency, FOBAPROA had a mandate to protect bank creditors and depositors. The SHCP determined public policy that no banks will be allowed to fail. The Technical Committee determines each year the extent of the coverage of creditors and depositors and the Bank of Mexico publishes the coverage limits annually in the Official Gazette.

The powers of the Technical Committee and SHCP overlapped in their respective authority to determine the amounts and terms of the initial contributions paid by the institutions. However, there is no mention in either of their statutes or operational rules that the above policy determination is to be conducted as a joint effort nor is there a cross-reference made to the other authority. This overlap of power is unnecessary and in fact could cause discrepancies and confusion, making accountability for actions more difficult.

Conclusions and Recommendations

The problems caused by overlapping responsibilities are:

- the creation of structural weaknesses;
- the lack of achievement of accountability;
- confusion over responsibilities, potentially causing important areas to be overlooked;
- the utilization of resources which could have been used to perform other necessary functions; and
- the burdening of financial institutions with excessive financial reporting requirements.

On the other hand, overlapping powers may provide additional checks and balances, and may enhance analysis.

Although only the most significant areas were chosen for discussion, due to the impact of the negative aspects mentioned, it is suggested that all overlapping areas identified be re-examined to ensure a more efficient and effective regulatory framework.

Due to the negative impact that overlapping responsibilities and powers may have, it is suggested that all overlapping areas identified be re-examined to ensure a more efficient and effective regulatory framework. In addition the following is recommended:

- A prominent mechanism could be established, whereby the financial authorities can convene on macro and micro economic issues, financial system regulations and performance of the overall system mechanism.
- Efforts should continue to be made to improve the sharing of information between the regulatory bodies.
- In order to avoid duplication of functions between IPAB and CNBV with respect to assessing compliance with support programs, steps could be taken to ensure that this function is formally co-ordinated.
- In the future, the regulatory authorities could revisit the overlapping management intervention powers of the IPAB and CNBV and determine whether a co-ordination mechanism is warranted.
- As is currently being pursued by CNBV through pending legislation, CNBV should be given statutory authority to issue all prudential regulation.

Mandates with regards to Public Policy objectives are clear and concise. Two of the regulatory authorities include in their mandate or objective the "maintenance of public confidence in the system" and the "promotion of stability, soundness and functioning of the financial system" in the legislation. However, it is also crucial to state how they expect to achieve these goals.

Accountability

CNBV, the Bank of Mexico and SHCP, dictate the terms, functioning and operations of financial institutions. As a result, they have significant influence over both the institutions they regulate and the users and stakeholders of these institutions. It is because of this power that the regulatory bodies need to be held accountable for their decisions, actions and inaction.

According to the Basle Committee on Banking Supervision, there are two main characteristics required in a system to help ensure accountability is achieved, they are:

- clarity of roles and responsibilities in the governing legislation; and
- transparency of information to the users and institutions subject to such regulations.

Clarity of Roles

Clearly defined legislation helps to ensure that the regulatory authorities are aware of their responsibilities and have procedures in place to aid in compliance. In Mexico, the mandates of the regulatory authorities are at times unclear or do not have statutory support as to how the mandates are to be achieved. An example of this is the bank transfer approval process whereby Mr. Cabal, while apparently under investigation in the United States of America, was able to purchase Grupo Financiero Cremi. The laws dictate that information on potential shareholders must be obtained by SHCP but do not go into specifics on how the shareholders are to be evaluated and what minimum criteria they must meet.

Division of Responsibilities and Increased Transparency

Transparency promotes accountability by advising the public and the financial institutions of the powers of the regulatory authorities and the regulatory measures that can be taken upon infringement of regulatory laws. Transparency also aids in the follow up evaluation of the regulators' performance.

There is often no clear division of responsibilities between the regulatory authorities in Mexico. Examples are as follows:

- CNBV and IPAB both have responsibility for initiating the procedures for bankruptcy and suspension of payments; and
- CNBV and IPAB both have the responsibility for management interventions.

As such, it is often difficult to determine who is ultimately responsible for a particular action or inaction.

Conclusions and Recommendations

The lack of both transparency and clear legislation make it difficult to determine which regulatory body is responsible for specific events or inactions and to what extent they are responsible. As a result, the public is unable to adequately ascertain that the regulatory bodies are fulfilling their required mandates and whether those mandates are being successfully fulfilled.

It is recommended that attention be paid to defining clearly the roles of the regulatory authorities and processes for evaluation, as well as, providing details as to how regulatory mandates are to be achieved.

Moreover, in areas where regulatory responsibilities continue to overlap, frameworks setting out the requisite functions of each should be developed to enhance the accountability inherent in the overall framework.

In addition to the comments below concerning capital adequacy, additional comments are contained in the CNBV evaluation.

CAPITAL ADEQUACY RULES FOR BANKS

SHCP issued rules for calculating the net capital for institutions in the Mexican banking system, which were intended to be in accordance with the international standard set by the Basle Capital Accord. However, the rules have significant exceptions, which will be set out in this evaluation.

The principal exception between the two approaches to calculating net capital is in the components of Tier I capital. The Basle Capital Accord defines Tier I capital as issued and fully paid common shares, perpetual non-cumulative preferred shares, and disclosed reserves.[95] Mexico defines Tier I capital as that which does not bear interest and has a stable value in order to absorb loss.

According to the Basle Committee on Banking Supervision, Tier I capital is expected to be the majority of capital and is intended to represent the highest quality of an organization's capital. High quality capital consists of paid up capital, retained earnings and disclosed reserves. Tier II capital generally includes items of a lower quality but that still carry aspects of being capital in nature. These would include portions of preferred share issues, subordinated debt and revaluation reserves.

When assessing capital adequacy, emphasis should be placed on Tier I capital for the following reasons. First, it is the key element of capital that is common to all countries' banking systems. Second, it is directly visible in published financial statements and is the basis on which market judgements of capital adequacy are made. Finally, it has a crucial effect on profit margins and the bank's ability to compete.[96]

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[95] Basle Capital Accord, April 1997
[96] Basle Capital Accord, April 1997

Basic Components of Capital

	Mexican Banking System	Basle Capital Accord [97]
Basic Components of Tier I Capital	Paid-up capital.	Issued and paid-up capital and non-cumulative preferred shares.
	Retained earnings and capital reserves.	Disclosed reserves from post-tax retained earnings.
	Mandatory convertible subordinated debt (up to 30% of Tier I capital excluding these instruments).	Retained earnings and capital reserves.
	Revaluation surpluses of real estate and real estate shares (80% in Tier I).	
Basic Components of Tier II Capital	All additional reserves.	Undisclosed reserves that have passed through the profit and loss accounts.
	Subordinated debt (not exceeding 50% of Tier I capital).	Subordinated debt (not exceeding 50% of Tier I capital).
	Revaluation surpluses of real estate and real estate shares (20% in Tier II).	Conservatively valued revaluation reserves.
	Loan losses on B and C grade credits.	General loan loss reserves.
	Mandatory convertible subordinated debt not included in Tier I capital.	Hybrid debt instruments available to support losses without triggering liquidation (includes mandatory convertible subordinated debt).
Basic Standards	Tier I Capital must equal at least 50% of Tier II Capital. The minimum required net capital as a percentage of risk adjusted assets must be 6% (however, CNBV and banks use 8% as the minimum).	Tier I Capital must equal at least 50% of Tier II Capital. The minimum required net capital as a percentage of risk adjusted assets should be at least 8%, however, adaptations including higher percentage requirements may be appropriate depending on local market conditions.

Impact of Low Capital

The concept of risk adjusted capital is to ensure that there is adequate protection for depositors and that management of the bank is not taking undue risks. Under the Basle Capital Accord, suggested minimum Tier I capital ratios are 8% and should possibly be 10% in countries where there is a low country savings rate, such as is the case in Mexico. If capital is not sufficiently high or of good quality, then there is more risk being effectively assumed by depositors. This risk is then potentially transferred to deposit insurance institutions or to the government if there is unlimited deposit insurance.

Quality and Quantity

After having reviewed the computation of the net capital of a sample of banks, it was determined that certain soft capital components were included in the capital balance of such banks. Such soft capital components included deferred income taxes, revaluations as a result of inflationary accounting, and a deficiency in provisions relating to non-accrual loans. In addition, included in Tier I capital were mandatory convertible subordinate debentures, which would be included in Tier II capital under the Basle Capital Accord. The following details the components that would need to be adjusted to recalculate net capital in order to bring the Mexican capital ratio calculations more in line with the Basle Capital Accord.

[97] Basle Capital Accord, April 1997.

Deferred Income Taxes

A significant component of Tier I capital, in some banks, consists of deferred taxes, recorded as assets, which have become integrated into retained earnings. Deferred taxes can be recorded as assets as a result of two types of timing differences.

a) *Provisions for losses:* Under Mexican tax law, the amount of provisions for loan losses that is deductible in any one year is restricted to 2.5% of the average loan portfolio for the year. If the actual provisions are higher than 2.5%, then the loan losses can be deducted in ensuing years. There is no time limit for utilization of these losses.
b) *Operating losses other than provisions for losses:* If a bank incurs an operating loss, it may be carried forward for future years. They can be carried forward 5 years if there is an accounting profit and a loss for tax purposes and 10 years if there is both an accounting loss and a loss for tax purposes.

CNBV has adopted the approach that recording deferred taxes in this manner will be allowed for capital calculation purposes as long as it is permitted for accounting purposes, and is reflected in the audited financial statements. Basle is effectively silent in the area of deferred tax debits possibly because profitable banks normally have deferred tax credits. There have been no limits placed on the amount of deferred taxes that can be included in calculating capital. However, CNBV is concerned about the quality of this type of capital and is looking for methods to limit it.

The realization of the deferred taxes is based on the future profitability of the bank and is not necessarily certain. If the bank is not profitable the deferred tax debit will not be realized and that portion of capital is not available to protect depositors. Future profitability of the banks in Mexico is uncertain, and the deferred tax component of equity is significant, with an average of 32% for the system of non intervened banks.

Revaluations Due to Inflationary Accounting

Prior to the adoption of inflation accounting by the banks, the banks were permitted to revalue fixed assets based on appraisals. As of July 15, 1996, 80% of revaluations due to inflationary accounting are included in Tier I capital and 20% are included in Tier II. As per the Basle Committee on Banking Supervision, reasonable revaluations should be included only in Tier II.

Mexico is considered hyperinflationary, therefore it is reasonable under GAAP for banking institutions to integrally recognize the effects of inflation for financial statement purposes. Nevertheless, because this is soft capital, the quality of capital may be misleading if the portion of capital relating to the revaluations is included as part of equity.

Furthermore, as discussed with CNBV, it was determined that the opening value of tangible and intangible assets may have been overvalued when inflationary accounting became mandatory in January 1997. However, the amount of the overvaluation is difficult to determine and, thus, so is the quantitative effect on net capital.

Non-Accrual Loans

A significant amount of non-accrual loans have not been conservatively accounted for and as a result net capital has been overstated. Non-accrual loans, either on or off-balance sheet are unproductive assets that are recorded as performing loans on the financial statements. In the recalculation of net capital, these non-accrual loans would need to be deducted from net capital.

Such assets include:

Foreclosed assets: According to Prescribed Mexican Bank Accounting Standards, seized assets, given that they are unproductive, should remain classified separately until recovered.
The rent-to-own mortgage debtor program: Banks were able to transfer non-performing mortgages into off-balance sheet trusts while the former borrowers paid rent on the homes in which they continued to reside.
FOBAPROA loan trusts: The banks are responsible for a percentage of the loans, generally to a maximum of 25%-30% of the gross balance of the FOBAPROA notes exchanged for the assets. This percentage of the notes is represented by non-performing loans. Provisions are being made on a straight-line basis over eight to ten years as of July 1998.

Convertible Subordinate Debentures

The mandatory convertible subordinate debentures would need to be reclassified from Tier I capital to Tier II capital. In accordance with the Basle Capital Accord, such debentures, which are able to support losses without triggering liquidation, are considered Tier II capital, while Mexico has included this as core capital. Although the reclassification would not change the amount of net capital, it would help illustrate the deficiency in Tier I capital.

According to both Mexican regulations and the Basle Capital Accord, Tier II capital is not to exceed 50% of Tier I capital. Although the majority of the banks' Tier II capital exceeded this percentage (prior to the effects of the above reclassifications, the ratio of Tier I to Tier II capital was between 52-60%), the latter served to illustrate just how low Tier I capital is in the banks. Furthermore, Basle is moving towards the requirement that at least 70% of the net capital amount should pertain to Tier I.

Conclusion

Mexico allows deferred income taxes, inflation revaluations, and mandatory convertible subordinated debt to be included as Tier I capital. In addition, it was determined that reserves relating to non-accrual loans were not adequately provisioned. This fails to meet the criteria suggested by Basle Capital Accord, and the inclusion of these items in net capital may significantly overstate the quality and quantity of the capital of Mexican banks.

There have been various investment banker reports that have also identified the need for additional capital in the Mexican banking system (e.g. a US brokerage house reported recently that three banks together required up to US $887 million in additional capital). Representatives of CNBV have confirmed that both the quantity and quality of capital must be improved. However, they feel that this can only occur through gradual implementation of more stringent requirements and definitions of capital. They expect these conditions to improve over the next five years, but only if there is reasonable economic growth. In the absence of economic growth and if the present levels of loan delinquencies continue, there is a high possibility that IPAB will be called upon to further support the banking system and protect depositors.

Prior to January 1, 1997, accounting standards for Mexican banks were less onerous than international standards. Had the appropriate accounting standards been in place prior to the crisis, the extent of the poor financial condition of the banks would have been exposed much earlier. This also led to problems with accounting transparency in the banking system. The World Bank recommends that countries adopt internationally accepted accounting principles to better the regulatory framework in response to a banking crisis.

On December 29, 1995, CNBV issued new accounting standards to be followed by Mexican financial institutions. The new rules were to be internally reported to CNBV in the second half of 1996 and fully adopted by the banks as of January 1, 1997.

The new accounting rules are a much needed improvement to the Mexican regulatory framework. Significant improvements include that:

- financial groups are required to consolidate the financial position and results of operations;
- interest accrual will stop when the loan is classified as past due;
- past due loan payments and the corresponding principle will be classified as past due;
- more conservative rules establish when loans become past due;
- restructured loans are classified as past due until they demonstrate performance;
- inter-bank loans are grouped separately from other loans;
- real estate is recorded at the lower of net estimated market value and foreclosure value for property received as payment by the bank or at the lower of the agreed price or the appraised value; and
- securities be marked-to-market.

Full disclosure in the notes to the financial statements is anticipated while deferrals will be allowed in certain instances, but over a prescribed transition period:

- banks are provided a two-year transition period for the accounting of housing loans whereby the loans are adjusted to the value of the UDIs on a monthly basis;
- banks are allowed five years to account for the mark-to-market of the Mexican Brady bonds received as a part of debt restructuring; and
- past due mortgage portfolios are to be provisioned at a minimum of 35%. However, only 10% of the loan loss reserves must be provisioned immediately through existing or new provisions, and the remainder amortized during a period of up to eight years.[98] (All banks are provisioning at 35%).

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[98] Mexican Banks, New Accounting Rules: A Little More "Mex" Than "Tex", January 13, 1997, Goldman Sachs

Under US GAAP, the loan portfolio is evaluated on a loan by loan or by group of loans as the present value of the future payments. The practice in Mexico has been dictated by Circular 1128. Our experience indicated that the application of this circular resulted in loans being consistently overvalued. CNBV is in the process of replacing this approach with more realistic classification gradings which will lead to more realistic valuations.

Conclusions

CNBV's decision to bring in new accounting rules was an appropriate response to lessons learned from the banking crisis. However, some of the transition periods stated above were lengthy, such as eight years to set up loss provisions on mortgages. In addition, had appropriate accounting standards been in place prior to the crisis, the poor financial state of the banks might well have been exposed much earlier.

Corporate governance encompasses the system of principles and structures designed to enable the board of directors of a financial institution to carry out its responsibilities and comply with regulatory standards and laws.

Importance of Corporate Governance

For countries to reap the benefits of global capital markets, and to attract long-term foreign capital, corporate governance arrangements should be in place that are credible and well understood across borders. In addition, adherence to good corporate governance practices could improve the confidence of domestic investors, reduce the cost of capital, and attract sound financing.[99] Investors confidence is directly related to transparency. While disclosure standards have continued to improve globally as well as in Mexico, so have investors' expectations. The market is increasingly intolerant of disclosure that falls short of a full and plain picture of a company's financial situation.

Opportunities for fraudulent financial reporting may occur in the absence of a board of directors or audit committee that vigilantly oversees the financial reporting process, internal accounting controls and internal audit staff. The latter helps promote high ethical standards, and the establishment of a culture that promotes internal control, mitigating against the risk of fraud.

International Comparisons

Approaches to corporate governance by bank boards differ by country. In the USA, directors, who have a fiduciary responsibility to depositors, are legally liable for any infringements of law or wrongdoing. In Switzerland, Germany and Portugal, bank boards play a direct role in corporate affairs; they approve major loans, and often have responsibility for specific banking functions. In Canada, bank boards assume responsibility for stewardship and governance with respect to strategic planning, risk management, succession planning, communication and integrity of control systems. Toronto Stock Exchange listed companies incorporated in Canada must disclose their particular corporate governance disciplines in their annual report or information circular referencing the prescribed guidelines. If there is a discrepancy between the company's corporate governance system and the guidelines, an explanation must be provided.[100]

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[99] OECD Principles of Corporate Governance, Ad Hoc Task Force on Corporate Governance
[100] Criteria of Control Conference, The Road Less Travelled

The Situation in Mexico

There is little evidence to indicate that Mexican companies have demonstrated a sound system of corporate governance, which encourages the establishment of audit and corporate governance committees. Directors in Mexico are not personally liable for the actions of the institution, therefore, the incentives are limited to act and make decisions in a prudent manner in the best interests of the company and the shareholders. Accountability for bank failure does not fall on the directors of the institution.

According to the *Law of Credit Institutions*, the boards of directors of financial institutions in Mexico are selected from among persons of recognized integrity who possess sufficient knowledge and experience of financial and administrative matters. Management may not make up more than one third of the board members. Restrictions are also in place with respect to related parties. The appointment of the directors of a financial institution is subject to the approval of CNBV, however the specific criteria to be met are not explicitly stated.

CNBV may suspend members of the board if CNBV deems that such persons do not possess sufficient technical or moral ability to carry out their duties, do not satisfy the requirements established, or engage in serious and repeated violations of the law or regulations arising from the laws. In addition, CNBV may prohibit such persons from carrying out employment, duty or office within the Mexican financial system for a period ranging from six months to ten years if the last two transgretions above are proven.

Conclusions

While Mexico has punitive powers in place to sanction directors for misconduct and incompetence, the regulatory framework falls short with respect to responsibility and accountability. The duties and responsibilities of board members are not defined, nor is the requirement for specific sub committees of the board (i.e. audit committees).

Mexico, has an insufficient formal corporate governance system. A mechanism is required which holds the directors of financial groups or institutions explicitly accountable and responsible for the stewardship of the corporation. According to CNBV, this will be difficult due to the nature of the criminal code. Audit committees are needed to provide the crucial link between the internal and external auditors and the board. In addition, strong, independent boards would provide objective insight into the management of the institutions, particularly if the members possessed international financial banking experience.

The issuance of *CNBV Circular 1423* on January 25, 1999 is a positive step towards the awareness of risk management issues which is an important part of corporate governance. In addition, according to CNBV, Mexico has created a Corporate Governance Committee and has published in June, 1999 a *Code of Best Practices for Mexican Companies*. The committee has obtained advice on the development of corporate governance from England, Spain and the United States of America.

CREDIT DIVERSIFICATION

A review of Mexico's credit diversification limits (issued in 1988) indicates that credit diversification rules for banks in Mexico are quite conservative in comparison to best practices advocated by Basle and the limits established by other countries. No mention is made for the incorporation of collateral into the calculations so it is assumed that Mexico is taking a conservative position with respect to collateral. However, credit exposures are not measured at the financial group level as was set out earlier in this section under "Supervision of Financial Groups".

The following are the credit diversification limits as laid out by SHCP in 1988:

- Limit to individuals or groups of related individuals is the lesser of 10% of net capital or 0.5% of the total net capital of all financial institutions.
- Limit to companies is the lesser of 30% of net capital or 6% of total net capital of all financial institutions.
- Financing between financial institutions up to 100% of net capital of the creditor.

Other International Practices

Basle Committee on Bank Supervision (1991) recommends a limit of 25% of regulatory capital for exposures to single borrowers or related groups of borrowers as does the European Union. The European Union defines an exposure larger than 10% of regulatory capital as a large exposure.

The United States set the limit at 15% of a bank's regulatory capital for unsecured loans and an additional 10% for loans secured by specific and liquid marketable security. The European Union has set the limit for aggregate large exposures at 800% of regulatory capital. The United States of America has no aggregate limit for all large exposures.

For risk concentration rules to be effective, compliance with them must be assessed on a consolidated basis, taking into account exposures incurred by branches, subsidiaries and other related enterprises. [101]

Collateral

Gross exposure, not taking into account collateral, is a conservative basis for the application of exposure limits. If collateral is deducted, only very secure collateral, under direct control of the bank, and valued very conservatively, should be deducted.

Many supervisors set standards for the maximum percentage of the value of collateral that can be taken into account. [102]

Conclusions and Recommendation

Appropriate credit diversification rules are in place in Mexico with the exception of exposures at the financial group level. Given that the Mexican financial system is made up of many financial groups, limits and regulations regarding exposures at the group level should be adopted.

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[101] Toward a Framework for Financial Stability, International Monetary Fund, January 1998
[102] Toward a Framework for Financial Stability, International Monetary Fund, January 1998

Related Party Lending

According to Article 73 of the *Law of Credit Institutions*, multiple banking institutions require the consent of a majority of the directors in order to grant a related party loan. The current Mexican law has a very broad definition of related parties. Once the loan is approved, CNBV must be notified of the details plus any subsequent renewals or cancellation of the loan. Smaller related party loans do not require board approval. Generally, these smaller loans are not more than 0.2% of the net capital of the institution for loans to individuals and not more than 1% of the net capital of the institution for loans to corporations. Prior to 1995, the total of all such loans was not to exceed 20% of the total portfolio of the institution. In 1995, these aggregate limits were amended such that the total of related party loans could not exceed the amount of the net capital of the institution.

In various countries, connected lending controls vary from establishing limits based on a percentage of the bank's equity to forbidding connected lending all together. Mexico, like Canada, restricts maximum exposure to related party loans to 100% of the net capital of the lending institution. Chile's banking law specifies mandatory disclosure of loans to related industrial and commercial groups and loans to different members of the group are to be consolidated.

Conclusions

Mexico has been tightening its related partly lending rules over the years. Aggregate exposure to related party loans has been reduced to an amount equal to the net capital of the financial institution. This is an improvement to the regulatory framework as it exposes the institution to far less risk than the previous rules did.

Given that the banks are required to notify CNBV of all significant related party loans, in the absence of fraud or purposeful deception, the supervisory authority should be aware of all such transactions.

Due to the problems with related party loans in the Mexican banking system since privatization and the increased risk these loans pose for depositors, the regulatory authorities should consider putting in place stricter criteria for, and performing more due diligence on, related party loans.

Authorization of Banking Institutions and Financial Groups

Bank authorizations are granted and may be revoked by SHCP as dictated by the *Law of Credit Institutions* and the *Law to Regulate Financial Groups*.

The laws lay out the information that must be submitted to SHCP with a request for an authorization for a bank or a financial group. Although information on the background of the proposed shareholders is collected, neither the law, nor the regulators, explicitly state what depth of due diligence is performed.

New commercial banking organizations must meet minimum capital requirements as determined by SHCP and restrictions are put on dividends and the application of net profits. It is not specifically stated whether or not these minimum capital requirements are higher in the start up years when the institution faces increased risk of failure.

In order for SHCP to revoke a bank authorization, the bank must be in violation of one of seven specific clauses in Article 28 of *Law of Credit Institutions*. For other entities, SHCP must revert to the Articles of incorporation of that entity. Revoking an authorization results in the liquidation of the entity. Due to the complex legal process required to exit the system in this manner, SHCP has not used this power.

Conclusions and Recommendations

Authorization requirements for banks and financial groups are explicitly set out in the banking law. However, the depth of the review on the requests prior to authorization is not. As a result, the authorities are not bound to or accountable to the financial authorities for adequately assessing the backgrounds of those requesting the authorization.

Currently, authorization and supervision is not conducted by the same government agency, however, proposed new legislation would transfer the powers of authorization from SHCP to CNBV. Due to CNBV's involvement and experience in supervision of financial institutions and groups, it should possess more appropriate experience and knowledge to make authorization judgements than SHCP. This suggested transfer of powers is a positive step to improving the regulatory framework in Mexico.

3. CNBV

During the course of fulfilling our mandate, we were permitted access to all information at those banks which had been formally intervened. While some intervention was made available at CNBV, all non-intervened banks, our access was restricted in part by CNBV to information that was directly connected with the FOBAPROA programs entered into by such banks. Only limited access to financial information was made available at those banks which CNBV regards as having been intervened on a *de facto* basis. Consequently, our comments on the supervisory role performed by CNBV are necessarily limited to those actions taken by CNBV at the intervened banks.

In conducting this evaluation, we have undertaken an assessment of the timeliness and effectiveness of the supervisory actions undertaken by CNB/CNBV beginning in 1991. In addition, we have assessed the supervisory practices of CNBV in place for the period from 1995 to date and, in particular, we have commented on the evaluation of such practices and how they compare to international standards and practices.

In the evaluation, we have expressed some concern regarding the timeliness and effectiveness of supervisory actions taken in some banks. The capitalization initiatives taken by the banks have also been discussed.

We have also examined the evolution of the supervisory processes of CNBV and its actions from the period of weak banking supervision prior to the peso crisis in 1994, to the supervisory practices in place at the time of this report. CNBV has made substantial progress during this timeframe and key supervisory improvements have occurred, however, further developments are required, particularly in respect of the development of intervention criteria and internal performance measures.

The evaluation takes into consideration three distinct periods:

- 1991-1994, that covers the period between the privatization of the Mexican banking system and the appointment of new management at CNB;

- 1994-1996, that covers the period between the appointment of new management at CNB and the end of the peso crisis (by the end of 1996, the Mexican banking system was no longer in danger of collapsing due to the effects of peso crisis); and

- 1997-1999, that covers the period between the end of the peso crisis and June 1999 (the time of the preparation of this report).

- Each of these three periods is distinct in so far as the general state of the banking system is concerned and the performance by CNB/CNBV of its supervisory obligations.

The following table depicts the status of these two issues in each period:

Table 1

Period	State of the Banking System	Supervisory Performance of CNB/CNBV
1991-1994	Extremely weak	Ineffective
1994-1996	Systemic crisis due to the peso crisis	In transition
1997-1999	Still weak, despite some improvements	Capable

BACKGROUND

The following provides the context for the evaluation of CNB/CNBV and is divided into the three distinct periods, as mentioned above.

1991-1994

In the period preceding the peso crisis, the Mexican banking system was already very weak. One of the underlying causes of such weakness was the process of privatization of the banks in 1991, which contained a number of serious flaws.

The Mexican authorities maintain that the procedures followed during the course of privatization were sound. For instance:

- the financial authorities consulted with an investment bank regarding the process and hired two consulting firms to do due diligence in each of the banks;
- each potential bidder hired an investment bank to assist with due diligence;
- a screening process was performed by SHCP; and
- the banks were sold to the highest bidder.

However, this process had a number of weaknesses (some of which are identifiable with the benefit of hindsight). New bank authorizations were issued to individuals with no experience in banking who were subsequently shown to have been unsuitable as owners. Because transparency was considered paramount by SHCP, existing authorized banks were auctioned off to the highest bidder. There were inadequate processes in place to check the background of prospective owners and senior management of banks. The acquirers themselves had little opportunity to perform adequate due diligence on the bank portfolios that they were purchasing. Even though there was a six-month adjustment period in place, buyers in general, did not determine true portfolio values. In addition, in 1994 under NAFTA, the banking market became more competitive, a situation that new bank owners did not expect. The concept of "moral hazard" was very significant at this time. This environment created an atmosphere that was vulnerable to fraud.

The privatization of banks was carried out with considerable optimism and with high expectations of economic prosperity. This optimism led to an increase in the granting of loans between 1991 and 1994. This credit expansion, undertaken for the most part by inexperienced personnel, led to a decline in asset quality, an increased exposure to risk and a steady increase in past due loans. As a result of inexperience in lending, the provisions for losses recorded by the banks proved inadequate. Although aggregate loan loss provisions increased from 1991 through 1993, the ratio of provisions to past due loans actually decreased.

During the post-privatization period, the banking system was operating at capitalization levels that were below the levels suggested by international standards and well below the levels that would be appropriate considering asset quality. High provisioning requirements existing in the loan portfolios were apparently undetected in all the banks.

In addition to the deterioration in asset quality and the resulting capital deficiencies arising from the banking crisis, a significant number of fraudulent activities and other irregular operations were undertaken by many of the banks.

A combination of some or all of the above factors could quite clearly have caused significant problems for the Mexican banking industry. However, when one adds to them inadequate banking supervision and enforcement, and weak monitoring guidelines and procedures, conditions were ripe for a banking crisis in Mexico to occur.

The large-scale privatization that followed the old regime of nationalized banks was not supported by a complimentary bolstering of regulatory supervision, the need for which is much greater in a privatized environment. CNB supervisors had neither the experience nor the prudential regulation to regulate the newly privatized banks. The information gathering by CNB was outdated often making the information on which it relied redundant. The validity and reliability of such information was an additional issue.

1994-1996

The peso crisis occurred at a time when the banking system was already very weak. The effects of devaluation, extremely high interest rates, a sharp drop in real wages and a temporary contraction of the economy, affected the banks in two ways. It increased loan defaults and sharply reduced new lending.

Prior to the devaluation that occurred as a result of the pesos crisis, CNB was placed under new management which then began to investigate the real situation in the banking system. However, the peso crisis turned the attention of the financial authorities and they became preoccupied with preventing the complete failure of the banking system.

During the banking crisis, CNBV was operating in a legal environment that made it difficult for the effective enforcement of regulatory action. The legal system in Mexico did not forbid shareholders to borrow funds to purchase shares of banks, using shares as collateral. Related party lending limits were frequently exceeded, despite legislated limits, and related party loans were often traced to share purchases. The enforcement of collateral was ineffective. Historically, irregular banking activities in Mexico were rarely penalized. Prior to taking control of a bank, shareholder approval was solicited to avoid future legal problems, as had occurred in Cremi and Union . However, in the case of irregular activities, this was not a consideration and in some cases, legal proceedings had begun against management and key shareholders at the time of intervention.

The collection and foreclosure process in Mexico is very lengthy under existing legislation and impedes the ability of creditors to enforce their security. As the banks cannot effectively pursue debtors, over time it becomes increasingly difficult to stop potential good quality loans from deteriorating.

1997-1999

Progress was made towards the improvement of the banking system, for instance, through the reduction of the number of banks, the resolution, in general, of further asset deterioration, and the strengthening of accounting principles.

In addition, CNBV has been developing into a capable supervisory body. Accepted international practices have been implemented and its surveillance monitoring systems are advanced.

The banking system is still weak. The main issue affecting its condition is the asset quality problem that originated in the 1991-1994 period (and in the case of mortgage portfolios even earlier), and was never fully addressed.

Part of this problem is related to the bank and debtor programs that were introduced during the peso crisis. These programs managed to stop asset deterioration in the banks and partially addressed the asset quality issue through the removal of poor loan portfolios from the financial records of the banks. However, some of the balance sheet items may require additional provisioning that the banks have still not addressed adequately. These elements include:

- adjudicated (repossessed) assets;
- loan loss sharing on portfolio purchases; and
- mortgage loans restructured in UDIs.

International financial markets recognize the asset quality problem and continue to penalize the Mexican banking system with low ratings.

The weaknesses in the Mexican legal framework have also not been yet resolved. The banking system will continue to be affected by these weaknesses until the needed legislative and structural changes are made.

Supervisory Actions Taken by CNBV as a Result of the Banking Crisis

In order to put our comments in perspective and to recognize the limitations of our review, the following analysis of the relative significance of intervened, *de facto* intervened and sold banks to the total banking system compared to the total fiscal costs of the banks' bailout has been made.

Based on December 31, 1994 financial information, the twelve legally intervened banks represented approximately 12% of the total assets of the banking system. The estimated fiscal costs associated with these intervened banks is approximately 35 % of the total direct FOBAPROA fiscal costs.

In addition, there are four *de facto* intervened banks (Atlantico, Bancrecer, Promex and Serfin), which represented approximately 23% of the total assets of the banking system and an estimated 36% of the fiscal costs. There are also four banks which, without being intervened (Bancen, Inverlat, Mexicano and Probursa), were sold and represented 18% of the total assets of the banking system. These sales were accomplished at an estimated 21% of the fiscal costs.

Preliminary Supervisory Steps

In addition to its regular examination and surveillance activities, there were a number of other supervisory actions available to CNB for dealing with the impact on the Mexican banks of the peso crisis. CNBV undertook a number of supervisory actions on financially troubled banks prior to intervention. The supervisory steps taken (excluding the legal intervention actions) included:

- appointment of another bank to take control of management and merge operations;
- permanent supervision put in place at the bank;
- reporting structure of internal audit directly to CNBV;
- appointment of a quasi-intervenor to act as a second CEO of the bank;
- replacement of management;
- request to the bank to look for a strategic partner;
- supervision and/or suspension of money market activities;
- suspension of the authorization of the leasing and factoring companies;
- requirement for CNBV approval of transactions and loans;
- CNBV staff on-site permanently;
- approval requirements from CNBV for banks to issue dividends;
- CNBV requests for corrective actions; and
- close monitoring.

Interventions

Types of Intervention

The *Law of Credit Institutions* provides CNBV with the authority to carry out an administrative or a management intervention.

An *administrative* intervention is carried out when CNBV finds evidence that the financial institution or the controlling company has committed serious irregularities in violation of financial legislation. CNBV may first order that the operations be normalized within a specified time period. An intervenor will be appointed if the operations are not normalized, however, shareholders maintain management control of the bank. The intervenor is responsible for suspending, normalizing or resolving the irregular activities that have been detected.

A *management* intervention is declared when irregularities are discovered which may jeopardize the stability and solvency of an institution, where it is no longer possible for the shareholders to meet the capitalization requirements, or where the interests of the public or of the creditors are endangered. The purposes of the management intervention are to protect the interests of the depositors and creditors of the institution, to restore normality to operations, and to achieve the final outcome for the bank. The approval of the board of governors of CNBV is required to proceed with a management intervention and the president of the CNBV appoints an intervenor who is responsible for managing the intervened institution.

In addition, we were informed by CNBV that, with the agreement of SHCP and the Bank of Mexico, it may carry out an informal *(de facto)* intervention in which senior management of the bank is replaced by CNBV management appointees who report to CNBV, or the bank is managed by another bank with CNBV's approval.

<u>*Role of Intervenors*</u>

The following processes have been determined by CNBV, based on its experiences over the past five years, to be important in achieving a successful intervention:

- professional intervenors should be hired, avoiding the use of the same banks' personnel;
- the intervenor should be well paid, and should propose a scheme of appropriate performance-based incentives, to be approved by the authorities;
- an advisory board formed by the intervenor should be used to provide guidance and control rather than the intervenor acting as the sole administrator;
- good and bad assets should be identified as soon as possible; and
- the intervention should be completed within the shortest possible time.

The main tasks of the intervenor should include:

- developing objectives to make the bank viable;
- making operations transparent;
- improving efficiency, reducing operating costs and management overheads;
- evaluating the long-term viability of the bank;
- interrupting irregular transactions, or transactions that do not comply with sound banking practices;
- performing the functions of the bank's board of directors and the president;
- analyzing the costs of liquidation, or sale of the bank or branch network;
- understanding and evaluating the problems in the bank and devising appropriate corrective measures; and
- achieving the final outcome for the bank (such as the sale, partial sale of branches or liquidation).

In order to minimize the operating costs of the financial institution, intervention procedures include requiring the intervenor to:

- obtain and verify a provisional balance sheet at the date of intervention;
- take control of management information systems and easily marketable assets;
- inform the institution's officers of their responsibilities;
- evaluate, and if necessary, revoke the institutional powers to take actions related to management, procurement, litigation, etc.; and
- evaluate the quality of the portfolio, establishing its degree of soundness and liquidity, and estimated term for recovery, including cash flows.

Appointment of Intervenors

The selection of intervenors is important given the level of responsibility, care, skill, prudence and diligence required to fulfill the objectives of the position. The main criteria for selection is their previous experience, performance, integrity, and availability to carry out the job.

CNBV aims to ensure that the appointed intervenor does not have present or past connections with the intervened bank and is independent to carry out the role of an intervenor objectively. However, in the cases of Industrial (CNBV had previously changed management) and Obrero, the previous director generals of the banks were appointed as intervenors. According to CNBV, this was done to maintain continuity in the bank. However, this practice poses a potential conflict. The replacement of senior management in all cases would be more appropriate.

Intervenors are paid by the banks at a rate based on the second level of bank management i.e. one level below the director general. Intervenor costs are borne by the intervened institutions.

Criteria for Intervention

The SHCP policy at the time of the crisis was that financially troubled banks would not be allowed to close due to the possibility of systemic damage and loss of investor confidence. Prior to intervention, CNBV considered the views of SHCP, the Bank of Mexico, FOBAPROA and the Executive Power. In addition, the financial authorities needed to take into consideration the financial markets and the general economy.

Intervention at the time of the crisis was not based on specific criteria. Had minimum insolvency levels (such as lack of capital) been used as the intervention trigger, all the banks would have been intervened due to the effects of the crisis. According to CNBV, its experience suggests that intervention is the most costly alternative, thus, system-wide intervention would have resulted in further inefficiencies and market deterioration, resulting in much higher fiscal costs. As a result of this view, intervention was used by CNBV as a last resort in the banking resolution process, for the sake of cost minimization and market stability. However, no evidence has been made available that establishes that intervention is the most costly alternative in all cases. It might well be argued that maintaining ailing banks for a number of years is more costly than immediate closure.

We believe that, in general, the costs of supporting an ailing bank are more expensive than a timely closure. The impact of continuing operating costs and portfolio deterioration will continue to drain an ongoing bank. While these costs might be justified if debtors refuse to meet their obligations in circumstances where the government owns the bank, in cases of intervened banks which we have reviewed,such an experience was not apparent. Also, in other intervened banks, debtors had stopped paying prior to intervention.

In the case of one bank, outside professional accountants estimated the cost to recapitalize the bank to be approximately MN $11,000 million in 1995. Allowing for inflation, this would be approximately MN $25,000 million in current terms. This bank was not closed and the current estimated cost to FOBAPROA to recapitalize the bank is more than MN $50,000 million. The main reasons for the increase in recapitalization costs are continuing net operating costs and further deterioration of the 1995 loan portfolio. This suggests that allowing ailing banks to continue increases the costs of supporting them. Further, in the case of another bank, FOBAPROA support was granted even though the CNBV viability study clearly indicated that the bank was not viable under any circumstances.

CNBV has no specific documented criteria as to when a bank should be intervened, other than the general criteria included in the legislation. CNBV (and CNB before it) should have developed specific intervention criteria to promote awareness and enhance the disclosure of the system of intervention for the banks it supervises. Among others, criteria should include the following risks to the financial viability or solvency of the banks which could deteriorate into serious problems if not addressed promptly:

- ability to meet capital requirements;

- deterioration in asset quality or value;
- detection of irregular activities;
- undue exposures to off-balance sheet risk;
- poor earnings or operating losses or questionable reporting of earnings or expenses;
- poor liquidity management or low level of accessible liquidity;
- unsatisfactory management quality; or
- other concerns arising from rapid growth, non-compliance with regulatory requirements, credit rating downgrades, systemic issues, or a financially weak or troubled owner.

The objective of the intervention process should be to identify concerns early and intervene effectively to minimize problems and additional losses to depositors and other creditors of the bank. CNBV (and CNB before it) should have put in place appropriate monitoring procedures. It could link its existing MACROS ratings into specific intervention actions. Different stages of institutional health could be developed ranging from no problems to non-viability/insolvency imminent and appropriate regulatory steps developed. CNBV currently has in place a number of processes to ensure that corrective actions are taken by banks. These could be codified into regulatory steps for each intervention stage.

Recognizing that each bank's problems are unique, the intervention steps should be flexible in order to allow for divergence as long as it is justified and properly documented. Further, a system that protects all creditors, as is currently the case in Mexico, requires flexible intervention criteria. Circumstances can vary significantly from case-to-case, and criteria developed should not limit the scope of action that may be taken by CNBV in dealing with specific problems or institutions. It is important to note that intervention criteria is not a rigid regime under which every institution or every situation is necessarily addressed with a predetermined set of actions.

Timeliness and Effectiveness of Supervisory Actions

Prior to 1994, problems arose in many of the banks that remained undetected by CNB until the supervisory regime was strengthened. At that time, CNB had an inadequate surveillance system which was unable to detect problems in a timely manner. Consequently, the main sources for the subsequent identification of problems by CNB were often the financial markets and rumors, even though some issues were uncovered during on-site inspection visits. Many problems stemmed from the lack of oversight of a flawed privatization process, weak supervision and a lax regulatory and legal environment.

This failure to detect problems in a timely manner has resulted in additional costs since, in most cases, irregular operations continued for a substantial period of time resulting in the ultimate losses being considerably higher that they would have been had the problems been detected earlier (e.g. in the case of several banks such as Capital, Inverlat and Union, irregular lending occurred immediately following the change in ownership). As previously described, CNBV undertook many supervisory actions on financially troubled banks. In some cases, these preliminary supervisory steps were effective. The problems were regularized and prevented from worsening or the banks were sold (e.g. Bancen, Mexicano and Probursa). However, in a number of cases, the preventative steps taken, including shareholder commitments, failed to materialize in full (e.g. BanCrecer, Capital, Confia and Promex). The irregularities detected by CNB in Union in July 1993 should have prevented Union's shareholder from acquiring Cremi in late 1993. In the case of Obrero, bank officials stated that although there was permanent CNB on-site presence between 1992 and 1994, the two supervisors were not involved in the management of the bank, and generally, had little impact.

CNBV's position is that intervention should be used as a last resort. In the cases of Bancen, Inverlat, Mexicano and Probursa, sales were made without requiring intervention. In other cases, intervention was delayed while sales were attempted, due to the necessity to obtain appropriate evidence for intervention or while attempts were made to have shareholders raise capital. Furthermore, CNBV was concerned about potential lawsuits.

Key problems in the banks that could have led CNBV to commence intervention actions were as follows:

- non-compliance with net capital requirements;
- cross lending and related party lending not classified as overdue, leading to inadequate preventive provisions;
- exceeding the maximum financing limits pertaining to related loans;
- non-compliance with required corrective actions;
- large overdue loans;
- high funding costs;
- lack of liquidity;
- decline in cash flows and profits;
- irregular or fraudulent activities; and
- contagion risk resulting from problems identified in an associated brokerage house.

Of the twenty-four banks subject to review, twenty-two lacked capital and a similar number demonstrated a lack of adequate reserves for loan losses. Of these, twelve banks were subject to management intervention. In the twelve non-intervened banks, similar problems were identified by CNBV, however, CNBV believed that the problems were less severe. In Serfin's case, it appears that the deciding factors against intervention were the size of the bank (this was the third largest bank in the system and there were concerns that its intervention may cause a systemic crisis; in addition the size of the bank precluded the sale of foreign interests), and CNBV's confidence that the bank's new management could resolve the problems. There has recently been announcements in the public press that IPAB will recapitalize Serfin with approximately MN$ 130,000 million.

The common problems that were identified in the non-intervened banks were a lack of capital, inadequate loan loss provisions, non-recoverable loans to shareholders and administrative deficiencies. Out of the twelve non-intervened banks, four were sold (Bancen, Inverlat, Probursa and Mexicano), two are awaiting sale (Atlantico and

Promex), four are currently operating (Banamex, Bancomer, Banorte and Bital) and two remain with significant problems (BanCrecer and Serfin). Atlantico, BanCrecer, Promex and Serfin were subject to *de facto* intervention.

On BanCrecer and Serfin, subsequent to 1996, CNBV maintained continuous supervision. Although some capital was injected and lending operations ceased in 1995 in these two banks, it should be noted that the financial condition of both banks has deteriorated significantly over the past five years.

When looked at in totality and considering the entire banking system, two factors mitigated against taking pre-emptive action: the banks had recently been privatized and it was perceived by the financial authorities that wholesale intervention would be regarded as renationalization, which was apparently not a desirable option. CNBV has stated that the government did not have the financial resources to support all banks without affecting the fiscal policy of Mexico. In our view, failing to protect every one of the banks would not necessarily result in renationalization. Further, with respect to the necessary financial resources, it appears that over MN $600,000 million of resources has already been committed to the banking system.

Accordingly, other strategies were implemented to assist the banking system including:

- increased supervision in each bank;
- a merger or a change of control was sought, as was the case with Probursa-BBV, Mexicano-Santander, Bancen-Banorte, Inverlat-Bank of Nova Scotia, Promex-Bancomer and Atlantico-Bital;
- implementation of corrective measures;
- bank capitalization through loan portfolio purchase programs; and
- implementation of debtor programs.

After the interventions of Cremi and Union, CNBV's position was that intervention was very costly. It appears that the reason why the interventions were costly is primarily due to the corrupt practices at these banks before intervention rather than due to the intervention policy itself. It was initially decided that only those banks with irregular activities and those in which the shareholders had no other alternative but to give up the bank due to deep insolvency, would be formally or *de facto* intervened. In those banks where management performance was viewed to be acceptable, two strategies to save the bank were considered: shareholder initiatives to inject additional capital; and a change in control while continuing operations.

During the crisis, brokerage houses also had severe financial problems, which tended to be supported by the group to the detriment of the associated bank. This was the case with Anahuac, which was intervened to avoid any risk of contagion resulting from illegal transactions and pending law suits against its related brokerage house. Further, the financial group to which Pronorte belonged was intervened due to irregularities detected in its brokerage house. Among other factors, the intervention of this bank was later carried out to establish an official presence, thus, avoiding problems with the minority shareholders.

There were three primary reasons for financial group interventions:

- to prevent the existing shareholders from withdrawing value from the group (Banpais, Cremi, Pronorte and Union);
- to prevent contagion effects on the bank; and
- to minimize inter-group loans as a means of reducing capital in the group.

Since there was no specific intervention criteria, other than that provided by law, this made the intervention process more difficult to explain to other government bodies.

As shown below (Table 1), of the twelve banks formally intervened, six were intervened in less than one year after the problems were identified by CNB/ CNBV. Formal intervention within twelve months of problem identification is not necessarily an unreasonable period of time for regulatory authorities to gather enough evidence in order to take the necessary legal action. The six remaining intervened banks had a longer time span to intervention.

Table 1

Dates of Intervention				
Bank	**Problems Identified**	**Date Intervened**	**Time Span (months)**	**Summary of Supervisory Actions Taken Prior to Intervention**
Anahuac	Mar-96	Nov-96 (Mgmt)	8	The bank was granted a bank authorization in Mar-95. CNBV identified unacceptable credit granting procedures and weak loans to related parties in Mar-96. Permanent supervision began in Jun-96. Proposals provided by the shareholders to capitalize the bank were not successful. delaying the intervention.
Banpais	Sep-94	Mar-95 (Mgmt)	6	CNBV requested correction of bank irregularities involving the extension of loans to shareholders of the group to purchase stock of the group, and the extension of other related party loans. The bank manipulated the issues raised by CNBV to make it appear that the irregularities had been corrected. The group was intervened in Mar-95.
Capital	Oct-94	May-96 (Mgmt)	19	Lack of capital was not detected until Oct-94, despite capital deficiencies from the banks' inception in Aug-93. Shareholders failed to meet the capital injection requirements within the stipulated time frame. CNBV instructed the bank to reduce related party loans in June-95, however, management failed to comply.
Confia	Mar-94	Aug-97 (Mgmt)	41	In Oct-95, CNBV required the majority shareholder to inject new capital. Negotiation continued to May-96. Custodianship of the bank began after Aug-96. The majority

				shareholder presented several non-viable capitalization options to CNBV to gain additional time. Capitalization commitments went largely unfulfilled. An external consulting firm was hired to look for a strategic partner. However, no one was interested in a minority interest. CNBV ordered the bank to search for a controlling partner. The original plan was to sell the bank to Citibank without performing a management intervention. CNBV did not believe fraud was a concern at that time. Negotiations were nearing completion when the transfer order for US $80 million to offshore companies was detected by the internal auditors at Confia, who were at that time, reporting directly to CNBV. When evidence was gathered the management intervention was triggered.
Cremi	Feb-94	Jul-94 (Admin) Sep-94 (Mgmt)	5 7	An administrative intervention was declared in Jul-94. CNBV delayed the management intervention to compile evidence in order to commence legal action against the bank's major shareholder and senior management. The management intervention of the group was declared in Sep-94.
Industrial	Jun-96	Feb-98 (Mgmt)	20	CNBV detected loan irregularities in 1996, however, no action was taken by the bank to correct these operations. Permanent CNBV supervision was in place starting in early 1997. Most of the debtors of the bank were in FOBAPROA trusts with other banks. Several unsuccessful attempts to sell the bank to foreign investors in 1996/1997 delayed the intervention.
Interestatal	Mar-95	Sep-95 (Mgmt)	6	Time was given to shareholders in Jun-95 to inject new capital into the bank, which had originally been obtained from loans granted by Nafin S.A. CNBV discovered the new capital was obtained from cross credits obtained from Banpais, an intervened institution.
Obrero	Oct-91	Nov-95 (*de facto*) May-97 (Mgmt)	49 67	Irregularities were first discovered by CNB in 1991. In Nov-95, FOBAPROA became the majority shareholder and bank management reported to CNBV. CNBV essentially had control of the bank from this point forward. The fact that Obrero was once a trade-union owned bank, impeded CNBV from performing an intervention prior to May-97.
Oriente	Feb-95	Oct-95 (*de facto*) May-97 (Mgmt)	8 27	In Mar-95, CNBV required shareholders to inject additional capital in the bank. Shareholders were unable to meet the requirements, thus FOBAPROA injected the capital, assuming 99.9% of the shares. CNBV changed the management of the bank in Oct-95. Management intervention was not declared until May-97.

Pronorte	Dec-94	Jan-96 *(de facto)* Nov-96 (Mgmt)	13 23	Supervisors representatives were appointed in the group in Jan-96. The financial group was intervened in Nov-96 because of problems detected in the brokerage house. It was determined that the group would not be able to repay a loan granted by FAMEVAL in 1994 for which the group's shares were given as collateral. At this time, CNBV replaced the management in the bank to prevent contagion risk. The bank was intervened in Sep-97 to avoid contagion and to establish a legal presence, thus avoiding problems with minority shareholders when trying to sell the bank.
Sureste	Jan-95	May-96 (Mgmt)	16	Problems were first detected in the group's brokerage house. FAMEVAL granted a loan to the brokerage house which could not be repaid because of the high interest rate and penalty charges. The bank was intervened to prevent contagion risk.
Union	Jul-93	Jul-94 (Admin) Sep-94 (Mgmt)	12 14	Problems were initially detected by CNB in Jul-93. An administrative intervention was declared in Jul-94. CNBV delayed management intervention of the group by two months to compile evidence in order to commence legal action against the bank's major shareholder and senior management.
Total: 12			Average: 17 Months	Average is based on the earliest intervention date.
Source of information: CNBV				

In many situations, resolutions to the problems identified were not timely. According to CNBV, no intervention has been unnecessarily prolonged.

This regulatory forbearance by CNBV was in part a measure to retain confidence in the Mexican financial system. However, Mexico should have moved away earlier from a determination to rescue all financially troubled banks toward a more selective approach that would have targeted the most viable banks for future financial support. CNBV should continue to act proactively to encourage the liquidation, merger, sale or foreign participation in Mexican banks.

Evaluation of the Performance of Intervenors

The intervenors were appointed by CNBV, which is responsible for their actions. Accordingly, CNBV is accountable for their performance. Intervenors have little decision making authority. In this evaluation, therefore, any comments relating to the performance of the intervenors are a reflection of the quality of the monitoring and supervision activities of CNBV as related to the intervenors.

The evaluation of the performance of the intervenors is difficult, primarily due to:

- lack of specific performance targets;
- non-quantitative nature of the work performed; and
- different problems and circumstances at each of the banks, requiring different corrective measures.

Furthermore, it was only after a period of time subsequent to the intervention and after the operations of each bank had been thoroughly reviewed, that the extent of each banks' problems was revealed.

In some cases (Banpais and Union), the intervenor made efforts to improve the internal control systems and hence costs were incurred (while efforts were made to sell the problem institution), even though it was clear that the bank was eventually going to be liquidated or sold. One of the reasons stated by a number of intervenors for prolonging the intervention was the extended wait for IPAB to be set up.

Although significant staff reductions have been achieved by intervenors in some banks that are in the process of winding down (Oriente 84% and Obrero 92%), in other cases, a large number of employees remain employed by the banks awaiting liquidation. For example, Pronorte has a portfolio of only nineteen loans, but has fifty-three employees who are also working in the brokerage house. Cremi and Union have no branches, and have 1,900 employees, but share certain activities with two other intervened banks (Obrero and Oriente), and employ approximately ninety internal auditors, performing a variety of functions. In addition, BanCrecer still has 7,000 employees out of an original number of 9,000 and is awaiting IPAB resolution.

If the intervened banks were found to have little value as a going concern, the authorities should become more proactive in loan realization actions. It has been shown that few formal business plans are in place to proceed with loan realization (e.g. Cremi, Obrero and Oriente). A formal business plan with clearly defined targets for the realization of assets is necessary to assist in this process. Bank management needs targets, deadlines and incentives to promote speedy recovery efforts, as well as the appropriate legal framework.

Based on reviews of the banks, financially troubled banks are not being downsized effectively (i.e. loans have been slow to liquidate). Part of the reason for the poor recoveries in the intervened banks can be attributed to the lack of direction provided to the intervenors and the fact that FOBAPROA does not have direct access to the intervened banks.. As a result, the recovery process is not managed operationally. In the case of Banco Capital only seventy-five loans have been collected out of 525, since May 1996. In some banks, the intervenors were changed on a number of occasions as a result of the changes in the strategy of CNBV. For example, Cremi, Obrero, Oriente and Union shared the same intervenor. The intervenors were changed four times with the final change resulting in each bank having its own intervenor. The constant change in intervenors affects the recovery efforts and the direction provided to bank management and staff.

In the cases of Obrero, Oriente and Promex, loan recoveries substantially increased once the loan realization activities were transferred to a different entity. This demonstrates the ineffectiveness and the costs of delaying the resolution of the asset disposal process partially due to the shortage of professional liquidators.

Some measures taken by the intervenors have been effective, including actions relating to the sale or merger of some banks and branches. However, when evaluated against the key objectives of an intervenor, which include achieving the final outcome for the bank and completing the intervention process within the shortest possible time, improving operational efficiency and reducing operating costs, the intervenors' execution of their duties could have been better. CNBV considers that the intervenors carried out their functions in an efficient and effective manner.

In some situations, there was little that could be done by the intervenors. The complex problems involved and the failure of the bank owners to fully implement corrective measures and live up to their commitments, especially to inject new capital, combined to prevent the intervenors from accomplishing their key objectives. Further, a general lack of experienced intervenors existed in Mexico from which CNBV could draw. Experienced intervenors may substantially reduce intervention costs. The intervenors were not professional liquidators; some receive inadequate pay for their duties and responsibilities; and no legal protection is provided for intervenor actions, which places intervenors at personal financial risk.

Although the circumstances faced were complex, the intervenors' actions could have been more proactive in the liquidation of the financially troubled bank loan portfolios and the resolution of the final outcome for each bank. The intervened banks which were considered sale candidates did not have contingency plans in place should proposed deals or purchase agreements fall through. For the banks still awaiting resolution from IPAB, operating costs in excess of revenues have continued to accrue (e.g. BanCrecer has currently total monthly costs of MN$ 2,500 million).

Sales of Banks and Branches

The decisions to sell or liquidate banks after management intervention were made by FOBAPROA's Technical Committee. CNBV, SHCP and the Bank of Mexico were involved in assisting with the sale of intervened and other banks to foreign banking institutions.

In some cases, foreign banks were turned away because the majority shareholder did not want to relinquish control of the bank, or the foreign bank was not economically strong.

The decision of the financial authorities to sell the branch networks of some banks under FOBAPROA programs, was based on the following objectives:

- preservation and continuity of the payment system;

- continuation of banking services;
- avoidance of the accumulation of power or market share;
- avoidance of staff reductions in sold branches;
- reduction of staff and costs in financially troubled banks;
- strengthening of competition in the banking sector;
- rendering of bank services to the private sector; and
- consolidation and strengthening of viable banks.

The financial authorities were successful in arranging the sales of branches of financially troubled banks to operating banks on three occasions (BBV acquired Cremi and Oriente branches, and Afirme bought Obrero branches). However, in two instances, branches were eventually sold to other troubled banks (Promex purchased Union branches and Atlantico purchased Interestatal branches). The sale of branches from financially troubled banks to other problem banks may ultimately increase the costs of the crisis, since the operating costs of the financially troubled banks will increase without necessarily producing profits. It has been noted that the administrative expenses of the Promex-Union transaction exceeded the income generated by the branches. CNBV and FOBAPROA stated that this sale was to increase the size of Promex, allowing it to become more saleable.

Status of the Banks as at June 30, 1999

The following (Table 2) summarizes the current status of the 24 banks covered in the review.

Table 2

Status of the Banks as at June 30, 1999

Bank	Operational	Management Intervention	Branches Sold To	Bank Managed By	Bank Sold To	Current Status	
Anahuac	No	Nov-96				Waiting for liquidation.	•
Atlantico	Yes	No		Bital		Operating with problems, bank closely monitored by CNBV. Probable sale to Bital.	•
Banamex	Yes	No				Currently operating.	
Bancen	Yes	No			Banorte	Sold to and operating as Banorte.	
Bancomer	Yes	No				Currently operating.	
Bancrecer/ Banoro	Yes	No				Operating with problems, bank closely monitored by CNBV.	•
Banorte	Yes	No				Currently operating.	
Banpais	Yes	Mar-95			Banorte	Sold to and operating as Banorte.	
Bital	Yes	No				Currently operating. Purchase of Sureste and Atlantico contingent upon IPAB resolution.	
Capital	No	May-96				Waiting for liquidation.	•
Confia	Yes	Aug-97			Citibank	Sold to and operating as Citibank.	
Cremi	No	Sep-94	BBV			Waiting for liquidation.	•
Industrial	Yes	Feb-98				Operating with problems, bank closely monitored by CNBV. Sale to Banorte outstanding.	•
Interestatal	No	Sep-95	Atlantico			Waiting for liquidation.	•

Inverlat	Yes	No			Scotiabank	Sale of the majority shares to Scotiabank outstanding.	•
Mercantil Probursa	Yes	No			BBV	Sold to and operating as BBV.	
Mexicano	Yes	No			Santander	Sold to and operating as Santander.	
Obrero	No	May-97	Afirme			Waiting for liquidation.	•
Oriente	No	May-97	BBV			Waiting for liquidation.	•
Promex	Yes	No		Bancomer		Sale to Bancomer outstanding.	•
Pronorte	No	Sep-97				Waiting for liquidation.	•
Serfin	Yes	No				Operating with problems. Bank closely monitored by CNBV. IPAB will determine the plan of action for resolution.	•
Sureste	Yes	May-96				Sale to Bital outstanding.	•
Union	No	Sep-94	Promex			Waiting for liquidation.	•
Total 24	16	12	5	2	6		15

Note: Excludes Interacciones
• Banks waiting for IPAB to decide their sale, liquidation or restructuring.

In summary, the current status of the Mexican banks that originally fell under the FOBAPROA programs during the crisis period is (assuming the proposed mergers take place under IPAB), eleven operating banks, eight banks in the process of being wound down and five having been effectively merged.

Capitalization

Extent of Capital Injections

From 1991 to the onset of the peso crisis, the capital ratio of the Mexican banks was insufficient and its quality was questionable due in part to the accrual of interest on non-performing loans and the restructuring of loans that were treated as new loans. During 1994-1996, the capital levels requested by CNBV were much lower than the capital levels actually needed by the banks since their non-performing portfolios continued to increase and the need for additional loss provisions intensified. This was a clear example of the regulatory forbearance granted by CNBV. CNBV stated that the reasons for not requiring capital injections during the crisis period to the full extent of loss provisions required were as follows:

- asset valuations were done at a time of crisis (conservative valuations) and the values were expected to recover over the short-term;
- the Mexican banks' capital would be negative (except one), if the full extent of CNBV provisions were known and recorded;
- shareholder capital injections reduced the fiscal costs borne by the FOBAPROA trust, and if greater capital injections had been demanded the shareholders would have abandoned their investments; and
- the conservative inspection approach adopted in 1994 considered payment experience and financial soundness, resulting in capital deficiencies in all the Mexican banks, therefore, CNBV applied a dynamic approach, considering the cash flows of the banks under various scenarios, and providing a five-year window to correct the capital deficiency.

With regard to the loan security valuation issue, the use of potential future asset values is not a realistic or generally accepted approach to establishing values for the purpose of either establishing loan loss reserves or estimating capital requirements.

In the case of Confia, the diagnostic review performed by a professional accounting firm indicated capital requirements of between four and five billion pesos. However, the shareholders committed to an injection of only one billion pesos. This amount was agreed upon by CNBV. The criteria used by the accounting firm was more conservative than CNBV, and CNBV wanted the bank's shareholders to make a capital contribution rather than abandon the bank. CNBV thought the amount committed by the shareholders was enough to allow the bank to reach its equilibrium point (a zero capital base) within a five-year period.

In the case of another bank, capital deficiencies of five billion pesos were identified in June 1997. However, an immediate injection of only one billion pesos was requested by CNBV for the same reasons as stated for Confia.

Source of Funds

Prior to 1994, when capital was injected, the source of the shareholder funds was not always investigated by CNB. This was the case with Cremi and Union, where the shareholders used resources obtained from the bank through nominee companies. In the case of Banco Capital, capital deficiencies existed from the time of the bank's inception in 1993 that were not detected by CNB until the bank was under regulatory review in 1994.

Extensions

In some cases, extended periods of time were granted to bank owners to obtain financing and/or meet capitalization requirements, leading to higher eventual costs in the banks. The extensions granted to obtain the required capital levels were not granted on a consistent basis across all the banks. In addition, shareholders of banks prolonged compliance with CNBV corrective actions by requesting and receiving numerous time extensions. In the case of Banorte, for a portion of the capital, the deadlines were extended to September 1997. In December 1996, Promex's capitalization terms were extended to March 1997. In May, the terms were extended a second time, until June 1997. The capital requirements were never fully met by the bank's shareholders and as a result the shareholders interests were taken over by CNBV. In the case of Confia, CNBV requested the injection of capital in 1995. The shareholders' commitments were never fully met, and finally the bank was intervened in August 1997, and then sold and merged with Citibank in 1998. It is recognized that where partial injections of capital were made, they reduced costs to FOBAPROA.

Quality of Capital

Prior to 1995 there were requests for additional capital significantly less than the amount known to be required, the majority of the capital eventually paid into the banks was not necessarily new capital. It was, in many situations, capital coming from loans from the bank itself, or other banks and cross credits (e.g. Banpais, Cremi, Oriente and Union prior to 1994). In effect, very little if any new unencumbered capital was being injected into the Mexican financial system relating to those requests. In addition, Banco Capital and Interestatal were created using capital resources obtained from other Mexican financial institutions prior to 1994.

Capital injections under the agreements in respect of the loan purchase program were met in terms of quantity and various degrees of quality as allowed. According to CNBV, only 52% of the capital injections were fresh capital, 32% was from convertible debentures, 11% was from non-convertible debentures, 4% came from mergers with subsidiaries, and 1% of the funds came from resources from other subsidiaries within the financial group.

Capital Adequacy Calculations

As described in the evaluation of the overall regulatory framework, the calculation of capital adequacy for banks shows deficiencies. In many cases, capital has been strengthened for capital adequacy purposes, when there may not have been enough core capital in place to meet regulatory requirements.

It should be noted that CNBV is considering the following measures to improve the quality of capital in Mexican banks:

- obtain independent appraisals of fixed assets, primarily land and buildings to identify overvaluations;
- explore ways of reducing the ability to set up deferred income taxes;
- explore the use of financial instruments that are allowed in other countries for capital purposes, such as cumulative preference shares; and
- enact additional provisioning levels for loans.

Repossessed Assets

Many of the banks (e.g. Atlantico, Banamex, Bancomer, BBV, Bital and Serfin) transferred repossessed assets to the FOBAPROA trust. In exchange, the bank received promissory notes. This asset trust is to last for five years where upon unsold assets revertback to the bank and the bank takes all losses. Therefore, the program has no fiscal cost. The interest on the promissory notes was included in income, and the revaluation of those repossessed assets was included directly in equity. This transfer of assets for promissory notes, in effect, created artificial income and consequently equity, as the assets were still effectively owned, managed and eventually sold by the bank. Further, in most cases, the actual value of the repossessed assets was lower than the book value. These potential future losses are, in effect, contingent liabilities of the banks. This was an example of boosting the nominal capital levels of Mexican banks that was not supported by core capital injections. International markets have recognized this and generally discount capital for these assets.

Authorization to Issue Dividends

For the immediate period following the crisis, there were no requirements in place for banks to seek authorization from CNBV to pay dividends, nor to inform CNBV of such transactions. Some banks (Confia, Inverlat and Santander) paid dividends when they were under pressure to resolve capital deficiencies.

Since late 1996, banks have been required to obtain authorization from CNBV prior to paying dividends. No such approvals have been granted. In the case of Bancomer where unauthorized dividends were paid, a fine was subsequently levied by CNBV.

Conclusion

The banks entered into the peso crisis with a weak capitalization base which became even more exacerbated as a result of the crisis. During the 1995-1998 period, while more capital was injected into the system, it has been used to absorb operating and loan losses. At June 30, 1999, the banking system is still significantly undercapitalized, some of which is of questionable quality as discussed in the evaluation of the regulatory framework. Primarily for reasons beyond its control, CNBV has not been successful in ensuring that the banking system is adequately capitalized. The reasons for this include the reluctance of investors to inject additional capital into a banking system with a legal framework that protects the rights of borrowers, especially in an environment where non-payment of debt is acceptable.

THE EVOLUTION OF CNBV AND AN ASSESSMENT OF CURRENT SUPERVISORY PRACTICES

History of Supervision

In 1995, the merging of CNB and the National Securities Commission into CNBV was a positive step toward the supervision of the Mexican banking system.

During the nationalization period, the heads of the large banks were more powerful than the president of CNB, and CNB supervisors were out of date regarding supervisory practices. Consequently, a number of steps were taken to increase banking supervision and strengthen the regulatory framework. In April 1994, following the appointment of the new president at CNB, a substantial reorganization took place and an institutional development program was initiated to rationalize responsibility for on-site and off-site supervision, and to modernize the training of examiners and other staff. Implementation of the institutional development program also involved the hiring of a substantial number of new staff at the management level. Almost all of the current senior management team at CNBV were hired since 1994.

The Core Principles for Effective Banking Supervision, prepared by the Basle Committee on Banking Supervision in September 1997, which is considered to be the best practices standard adopted by financial institution regulators worldwide, were adopted, as well as the methodologies used by the U.S. Federal Reserve Board, the U.S. Office of the Comptroller of the Currency, and the U.S. Federal Deposit Insurance Corporation.

Prior to 1994, there is little evidence that banking supervision in Mexico had formal methodologies in place or that there were effective enforcement provisions. CNBV indicated that supervision was focused primarily on:

- accounting audits;
- non-compliance with formal regulatory limits resulting in the levy of fines; and
- loan portfolio analysis:
    - ratings based on the collateral, not on borrowers' creditworthiness or loan quality; and
    - reviews focused on documentation in the credit files.

There were no formal supervision methodologies that could provide an early warning as to the solvency of the financial institutions. In 1994, the CNB off-site and on-site examination departments were independent from each other with little communication between them. No formal examination procedures were in place, and monitoring processes were inadequate. Furthermore, no significant supervisory issues were identified as a result of the inspections and surveillance carried out prior to 1994.

After the second quarter of 1994, supervision became more proactive. In addition to the procedures listed above, the following supervisory processes, amongst others, were implemented:

- identification and measurement of risk assessments, based on market, credit and operational risk standards;
- review of internal controls;
- evaluation of transaction and information handling procedures;
- consolidated supervision;
- adoption of best practices obtained from international agencies;
- the use of standard procedures and examination methodologies, similar to the U.S. Federal Reserve Board and U.S. Office of the Comptroller of the Currency; and
- review of the external auditors' performance.

Starting in 1995, representatives from the U.S. Federal Reserve Board and other U.S. agencies spent 18 months assisting CNBV in the development of regulatory manuals. CNBV's supervisory processes over the past few years have been based on these manuals and their updates. Furthermore, the U.S. Office of the Comptroller of the Currency provided CNBV with enhanced procedures to perform on-site examinations.

As a result of the banking crisis, CNBV recognized the need for the development of supervisory initiatives that could effectively meet the challenges of a financial crisis as well as providing for a future supervisory structure and practices that would meet the rigors of international standards, and in turn provide effective protective mechanisms and confidence to the Mexican financial system and its depositors.

While the period 1994 to 1997 in Mexico was clearly a time of crisis management, Mexican regulators were successful in amending and improving measures aimed at strengthening regulatory procedures and self-regulation. Financial disclosure for banks was improved, the role and scope of external auditors were expanded, rating agency activity was favored, and the formation and use of credit bureaus was encouraged. The impact of these changes increased over time as the measures were implemented.

Information Gathering and Surveillance Techniques

Prior to 1994, most of the financial information obtained from banks was available only on paper. The databases of the different agencies were not centralized, and duplicate reports were produced, often containing inconsistent information. It would appear that more time was spent gathering the required information than was actually spent analyzing it. Monitoring and surveillance systems to detect problems in a timely manner were inadequate during this period.

Since the crisis, CNBV has made efforts to make the receipt and processing of information more efficient. Off-site surveillance and monitoring is now conducted using a red flag detection system to perform an analysis of the electronic financial information obtained from the banks as well as international and foreign operations.

Information gathering tools developed by CNBV include the following:

SAF (Financial Analysis System)
This is an institutional analysis and supervision tool that began development in mid-1994. It allows efficient use of CNBV's database for better and focused supervision, analysis and follow-up. This system is shared with SHCP, FOBAPROA and the Bank of Mexico and its users have worldwide remote access.

SITI (Inter-institutional Information Transfer System)

The SITI system allows for the integration, extraction, preparation, validation and delivery of information to CNBV. Information is received on a real time basis, increasing its reliability. It is expected that by the year 2000, SITI's coverage will be fully operational.

On-Site Supervisory Approach

During the second quarter of 1995, the "MACROS" supervision approach was fully implemented. This approach is based on the U.S. Federal Reserve Board's "CAMELS". The approaches used to apply the MACROS methodology include business processes, quantitative analysis, accounting processes and regulatory compliance.

The MACROS supervision methodology comprises the following six components:

1. Liquidity and Sensitivity Analysis

2. Capital Adequacy
3. Asset Quality
4. Earnings Quality
5. Management and Organizational Structure
6. EDP

In addition, specialized inspections and supervision are conducted as required in connection with specific or thematic problems (e.g. credit, capital markets, systems, etc.). A series of MACROS/CAMELS inspections was launched in every commercial bank in mid-1995. Deficiencies were detected across the board regarding internal controls, sufficiency of credit analysis, and management of liquidity and risk. On-site MACROS inspections are now carried out at least annually.

The CNBV Today

Currently, CNBV is responsible for supervising virtually all financial holding companies in Mexico, as well as banks, brokerage firms and other related intermediaries.

Regulatory systems cannot always prevent failures, but properly structured and maintained processes can detect unsound business practices which could lead to failures and increased fiscal costs. Effective supervision requires that comprehensive inspection procedures cover all aspects of the financial groups' operations (consolidated supervision) by skilled and experienced staff. While developments to the CNBV supervisory methodologies are under continuous improvement, significant progress has been made to date.

As compared to the pre-1994 period of ineffective supervision and inefficient and unreliable data gathering tools, CNBV is developing into a capable and effective supervisory organization that has in place advanced information gathering tools.

Staffing and Training

As previously mentioned, most of the CNBV current senior management team were hired subsequent to 1993.

Large investments have been made by CNBV to improve its supervisory processes and implement international best practices of supervision. Considerable steps have been taken by CNBV to recruit quality personnel, develop supervisory methodologies, monitoring tools and systems, and train staff.

Having the right staff is critical to CNBV's success. The ability to attract and retain highly qualified people who understand the institutions they regulate and are up-to-date as to industry developments is important as the industry continues to change. CNBV personnel receive training from three main sources covering all major technical and academic areas applicable to financial institutions. CNBV has in place an effective staff development program in keeping with the current risks facing the financial services sector.

Quality of Current Examination Processes

National Banks

The tools used in the supervision of domestic banks include on-site examinations, off-site surveillance and monitoring systems, external audits and bank specific authorizations and opinions. The output of the analytical supervision performed by CNBV includes timely information reports, performance and risk diagnostics, final examination reports, a copy of which is provided to the president and the board of directors of the institution, and corrective programs. The final examination report identifies all the findings detected during the examination under each of the MACROS areas, and provides a rating (1 to 5) for each area. The comments of bank management are also included. Sensitivity and scenario analysis is provided, as well as the financial position of the institution as compared to other banks in its peer group, and in the Mexican commercial banking system. These procedures are applied across all the banks without regard to size. Recommendations are provided, as well as proposed corrective programs. Deadlines to implement the recommendations and corrective programs are established with senior management. Periodic CNBV surveillance ensures compliance with the corrective measures. In the past, CNBV was more tolerant of delays in implementation, but this has now changed and deadlines are more strictly enforced.

An area for potential additional disclosure involves the CNBV's supervisory approach. This could be communicated to the financial institutions which would aid the banks in complying with regulatory requirements and taking corrective action prior to being notified or penalized by the regulatory authorities. A second objective would be to advise the public of CNBV's supervisory methodologies, which would instill confidence in its supervisory capabilities.

Based on the review of certain sections of the 1997/98 on-site examination files of Banamex, and the planning phase of the 1999 examination of Banorte, a risk based approach is being followed and the planning process is effectively carried out. Furthermore, documentary evidence is provided to support examination findings.

Consolidated Supervision

Controlling companies of financial groups that include a bank are subject to the inspection and oversight of CNBV. In addition, CNBV is empowered to review the bank as well as its related intermediaries, such as the leasing company, factoring company and foreign exchange house that are part of the financial group. A separate department within CNBV is responsible for the supervision of brokerage houses. Both departments work together to provide consolidated supervision of the financial group. The supervision of brokerage houses is carried out through an annual inspection program.

As described in the evaluation of the regulatory framework, improvements are required in the following areas of consolidated supervision:

- capital adequacy requirements for holding companies needs to be developed;
- regulations to limit overall group exposures are required; and
- fit and proper tests for significant shareholders and management of controlling groups need to be enhanced.

These deficiencies impeded the effectiveness of CNBV in the area of consolidated supervision. However, difficulties in calculating and enforcing capital adequacy requirements have been noted with respect to groups which include insurance and bonding companies due to accounting differences and the lack of authorized supervisory oversight by CNBV over these entities.

As referred to in the basis for evaluating the *Law to Regulate Financial Groups*, the controlling company is responsible for the debts of its financial subsidiaries. While we have seen examples of where bank funds have been used either directly or indirectly to support sister companies, with the exception of some consolidations of factoring or leasing companies into the banks, no examples were seen where sister companies' funds were used to support the banks. It is not clear whether CNBV has exhausted all possibilities of persuading controlling companies under this law of responsibilities.

Where a bank has loaned funds to a sister company which is either a factoring or leasing company and these companies in turn loan funds to outsiders, the loans to the sister companies are not regarded as related party lending by CNBV. These loans were made with bank insured deposits. We disagree with the CNBV position as the credit making decision for the third party loans is outside of bank control and the bank must look to the sister companies for repayment.

Supervision of Foreign Bank Subsidiaries

With the enactment of NAFTA in 1994, foreign banks with operations in Mexico were transformed into subsidiaries of foreign controlled banks. CNBV supervises these subsidiaries in the same manner as it supervises national banks. The subsidiaries are required to comply with Mexican banking regulations. CNBV performs on-site and off-site supervision of these banks using the same approach (MACROS) that is used to review national banks. In some cases, the reports resulting from the supervision are shared with the regulatory agency of the institution's home country. In certain banks, CNBV performs the inspection in conjunction with the foreign supervisors. To date, CNBV has participated in nine joint inspections of foreign subsidiaries. This provides CNBV with opportunities to gain exposure to the methodologies used by foreign agencies.

The foreign bank subsidiaries have found the Mexican financial market to be very challenging and high returns difficult to maintain. Accordingly, some banks have expressed a desire to leave the Mexican market. However, exit requirements for foreign banks have not been developed. CNBV is currently developing an exit process for foreign bank subsidiaries.

Specialized Supervisory Groups

There are three specialized supervision groups within CNBV that provide support to the inspection teams. Over the past five years, CNBV has developed strong and effective market and credit risk groups, and EDP specialists.

Market Risk

CNBV's market risk group was set up at the end of 1994 with the additional responsibility of supervising the international operations of Mexican banks operating abroad.

The market risk group performs ongoing assessments of the qualitative and quantitative standards of the risk management units in banks, based on international best practices (i.e. Basle Principles, G-30 and the U.S. Federal Reserve Board system). Since the risk levels undertaken by banks changes frequently, CNBV monitors market risk levels on a weekly basis.

Credit Risk

The credit risk group at CNBV monitors the credit portfolios of the Mexican banks. The group also has responsibility for supervising the credit bureaus in Mexico. CNBV is encouraging all banks to develop their own models for credit risk. CNBV has developed its own models for default probability, unexpected loss and insolvency prediction.

EDP Systems

The EDP specialist group was established in 1995 with only two staff (there are now seven). The EDP examiners participate in each bank examination as part of the team that generally involves five people for approximately one month. The EDP group has its own ratings for its systems review that helps feed into the overall systems rating.

Participation in bank examinations by the EDP group ended at the end of 1998 when the decision was made for the group to focus on the Year 2000 issue for the whole of 1999 and into early 2000. The Bank of Mexico is responsible for the financial sector conversion and CNBV is represented on the relevant committee. CNBV also has its own internal committee. The EDP group has been monitoring the progress made by Mexican banks in preparation for their readiness for the Year 2000.

Quality Control of the Examination Process and Post Mortem Analyses

Quality control is an essential aspect of an effective supervisory body. It enables the examination process to continually improve and provides assurance that internal standards are complied with.

CNBV should consider the development of post examination quality control reviews subsequent to bank examinations to ensure consistent application of supervisory methodologies and to identify improvement opportunities for the examination process.

There are many lessons to be learned by the supervisors from bank failures that can be utilized in the future to mitigate similar occurrences.

CNBV should carry out post mortem analyses of financial institutions that failed or were subject to distress sales, and use the experience to enhance regulatory practices.

Recent Developments Enhancing the Supervisory Effectiveness of CNBV

The financial authorities in Mexico have undertaken important steps to enhance information disclosure, security and efficiency of the financial system. The rationale behind these measures has been to achieve a more self-regulated, complete, and competitive system that promotes investment and saving. Some of these initiatives are discussed below.

Legislation

On March 26, 1998, new legislation was presented to Congress, which would strengthen the Bank of Mexico's autonomy and give CNBV greater autonomy and powers for banking supervision. The proposed new legislation changes the reporting structure of CNBV, which is currently a semi-autonomous branch of SHCP.

The intent of the new law is to provide more independence to CNBV, ensuring its actions are based on technical decisions rather than political decisions.

Prescribed Mexican Bank Accounting Standards

Some significant problems with prescribed Mexican bank accounting standards prior to 1997 were:

- continued accrual of interest on the principal amounts of overdue installment loans;
- accounting for only past due loan payments as past due, and not the corresponding principal amount;
- restructured loans classified as new loans;

- revaluation of real estate assets with inflation based on appraisals, with the revaluation surplus credited to equity; and
- no mark-to-market of the investment portfolio.

These factors resulted in the overstatement of bank profits and capital adequacy. New accounting principles issued in 1997 improved disclosure and accounting practices and represented a positive step towards more conservative accounting principles.

The most significant result of the changes in accounting principles related to income recognition from past due loans, and the accounting for past due loans. Compliance with the new accounting standards significantly impacted loan provisions. According to the accounting principles in effect in 1995, provisions constituted on average 43% of the past due loan portfolio. With the implementation of the new accounting principles in 1997, past due loan portfolios increased. As a result, the banking system required an additional 16.6 billion pesos of additional provisions to meet the minimum standards imposed in 1995. This represented 27% of the net equity in the system and an increase of 50% over the existing reserves.

The enhancements to prescribed Mexican bank accounting standards have improved the reliability and consistency of reporting by the banks, but steps must continue to be taken to further develop appropriate accounting principles that are internationally recognized (e.g. segmented information).

External Audit

There was little evidence that the external auditors of the banks reported any irregularities or solvency issues prior to the 1994 crisis, despite the requirement for the external auditor to report to the president of CNB any irregularities which could endanger the stability, liquidity or solvency of a commercial bank. Usually the banks external auditors were replaced at the time of intervention. Changes to external audit requirements of banks in 1995, were made to improve the quality of the work performed.

Circular 1222 establishes that, in addition to the auditors' reports on the financial statements, the auditors should comment on any irregularities observed in the review of the commercial banking institution that have not been corrected. A detailed description of the variations between the December 31 financial statements provided to CNBV and those published by the commercial banking institutions, as reported by the external auditor, is also required. The purpose of the additional information is to obtain an opinion on specific topics, such as the mark-to-market of financial instruments, the internal control systems for credit, derivatives, securities, foreign exchange and market risks, loans granted to purchase equity, the internal audit function, and management recommendation reports provided to the institution. Once CNBV receives the external auditors' reports, they are reviewed and compared with other sources of CNBV information. If discrepancies are found, the auditor is requested to clarify those differences. CNBV reviews the quality of the reports and the external auditor's performance is assessed using a rating scale from one to five (satisfactory to unsatisfactory). If CNBV has any questions concerning the work performed, it has the authority to review the auditor's working papers. CNBV does not have the power to remove the external audit firm, however, it can suggest changes, and can require a change in the lead partner.

The issuance of Circular 1222 was a major step in improving the quality of the workplan of the external auditors of banks. The ongoing review by CNBV of the compliance of the audit firms with the circular will help to ensure the maintenance of appropriate auditing and reporting standards.

Circulars

CNBV intends to issue a circular later this year that contains the minimum characteristics and attributes that must be followed by the boards of directors of financial institutions in order to strengthen the development of the banks. It is anticipated that this circular will require the financial institutions to report the results of the performance of the board to the market. Recently, a Code of Best Practices for Mexican companies was published. The new code will apply only to publicly traded companies. Further, it is not mandatory as this would require legislative changes. Strong corporate governance is important in all banks, and CNBV should encourage the early adoption of the code on a system-wide basis.

As previously set out in the evaluation of the overall regulatory framework, enhancements are required to the corporate governance processes within the banks, that will enable CNBV to better focus its supervisory activities on the roles and responsibilities of senior management and the boards of directors. Strong corporate governance is especially important where there is shareholder concentration.

A professional accounting firm is consulting on the circular relating to commercial loan classification and reserves, which changes the classification grading to seven levels, from the current five. This circular will replace Circular 1128, which established the methodology to classify the loan portfolios in 1991.

According to the CNBV credit risk group, the limit on large loan exposures currently being considered in a circular is 30% of the equity of the institution for single loans. The proposed limit appears to be reasonable.

The circular on institutional database sharing will include the credit bureaus, providing better credit and lending information about related parties and the information to monitor lending limits.

It has been noted that CNBV has continued to be proactive in the development of supervisory circulars.

Automation of Supervisory Processes

CNBV has developed, with the technical assistance of GE Capital, the Electronic Examination System (EES). This system was used in CNBV examinations in

October/November of 1998, and will be fully operational by August 1999. EES facilitates the sharing of information between the different supervisory departments by centralizing the information in a central repository.

Based on the review of the EES, its development is a positive step in completely automating the supervisory process at CNBV.

Measurement of the Effectiveness of CNBV

Like many regulatory agencies, CNBV has no formalized performance measures and generally reports the achievement of its objectives through the comparison of its expenditures against budget. This makes it difficult for CNBV and others to judge how well it is doing in achieving its objectives. Measuring performance against objectives would make the process more informative. Accordingly, CNBV should consider developing performance and accountability measures that government bodies and the public can use to evaluate its effectiveness against objectives. Key performance measures can be used to manage performance by comparing results achieved with expected results for each of CNBV's strategic objectives.

Examples of effective performance measurements that CNBV should consider include the following:

- intervention effectiveness measurement to monitor the effectiveness of CNBV in identifying financially troubled institutions and intervening in a timely manner to address regulatory concerns;
- external service quality measurement to assess the quality of activities in response to external requests for services, rulings and approvals outside the general supervisory process;
- internal service quality measurement to assess the quality of key internal services which support CNBV regulatory and supervisory activities, and benchmark against industry standards;
- cost of compliance measurement to assess the total cost of CNBV's regulatory approach on industries affected by CNBV's activities and rulings, and benchmark against other regulators; and
- internal cost measurement as a means to compare actual costs of CNBV's key regulatory and internal processes with other jurisdictions or industry standards.

CNBV performance measures could be based on the strategies and objectives outlined in its Institutional Program for 1997 – 2000.

Comparison of CNBV Current Practices to International Standards

Strong and effective bank supervision, and prudential regulation are the cornerstones of a healthy financial system.

As described above, CNBV has made significant improvements to its supervisory practices over the past five years. It has developed methodologies and standards based on the Basle 25 Core Principles and , according to CNBV, an internal survey indicated that it had substantially complied with the implementation of these principles.

Based on analysis, CNBV has, to a large extent, fulfilled the requirements of the 25 Basle principles, except for those noted below. While CNBV meets some of the aspects of the following principles, only the exceptions have been noted. Also, a review of the CNBV practices against the International Monetary Fund document "Toward a Framework for Financial Stability" indicated that, apart from the following exceptions, CNBV was in substantial compliance.

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

CNBV is not structured as an autonomous agency as it reports to SHCP, which reports to the Federal Executive (the President). However, there is currently proposed legislation before the Congress to provide CNBV with greater autonomy and additional powers.

Also, a number of instances were noted in the Mexican legal framework with regard to overlap in the responsibilities of the regulatory authorities.

Supervisors and intervenors in Mexico are not provided with legal protection in respect of their actions in the performance of their supervisory or intervention duties. This could result in examiners operating with undue caution and endangering the objectivity of inspection functions. It also hinders the ability of intervenors to fulfill their objectives.

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

As described in the evaluation of the regulatory framework, the capital adequacy requirements for all banks set by the authorities have not been entirely prudent and should continue to be improved. The deficiencies that were noted include:

- inappropriate inclusion of material deferred income taxes, inflation revaluations and mandatory convertible subordinated debt as Tier I capital;
- banks are not well provisioned; and
- resulting significant overstatement of the quality and quantity of the bank's capital.

20. *An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.*

As described in the evaluation of the regulatory framework, the ability of CNBV to supervise banking groups on a consolidated basis is impeded by the following deficiencies:

- lack of assessment of capital adequacy on a group-wide basis;
- lack of regulation to limit overall group exposures; and
- need for increased definition and rigor over fit and proper tests for significant shareholders and management.

22. *Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking authorization or recommend its revocation.*

Although CNBV has the necessary powers to bring about timely corrective action when banks fail to meet prudential requirements, it has on some occasions, been unable to resolve such problems in a timely manner due to a number of reasons as previously discussed.

Further, CNBV does not have specific documented intervention criteria, other than that provided by law, therefore, it is not possible to conclude whether a consistent intervention approach is followed. The lack of criteria makes the intervention process more difficult to understand for other parties.

CNBV does not have the ability to revoke bank authorizations. This power is vested with SHCP.

FUTURE CHALLENGES FACING CNBV

Mexico's banking sector is still weak and within this environment, CNBV will face a number of challenges.

The pace of change has accelerated, stimulated by the globalization of the financial services industry and the advancement of communication and information technology.

CNBV has made diligent efforts to date in addressing the problems of the financial sector and the banking system. The impacts of technology present a significant risk for all regulators. New products such as internet banking and increased competition from foreign participants pose additional complexities and risk. CNBV must be able to anticipate future challenges and adjust activities to meet them.

Although the Mexican regulatory framework has significantly progressed since the crisis, there remain certain risks in the banking industry that will need addressing in the short-term. Capital levels and loan loss provisions on past due loans need to be increased and, in fact, have not sufficiently improved since 1994. According to a recent analysts report, Mexican banks should have a minimum Tier I capital adequacy level of ten percent as a prudential level. At the end of 1998, Banamex and Banorte were the only Mexican banks above the minimum ten percent with a recorded Tier I capital adequacy ratio of 11.1% and 12.5%, respectively.

Looking forward, there is a requirement for focused restructuring of each of the troubled banks. Further consolidation will probably occur in the banking industry and the less successful banks may not survive. In the future, there should be a sustained effort to reduce the number of banks through consolidation that will result in fewer, but stronger banks. There is also a need to introduce measures for maximizing debt recoveries and fighting the pervasive non-payment culture. This can be done by enhancing the performance of credit bureaus and studying possible amendments to Mexico's bankruptcy laws. Some banks (Banamex and Bancomer) are sharing their synergies in order to reduce operational costs.

Although significant progress has been made by CNBV, there is a continuing need to further improve the quality of bank supervision, with emphasis on making systematic use of the diagnostic audits, and more effective analytical use of the extensive information base available in CNBV.

The increase of foreign banks coming into Mexico requires a corresponding increase in cooperation with foreign regulators, and the need for an increased ability to respond quickly to new developments. CNBV will need to continually evolve in response to increasingly rapid changes in the industries it regulates, as markets continually become more global.

Conclusions and Recommendations

Many factors contributed to the Mexican banking crisis in 1994 that eventually led to the bail out of some banks and the intervention of others. A major cause was the result of the privatization of the banks in 1991 and 1992, the seeds of which were sown as early as 1982, when the Mexican banks were nationalized. With weak banking supervision at the time of privatization and a weak economy, the Mexican banking system experienced deterioration.

The reasons for the weak supervisory practices can be traced to the nationalization of the Mexican banks in 1982. The CNB was inadequate in performing effective surveillance of the government-owned banks. In any event, regulatory oversight was not viewed as being essential as it was one government body regulating another. It was essential that effective supervision be in place even though the banks were nationalized. Banking regulation and supervision were not changed with privatization, despite the increased need for regulation in a privatized environment. The privatized banks were undercapitalized, had inadequate technology and management systems, untrained staff and lacked a proper credit culture. The indications that major problems were about to arise in the Mexican banks were clearly present at that time.

Even though the Mexican peso crisis arose in 1994, it was apparent that a number of banks already had significant problems, especially if the changes in prescribed Mexican bank accounting standards had been applied during the period leading up to the crisis.

Due to the lack of strong regulatory oversight combined with implicit government guaranteed depositor protection, problems arose in many of the banks that remained undetected by CNB for long periods of time. The sources for the identification of such problems by the supervisor were often the market itself or rumours, even though some issues were uncovered during on-site inspection visits. CNB did not have surveillance systems in place that could detect problems in a timely manner

The decision to intervene the first bank was taken by CNB shortly after the arrival of the new president of CNB in April 1994. At that time, government policy was that financially troubled banks would not be allowed to default and all depositors and creditors would be protected. The objective was to prevent potential runs on the banks.

Intervention was carried out on a case-by-case basis. CNBV had no set specific documented criteria, other than that provided by law, as to when a bank should be intervened. If the intervention trigger had been minimum solvency levels, then essentially all the Mexican banks would have needed to be intervened. Most interventions took place due to irregular operations, possible fraud or deep insolvency. Since CNBV had no specific intervention criteria, this lack of criteria made the intervention process less informative to other parties. CNBV should develop specific intervention criteria to promote awareness and enhance disclosure of the system of intervention for the banks it supervises.

As previously stated, interventions occurred sometime after the problems first arose in the banks, but generally because of the same problem initially detected. CNBV took a number of supervisory steps prior to the actual legal intervention process. However, evidence does not indicate that supervisory steps taken by CNBV in all cases were effective (i.e. problems identified were regularized and prevented from worsening).

In our view, maintaining ailing and insolvent banks for long periods of time is more costly than timely closure. In some cases, resolutions for financially troubled banks have been slow to materialize and they have not been downsized effectively. Experienced liquidators should be engaged and if necessary, international resources should be utilized.

Evaluated against the key objectives of the intervenor, which include achieving the final outcome for the bank and completing the intervention process within the shortest possible time, improving operational efficiency, and reducing operating costs, it appears that the intervenors' execution of their duties fell short in several instances.

A number of issues regarding the capitalization of banks concerning extent, source, extensions and quality were noted. The sale of branches to problem banks also gave rise to some concerns. Also, as at June 30, 1999, the banking system is still undercapitalized. CNBV, primarily for reasons beyond its control, has not been successful in ensuring that the banking system is properly capitalized.

Changes were required in the regulatory framework to mitigate against the potential reoccurrence of a banking crisis in Mexico. A number of recent developments have enhanced the supervisory effectiveness of CNBV including legislative reform, prescribed bank accounting standards improvements, external audit enhancements and the development of circulars. However, further changes in accounting practices are still required to meet international standards. CNBV still needs to further develop its consolidated supervision standards.

CNBV should consider the development of post examination quality control reviews subsequent to bank examinations to ensure consistent application of supervisory methodologies and to identify improvement opportunities for the examination process.

Post mortem analyses should be carried out of financial institutions that failed or were subject to distress sales, and the experiences used to enhance regulatory practices.

CNBV has qualified and competent staff, and is placing increasing emphasis on the supervisory function. Training programs have been developed in the key supervisory areas. CNBV should develop performance and accountability measures that government bodies and the public can use to evaluate its effectiveness.

Supervisors and intervenors in Mexico are not provided with legal protection in respect of their actions in the performance of their supervisory or intervention duties. This significantly impacts on the ability of supervisors and intervenors to effectively perform their duties.

CNBV has made substantial progress in dealing with the problems faced by the financial sector, however, a number of future challenges still remain that CNBV that will need to address in order for it to maintain strong, effective regulatory oversight and supervision of the Mexican banking system.

In conducting this evaluation, we focused, first, on an assessment of the supervisory actions taken by SHCP in the granting of bank authorizations and second, on an assessment of the SHCP regulatory and supervisory practices in place for the period 1994 to 1998.

In examining SHCP's role with respect to the authorization process, the process of privatization of the banks in 1991 and 1992 was analyzed from which it is apparent that, for transparency purposes the highest bidder obtained the authorization. This maximized the price obtained for the banks without sufficient regard to other important issues and objectives. It is evident that certain problems resulted as a consequence of this focus.

In order to assess the regulatory and supervisory role played by SHCP, its involvement in the regulation and supervision of banks was reviewed. While the supervision of the financial system during the period 1994-1998 is not without criticism, many of the difficulties encountered by the banking system can be traced back to an absence of regulation and supervision at the time of privatization through to the peso crisis.

BANK AUTHORIZATIONS

SHCP, a division of the federal executive branch of the government, is the principal authority in the Mexican financial system. Thus, it is responsible for, among other things, approving the operations of commercial banking institutions and granting the authorizations for such entities. The power to authorize commercial banking institutions is stated in the *Law of Credit Institutions*.

From nationalization in 1982, to consolidation immediately thereafter, followed by privatization in 1991-1992, policies governing Mexico's banking system have undergone significant changes.

Nationalization

On September 1, 1982, a decree issued by the President of the Mexican United States established the nationalization of the private commercial banks, except for Citibank and Banco Obrero . The nationalized credit institutions continued operating as commercial banks, but with the characteristics of a state controlled entity. The nationalization period effectively eliminated, through attrition, commercial banking expertise, as banks were required to act as government agencies.

During the period of nationalization, Mexico's banking system had relatively few depositors compared to its total population. Private sector deposits were mainly earmarked to finance government deficits and the lending culture in the banks was considerably subdued. In 1982, the banking system consisted of a few large and relatively modern financial institutions with access to economies of scale and the capacity to grant new services, and many small and relatively outdated banks with high operating costs and low profitability levels.

In the first stage of the nationalization period which occurred in 1982 and 1983, eleven banks went into liquidation, twenty were merged, and twenty-nine remained. By 1986, the total number of institutions has been reduced to eighteen from the original sixty nationalized banks. These eighteen institutions were classified according to geographical coverage and size of assets into the following three categories: six national banks, seven multi-regional banks, and five regional banks. During the period of nationalized banking, the financial, operational and institutional programs of the supervisory authorities were authorized by SHCP.

Prior to 1988 banks faced interest rate caps on their lending and borrowing activities, effectively limiting their financial margins. These caps were removed during 1988. This financial liberalization was the beginning of explosive loan growth in the commercial and individual loan sectors which was unaccompanied by sufficient regulation, supervision, and experienced commercial bankers, and ultimately contributed to the weak state of the banks at the time of privatization.

Privatization

Almost ten years after the nationalization of the banking system and in order to promote an open economy, the Mexican government commenced the privatization process of the remaining eighteen banks in 1991. For transparency purposes existing authorizations were auctioned off to the highest bidder, resulting in revenue for the federal government of over MN$ 38,000 million (US$12,500 million). This amount was placed in the public treasury and was not used to recapitalize the banking system. We understand that, in retrospect, SHCP was fully aware of the lack of capital in the system at the time.

While processes were in place by SHCP to ensure that the backgrounds of prospective owners and senior management of banks complemented the new banking requirements, these have been shown subsequently to have not been inadequate. In most cases, controlling shareholders lacked the lending experience and technical expertise necessary for prudent banking. Further, since the banks were not widely held, there was ample opportunity for the new owners to conduct banking activities that involved fraudulent and other irregular transactions.

An original principle set out by SHCP was to prevent the concentration of bank ownership, and to create an environment in which bank ownership could be widely held. In order to complete the privatization process, it appears that exceptions were made in the form of five year transitionary rules that allowed ownership to become concentrated.

Can't [illegible] each other if closely held.

New Banks

SHCP is responsible for issuing bank authorizations as dictated by the *Law of Credit Institutions* and the *Law to Regulate Financial Groups*, after considering the opinions of the Bank of Mexico and CNBV. In practice, little due diligence was undertaken in the granting of new bank authorizations (e.g. the capital to create Banco Capital was not fresh capital since it was provided by the same bank through related party loans). In Mexico, bank authorizations are granted on a national basis. Once granted, the bank had the option of operating regionally or nationally.

Subsequent to the privatization auctions, new bank authorizations were issued to some individuals with no experience in banking, (e.g. Anahuac), and to credit unions (e.g. Interestatal). In the case of Interestatal, a conflict of interest existed from the commencement of this new bank, since all the debtors became major shareholders. Two years later, this bank was intervened because of a lack of capital and irregularities in the loan granting procedures were detected.

Between 1992 and 1995, sixteen new bank authorizations were issued. The status of these banks is detailed below (Table 1). As can be seen, six of the sixteen new banks have been intervened. The authorizations for Anahuac and Bansi were as actually processed and approved in 1994, subject to the shareholders meeting certain conditions, which were met in early 1995. An authorization to operate a commercial bank in Mexico has not been granted since 1995.

Table 1

Bank	Date Authorized	Status
Afirme	Nov 29-94	Operating
Anahuac	Mar 30-95	Intervened
Bajio	Apr 5-94	Operating
Banregio	Nov 19-93	Operating
Bansi	Mar 30-95	Operating
Capital	Jun 3-93	Intervened
Industrial	Jun 3-93	Intervened
Inbursa	Sep 6-93	Operating
Interacciones	Jun 9-93	Operating
Interestatal	Jun 3-93	Intervened
Invex	Nov 19-93	Operating
Ixe	Apr 5-94	Operating
Mifel	Sep 6-93	Operating
Pronorte	Sep 6-94	Intervened
Quadrum	Sep 6-93	Operating
Sureste	Jun 3-93	Intervened

In 1998 there were thirty-four banks in Mexico, twelve of which have been intervened.

Credit Bureaus

In 1993, adjustments to the *Law to Regulate Financial Groups* established the basis for credit bureaus. However, the "General Rules that Credit Bureaus Must Follow" were not published by SHCP until 1995. The banks previously carried out the services provided by credit bureaus. Thus, they were the most interested parties in the creation of these agencies. In some cases, banks are the shareholders of the credit bureaus. By law, the banks are allowed to hold up to 100% of the shares of these agencies. This could cause a conflict of interest since the major shareholders could exert significant influence regarding the information provided to their own bank.

Impact of the Government's Policy of Preventing Bank Failures

The government's policy of not closing failed banks had a significant impact on the financial system and the recovery process.

Prior to the crisis, in 1994, two banks were intervened due to the detection of irregular operations (fraudulent activities). These banks should have been closed down to exit the system at this time for the following reasons:

- the costs associated with closing the banks would have been lower than sustaining the banks;
- bank depositors could have been protected, regardless of bank failure;
- market discipline would likely have been established and moral hazard decreased;
- the banking system was not in a state of systemic crisis, thus, allowing the failures would not have precipitated capital flight at this time; and
- if depositors' interests were fully protected in 1994, it may have mitigated the fear of loss to depositors in the future, and, therefore, would have reduced the probability of a future run on the banks.

Given the above factors, it may well have been easier to shut down banks during the crisis without causing systemic capital flight.

The policy of preventing any banks from failing promoted a system in which there were too many lenders in comparison to the number of legitimate borrowers. This perpetuated the already severe lending deficiencies prevalent in the banks and ultimately increased the costs to FOBAPROA.

By not forcing bank closures, SHCP has not provided for an environment in which banks that were assisted during the crisis were still performing poorly, and further interventions appear likely. As a result, two things occurred; non-viable banks were left in the system, and bank programs, such as the portfolio purchase program, were enacted. Allowing insolvent banks to close would have permitted market forces to establish themselves, providing for a more timely recovery while lowering the cost assumed by FOBAPROA.

Regulation and Supervision

As described in the evaluation of the overall regulatory framework, SHCP is the principal authority in the Mexican financial system and its mandate is to plan, co-ordinate, evaluate and supervise the banking system.

The power of supervision has been delegated to CNBV, thus, SHCP is not directly responsible for the supervision of Mexican banks. SHCP has the responsibility for issuing certain general regulations and rules under which the banks and financial groups have to operate (e.g. authorization criteria, general rules for evaluating the loans portfolio, minimum capital reserve requirements, investment limits, etc.).

The involvement of SHCP in the supervision of commercial banking institutions is done through its participation on the board of governors of CNBV. Five members from the SHCP sit on the governing board of CNBV. The only involvement of SHCP in the intervention process and the evaluation of the performance of CNBV is through its participation on the board of governors of CNBV. Therefore, reference should also be made to the CNBV evaluation in this report.

Conclusions

An underlying cause of the banking crisis in Mexico was the privatization of the banks in 1991 and 1992 which focused on price maximization rather than on ensuring that viable banking operations were established for the long term. Further, the proceeds received from the sale of the banks were not injected back into the banking system. Had net book value been the price paid for the banks (rather than approximately three times that amount), and the surplus of the agreed purchase been price used to enhance the banks capital, the system would certainly have been stronger. In addition, a number of weak banks with problem loan portfolios were privatized by SHCP, and later intervened by CNBV.

Adequate processes were not in place to conduct a thorough examination of the background of the prospective owners and senior management. This led to some banks being sold to individuals with little banking experience. As banking is a fiduciary business, in which responsibility is owed to depositors, it is incumbent upon the principal authority of the financial system to ensure high standards when choosing those in whom the responsibility is placed. SHCP did not ensure these standards were met.

The viability of the number of banks in the system was not addressed by SHCP in a timely manner. SHCP held to the principle that no banks would fail and that bank operations would be "regularized" rather than liquidated. Therefore, any evaluation of the regulatory agencies in the banking system must consider this principle and its effect on their ability to take appropriate action with non-viable banking operations. This rendered the regulatory agencies unable to fully achieve their mandates. Though consolidation in the industry has occurred of late, the timeliness of consolidation has been lacking.

SHCP did not appear to recognize the regulatory and supervisory needs of a privatized banking system, with the result that, few and insufficient actions were taken to prepare for it. Moreover, few steps were taken until 1994 by which time the explosive loan growth had already occurred, and the system was vulnerable to external shocks.

Furthermore, SHCP was aware that the system lacked capital at the time of privatization. Optimistic views of prospective economic growth were relied upon to address the capitalization issue. The awareness of the continuing lack of capital became more acute at the time of the peso crisis, but was still not fundamentally addressed at that time. Alternatively, SHCP permitted regulators to implement programs having objectives that were unlikely to be fully achieved given the vulnerability of many of the banks and the regulatory framework in existence at that time.

5. Bank of Mexico

The Bank of Mexico's role in the supervision and governance of the FOBAPROA trust, outside of the FOBAPROA department, has been limited to its involvement in the Technical Committee. As stated earlier in this report, all operational and strategic issues concerning the trust and its operations were the responsibility of the Technical Committee and have been evaluated in that section of this report. Therefore, the evaluation of the Bank of Mexico focused on its relationship with the Technical Committee.

The governor of the Bank of Mexico plus two deputy governors are members of the Technical Committee. In addition, close information links exist with CNBV and the FOBAPROA department. Accordingly, the Bank of Mexico had its most senior staff in a sufficiently informed position to carry out their functions on the Technical Committee. To further its accountability, the Bank of Mexico representatives on the Technical Committee reported to the board of governors of the Bank of Mexico as to the issues being addressed by the Technical Committee. Moreover, the Bank of Mexico, in its responsibility to report to Congress and the federal executive, from time to time between 1995 and 1998 submitted reports to it concerning FOBAPROA. In this regard, the Bank of Mexico has fulfilled its supervisory obligations over FOBAPROA.

In addition to its role on the Technical Committee, the Bank of Mexico is the fiduciary trustee of the FOBAPROA trust, and provides oversight to the FOBAPROA department within the Bank of Mexico. Considering the above noted responsibilities, the Bank of Mexico should have been aware and responded earlier to the apparent lack of resources in the FOBAPROA department. Certain actions were taken by the Bank of Mexico during 1995-1996 to borrow resources from CNBV and intervened banks, however, these actions were insufficient for the magnitude of the problem at hand. Actions taken by the Technical Committee in this regard during and subsequent to 1996, have been discussed in our analysis of the Technical Committee later in this report.

The Bank of Mexico's involvement in specific actions and decisions of FOBAPROA has been evaluated within the context of the FOBAPROA department and the Technical Committee sections of this report.

6. FOBAPROA

In an official annual government publication, the financial authorities reconfirm on a yearly basis that depositors would be protected, and no banks would default on their liabilities. The depository insurance agency FOBAPROA was chosen as the vehicle to support the banks.

An evaluation of FOBAPROA involves evaluations of the central bank acting as trustee specifically of the FOBAPROA department of the Bank of Mexico, and the Technical Committee, which is the decision maker of the Trust. Our analysis covered distinct time periods; the period prior to the peso crisis, the period from the peso crisis to April 1997, and the period from April 1997 to the present. The organizational structure and resources available to the FOBAPROA department of the Bank of Mexico underwent significant changes which culminated in 1997 with the arrival of a new management team, and the evaluation of achieving the FOBAPROA trust's overall mandate must consider these developments.

FOBAPROA trust's general mandate was always to protect depositors, and to enhance the operations of the financial system[103]. In May 1996, modifications to the FOBAPROA trust agreement specified in more detail the permitted operations to be performed by FOBAPROA, codifying what FOBAPROA trust was already doing[104]. In October 1996, as part of its strategic plan, this mandate was expanded to include additional objectives involving the administration and recovery of FOBAPROA trust assets, to coincide with a planned expansion of FOBAPROA, department resources, to address concerns as to FOBAPROA trusts ability to meet its objectives.[105]

HISTORY

Prior to the peso crisis (and interventions in Banca Cremi and Banco Union), the department of the central bank responsible for FOBAPROA did not conduct any operations except accounting for insurance contributions from the banks. In the fall of 1994, just prior to the crisis, two banks were intervened, Banca Cremi, and Banco Union, and the support required to enhance confidence in the banking system by depositors was initially drawn upon. From the onset of the peso crisis, it was clear that FOBAPROA financially and operationally could not deal with the crisis. That task was undertaken by the financial authorities, CNBV, SHCP and Bank of Mexico, each of whom was represented on the Technical Committee of FOBAPROA.

Technical Committee Operations

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[103] Article 122 of *Law of Credit Institutions.*
[104] Modifications to the FOBAPROA trust Agreement, May 3, 1996, Clause 3.
[105] Technical Committee Minutes, Number 37, October 9, 1996.

During the period from late 1994 to April 1997, urgent issues involving various aspects of bank survival and the implementation of bank programs were being dealt with and discussed by the Technical Committee. The Technical Committee was considered to have participation and input from all relevant financial authorities (4 representatives from SHCP, three from the Bank of Mexico and two from CNBV) such that any important problem or issue would be discussed with due process and with adequate information. In turn, instructions for FOBAPROA trust financial support were provided by the Technical Committee. The Technical Committee had the decision making power and authority and exercised it using information provided to it by the financial authorities. Decisions made by the Technical Committee included the approval of:

- organizational structure and responsibility changes to the FOBAPROA department;
- determinations and amendments of bank program rules;
- determinations and amendments of individual support operations of banks;
- support requirements for FOBAPROA trust financial assistance;
- branch and bank sale arrangements and agreements, and;
- creation and determination of the competence of subcommittees.

Any action taken by the FOBAPROA department had to be approved by the Technical Committee. In addition, the FOBAPROA department was required to follow the direction of any decision made by the Technical Committee.

CNBV was the most influential member of the Technical Committee. CNBV's influence originates from its mandate, as it is the only agency with complete access to all bank information and the most prepared, given recent technical enhancements.

During 1996 it appeared that resources available for maintenance and administration of the bank programs shown in the Technical Committee minutes were stretched. The recognition of resource requirements was finally presented to the Technical Committee in October of 1996, and implemented during April of 1997. Delays and difficulties in closing and executing various loan portfolio purchase agreements resulted from this limit of resources, among other reasons. Earlier recognition of these constraints by the Bank of Mexico should have been forthcoming.

Overall, the Technical Committee of the FOBAPROA trust appears to have operated in consideration of due process.

While the expansion and restructuring of the FOBAPROA department and the installation of new management hastened change in the department's operations, many decisions and courses of action had already been taken. This limited FOBAPROA's choices, leaving the department to try to effectively implement prior decisions and instructions from the Technical Committee. An example of this was the Loan Portfolio Purchase agreements, which had been entered into over the period 1995 to 1997, but had failed to yield a single closed transactions. The department first set out to finalize and close these agreements which had taken, in some cases, years of negotiation, review and audit to complete. Loan monitoring was initiated in 1998, and when information systems were upgraded, appeared to be effective. The recovery sub-committee was officially formed, to give methodology, and consistency, to restructuring decisions. FOBAPROA department personnel played a key role in analyzing and presenting options at this committee. In addition, a program of third party administration of loan portfolios was initiated which, when completed, proceeded to yield increased recoveries compared to prior experience. An external audit for 1997 was also performed, accounting policies were formalized, and administrative accounting procedures amended.

Asset Recovery

It has been observed that there is no formalized asset realization strategy in effect for FOBAPROA at the intervened banks. If such a strategy were put in place, all parties agree that realizations could be enhanced and costs reduced.

In April 1996, FOBAPROA made a strong attempt to implement an asset realization strategy when it incorporated a subsidiary for the Valuation and Sale of Assets ("VVA"). VVA was incorporated to design, negotiate and implement a mechanism to sell, transfer or assign properties and property rights. Unfortunately, these aspirations were never realized.

VVA encountered two fundamental problems. First, in order to obtain title to FOBAPROA assets, VVA would be required to pay a transfer tax, thereby increasing the costs without benefit. Second, FOBAPROA's interest in the loans in the trusts was restricted to the cash flows therefrom; the banks retained title to the loans. Therefore, VVA could not deal directly with any of the loan portfolios in which FOBAPROA had an interest. As a result of these obstacles, VVA was not a success. It can be noted that the obstacles to success should have been recognized at the outset, obviating the need to incorporate VVA.

The FOBAPROA Recovery Sub-Committee was subsequently formed, with the same objective of maximizing asset recoveries on loans greater than MN $50 million. This was to occur through presenting policies and recommending initiatives to improve collections. The sub-committee's recommendations regarding proposed restructuring transactions appear to have been well thought out and accepted by the Central Credit Committee. The suggestions regarding audits of the banks' administrative capabilities, resource issues within the banks and deficiencies in bank information systems were not followed up on a timely basis.

There remains no central, focussed asset realization strategy in effect. The assets at the intervened banks are in the hands of the intervenors, who report to CNBV. The realization of these assets will be for the account of FOBAPROA. In order to maximize realizations, CNBV should establish a mechanism to consolidate the assets of intervened banks along with the assets now in the possession of FOBAPROA, in order that a consolidated realization strategy can be designed. Such a strategy should be implemented by one party who should be oriented to maximize recoveries, as measured on a present value basis.

The results will be enhanced if an asset management company is utilized as a resource. This will result in the assets being in the control of individuals with realization skills rather than in the control of administrators. Notwithstanding that these steps were not taken in the past, they should be performed now in order to enhance future recoveries.

FOBAPROA Trust Accountability

During much of the period 1994 to 1997, the only accountability reporting of the FOBAPROA trust's budgets, financial position and results was to the Technical Committee.

During 1997 shortly after the appointment of new management, the decision was made to audit the FOBAPROA trust for the first time. The first step in this process involved a review of the operations of the Trust, and the accounting policies applied. The following issues were identified by the external auditors and addressed by the FOBAPROA department during the latter half of 1997.

In some cases the financial information used to prepare financial reports for FOBAPROA trust reporting was incomplete. The banks had not been revising the value of loans within the trusts, even though there was a requirement to do so quarterly. In some cases the banks did not pay enough attention to the trusts. The banks were instructed by CNBV to remove loans sold into trusts and put them back on the books in the fall of 1997 to properly reflect the nature of the sale of cash flow agreements. However, further instructions to the banks as to how to reserve for these loans, and how to account for loss sharing was not directed to the banks until February 1998. Consequently, the banks did not set up reserves for these loans, or account for loss sharing as at December 31, 1997 and instead commenced these policies in February and March 1998. The reason provided for returning the loan portfolio to the books and the obligation to create loss-sharing provisions over a period of time was that it provided better incentives to improve the portfolios administration.

Some banks had not consistently provided FOBAPROA with basic financial information. Audited financial statements from the institutions where FOBAPROA was a shareholder could not always be obtained.

Inappropriate Accounting Policies

The current accounting treatment for loans granted was to value the loans at cost, adding to the amount of capital, the capitalized interest. These loans were not classified in loans granted to controlled and non-controlled multiple bank institutions as they should have been. Allowances for doubtful accounts should have been recorded in a corresponding separate account. This is not consistent with current valuation policies in Mexico, although it may be consistent with standard valuation policies in other countries.

Accounting policy also affected the accounts receivable set up as due from the federal government, instead of being recognized as losses. Assets would have changed from an estimated MN$ 338,000 million to MN$ 154,000 million according to professional estimates.

Insufficient Communication

There was an insufficient level of communication noted between the accounting and legal departments of FOBAPROA. This was evident with respect to information that the accounting department was unaware of, and the time lags between the execution of agreements by the legal department, and the accounting for these agreements.

While FOBAPROA and CNBV work together and share information informally on a daily basis, there was an insufficient level of communication at times between CNBV and the FOBAPROA department. This was evidenced by information being held by CNBV relevant to the FOBAPROA trust that had not been shared. (i.e. foreclosed asset sales approved by CNBV, not communicated on a timely basis to FOBAPROA). This also resulted in missing and unrecorded transactions.

Insufficient Information

There was an insufficient level of information received relative to foreclosed assets. In some cases sales of foreclosed assets were recorded by the banks as a transfer in 1996 when, according to a circular issued by CNBV, FOBAPROA recorded the transactions in December 1997 when the transaction was formalized. The impact of this anomaly remains undetermined as it appears only to affect the recording of assets and liabilities. After five years any remaining foreclosed assets are to revert back to the banks with no cost to FOBAPROA.

Until April 1997 the FOBAPROA department did not appear to have adequate information to establish appropriate reserves for their loans and financial information used by the FOBAPROA department to prepare financial statements was in some instances unaudited. This was corrected in order to finalize the FOBAPROA 1997 audited financial statements.

As a result of the audit, significant adjustments were made to the asset figures, as well as other items. Due to the complexities and issues involved in auditing the Trust for the first time, the audit was not completed until July 1998. In July 1998 the unqualified audited financial statements were presented to the Technical Committee, together with a formal management report on operations (prepared for the first time).

An issue that was not addressed by the external auditors was the inclusion of contingent liabilities on the balance sheet and costs to the FOBAPROA trust. This issue arises as certain banks (i.e. BanCrecer, Promex, Atlantico) which are not currently owned or financially supported by the FOBAPROA trust, will eventually require financial support. However, given that no actual agreement or commitment has been entered into by the Trust, no accounting for these liabilities has been made by the FOBAPROA department for the Trust statements. This is the case despite the fact that an estimate of this liability is included on the FOBAPROA report submitted to Congress. This appears to be an omission of financial information relevant to the Trust which should be rectified.

Conclusion as to FOBAPROA's Reporting and Accountability

Prior to and during 1997, an accurate and appropriate picture of the Trust's financial position was unavailable. The problems encountered by the external auditors highlight this. As well, internal problems involving communication created situations where information was omitted from the financial records. While it does not appear any of these situations were intentional, and most of the corrections and implementation of new accounting policies were instituted prior to December 31, 1997, up until this point in time the Technical Committee and, therefore the financial authorities, did not require the production of all relevant financial information relative to the Trust's financial situation. As well, the financial results were not presented to the Technical Committee until July 1998. The delay is explained by the requirement to receive financial information from intervened banks and trusts before FOBAPROA's results can be presented. The lack of timely presentation of audited results has repeated itself with respect to the 1998 audit, as audited results have not been presented to the Technical Committee as of June 1, 1999. The co-ordination with the new IPAB regime and the pending FOBAPROA wind down have contributed to this delay.

Unrelated to timeliness of reporting is the issue of including contingent liabilities in the FOBAPROA trust accounts. FOBAPROA 1997 financial statements were prepared excluding contingent liabilities. To ensure complete and accurate reporting, future published reports should disclose contingent liability information. The reporting that was communicated to the Congress in February 1998 and subsequently, did disclose contingent liabilities.

The 1997 restructuring of the FOBAPROA department of the Bank of Mexico appears to have resulted in several key developments. In addition to initiating the audit, and acceptance of issues and recommendations made by the external auditors, loan portfolio monitoring commenced, communication issues were resolved, informational deficiencies were corrected, and in general the accuracy and quality of financial information improved.

FOBAPROA Trust and FOBAPROA Department Assessment

When the operations and activities of both the FOBAPROA trust and the FOBAPROA department are assessed against the regulatory framework within which they operated, there are few criticisms that can be made of either the Trust or the department's activities relative to available resources. Many criticisms originate from the weaknesses in the regulatory framework itself. For instance, the original mandate of providing depository insurance and protecting the well being of the financial system was overly broad, and not matched up against the resources needed to attain this mandate. The FOBAPROA trust was established to protect depositors in situations where single institutions were affected. The decision to use the FOBAPROA trust as the vehicle to support financial institutions to prevent banking and financial disasters did not follow with an expedient decision to redefine the FOBAPROA trust's mandate, and resource the department accordingly.

New Legislative Changes

It appears some of the shortcomings in the regulatory framework have been addressed in the new legislation for the protection of the bank deposits. This includes limits to depository insurance, a more defined mandate, and more power and funding to effectively fulfil its mandate[106]. According to the rules published by IPAB during a transitory period, unlimited depository insurance will continue.

Conclusions

Overall, the assessment of the FOBAPROA trust and FOBAPROA department activities is that they appeared, in general, to be appropriate relative to the regulatory framework in existence. However, the activities undertaken were insufficient for the magnitude of the crisis due to resources available and allocated to the department by the Technical Committee. This situation was not remedied until April 1997. The FOBAPROA department operated as a vehicle to carry out Technical Committee decisions and did not have sufficient legal authority to carry out its mandate.

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[106] *Law of Protection of Banking Savings* (IPAB)

7. Government Support Programs

1. Bank Programs

This section of the report presents our analysis and evaluation of the bank programs described in section IV, 5.2 of this report.

There were four bank programs which were introduced in response to the peso crisis in order to provide support for the banks. These programs were designed to achieve specific objectives (and to a certain extent they were successful), but the fundamental problem facing the banks was not addressed effectively.

The problem was a systemic lack of capitalization. This problem was in evidence at the time of privatization and had not been addressed by the end of 1994. Of the bank programs discussed below, only one in four specifically addressed increasing bank capital and it was of limited success. The net effect is that even after the bank programs were implemented, the shortage of capital in the banking system is still the fundamental problem.

The following bank programs were evaluated:

- Dollar Liquidity program;
- PROCAPTE;
- Capitalization and Loan Purchase of Bank Portfolio program; and
- Intervention and Rehabilitation program.

The programs were evaluated using the following criteria:

- *Design* – Assessing the extent to which the program design allowed for its success;
- *Compliance* – Assessing the activities of relevant parties against the set out rules and guidelines;
- *Supervision* – Assessing the supervision of the program against the set out rules and guidelines; and
- *Impact* – Assessing the impact of the program against the set objectives.

While this report has attempted to evaluate the programs against the above criteria, it is important to note that the ultimate success of the programs was often dependent on other factors. This report will discuss these factors where necessary.

DOLLAR LIQUIDITY PROGRAM

This program had a well-defined specific objective, the supply of foreign currency denominated loans to repay foreign currency denominated obligations of a short term nature, to banks that were unable to secure these funds from international lenders. The plan was structured to meet immediate short-term liquidity needs (seven days), then expanded to address monthly needs (twenty-eight days). The interest rate (i.e. cost of funds) was set so that rapid repayment would lower the interest rate cost to the banks. Both the financial authorities and the banks view this program as having been well designed to meet its objectives.

The only compliance rule was that the banks were required to repay the loans. This was done by all banks.

CNBV has indicated it performed no supervision of this program, but that all amounts were repaid. Given the high costs of these loans, CNBV did not see the point in reviewing the use of these funds because there seemed to be no incentive for management to borrow these funds for other purposes. Despite this, in one case, Banco Industrial was denied loans under this program based on the rationale that the bank should not have any foreign denominated loans. CNBV's conclusion that supervision was not required is inconsistent with the fact that two banks had been recently intervened and there was the knowledge that some banks were managed by inexperienced bankers, many of whom had engaged in imprudent banking practices.

The objective of the Dollar Liquidity Program was to ensure that Mexican banks fulfilled their obligations in foreign currencies through short-term financing in order to avoid a systemic crisis. The program appears successful due to the following:

- The banks were able to return to the foreign financial markets and continue borrowing in foreign currency by the summer of 1995.
- By December 1995 the banks were able to obtain financing at similar rates to those available prior to the peso crisis (December 2994).

Overall Evaluation

The framework for dollar liquidity was clear, with well defined and specific objectives directed towards the lack of available foreign currency funds to meet immediate and short-term obligations. The banks essentially complied with the program. The supervision process was ignored for the dollar liquidity program. The dollar liquidity program was effective within the context of its narrowly defined objectives.

PROCAPTE

This temporary program was set up in February 1995 to permit participating institutions to gain time to reach adequate levels of capitalization. At the time, PROCAPTE was the only program available to aid in the improvement of capitalization, and most banks required it because they could not comply with the established capitalization requirements. However, the program was designed with the narrow objective of being a temporary capitalization vehicle that would send a clear message to the financial markets that the government would support the banking system. It was not designed to provide new, permanent capital on its own, as was the case with the Capitalization and Loan Purchase of Bank Portfolio program, and the Intervention and Rehabilitation program. In general, the design of the program accomplished its objectives. However, in the case of Serfin, the PROCAPTE amount was converted to permanent capital and subsequently written-off.

The banks involved in PROCAPTE complied with requirements that the banks be prohibited from taking on additional term debt, issuing dividends, or issuing additional mandatorily convertible subordinated debentures. To exit the program the banks had to inject new capital. Some banks managed to accomplish that under the Capitalization and Loan Purchase of Bank Portfolio program, while the unsuccessful banks were taken over by FOBAPROA and, in some cases, intervened by CNBV.

No supervisory problems were identified. The main aspect of supervision in this program was the monitoring and facilitation of additional capital injections. In at least one case (Obrero), participation in this program was denied as it was clear that the shareholders could not inject additional capital.

While this program sent a clear message that the government was ready to support the banking system as a whole, the market did not appear to view the participation of the individual banks in PROCAPTE as a positive measure. The market considered participation as a sign of weakness or as a prelude to intervention. This perception caused some banks to avoid participation in the program entirely and other banks to end their participation in the program in a shorter period than expected.

Because of the negative public perception regarding participation in PROCAPTE, banks attempted to avoid participation by increasing their capital on their own. However, many banks were unable to raise capital during this period. As a result, additional measures were required following PROCAPTE.

Conclusions

PROCAPTE, while designed to provide temporary relief for the banking system, did not in itself offer a solution in terms of providing additional new capital. While the temporary capital could not be utilized by the banks because the proceeds of the subordinated debentures were required to be deposited in the Central Bank, such capital was available to be used to absorb losses (if required) and this was considered important in demonstrating, especially to foreigners, that the government would not withdraw its support from the banks. The banks essentially complied with the program and the supervision of the program was adequate. Overall, PROCAPTE appears to have been relatively effective if compared to its narrowly defined objectives of sending a clear message to the market that the government would support the banks.

Capitalization and Loan Purchase of Bank Portfolio Program

This was the first program that was designed to provide the banks with prudent capitalization benefits. However, the financial authorities did not fully anticipate the severity of the problems nor the duration of the crisis and the complexities concerning implementation of this program. As a result, authorities were forced to change certain parameters during implementation.

The issues observed were as follows:

- Initially, the banks were unable, in some instances, to meet informational requirements as bank information systems could not supply relevant information;
- The program framework stipulated that external auditors, FOBAPROA and CNBV had ninety days to value and accept loans. This was unrealistic due to the large number of loans in the purchased portfolios.
- Due to the above mentioned problems, the completion of initial purchases of portfolios took two years. As the recovery of the economy and the banking system were slower than expected, the Technical Committee of FOBAPROA decided to modify the program guidelines that excluded certain types of loans from the portfolio purchases (e.g. "E" loans, related party loans).

The decision to modify the loan restriction criteria and adjust the program to more realistic terms for some banks was the response of the financial authorities to the fact that the program was not effectively implemented and that the program did not lead with the fundamental issue. The alternative was to renegotiate the agreements with the banks, at the risk of the failure of some banks and a deepening of the crises, however, in the end, some nine of the thirteen programs put into place were subsequently reversed.

The inclusion of related party loans (Banamex, Atlantico, Promex, Bancomer) might have created a perception that those debtors received preferential treatment. CNBV and FOBAPROA have advised that no loans to controlling shareholders have been accepted in the purchased portfolios.

The CLPP program was originally designed with standardized criteria for loan purchases, with the objective of having loans purchased at a price based on criteria by CNBV for loan valuation their appropriately reserved values (or fair value). After audits of the required reserves were performed, the Technical Committee of FOBAPROA decided to modify the acceptance criteria for the loans. This lowered the required increase in missing reserves.[107] However, these reserves were not set below those established by the

[107] Technical Committee Minutes, October 9, 1996

external auditors. In return for agreeing to lower reserves, loss sharing, incentive arrangements and additional securities were negotiated with the banks. Rather than renegotiating items within these agreements, the Technical Committee approved the agreements with the loans the banks had initially assembled, but required the banks disclose those loans excluded under the original rules.[108]

The requirements for audits, reviews by multiple parties and agencies, and resulting negotiated terms for the agreements, made impractical the compliance with time limitations of 30 days (from the formalization of the operations) for review by an independent auditor, and 60 days thereafter for review and approval by CNBV. The extended period of time (up to two years) taken to finalize the agreements, may have contributed to the deterioration in the quality of the banks' loans contained in the loan portfolio trusts.

In addition, the requirement to inject capital was not always met in full, as shareholders either could not obtain funds to inject (or not by a set deadline), or the sources were not acceptable according to the program rules.

Twelve banks participated in the CLPP program. The second round of purchase agreements were more consistent as the loss sharing percentage was consistent, no incentive arrangements existed, reserves were set according to external auditor findings, and banks had no ability to negotiate these arrangements.

In general, banks were found to have complied with capital commitments according to regulatory capital as set out under their agreements. Where these commitments were not met, extensions were granted or small shortfalls were overlooked based on the market conditions of individual cases. If the program capitalization was not substantially met, banks were subject to the Intervention and Rehabilitation program. Loans to be excluded, or disclosed (under the first round of agreements) were found to have been excluded or correctly disclosed, and in general, only minor differences in reserve determinations were discovered.

The information requirements for tracking and recording loans included in the resulting agreements were not aligned with the banks' existing information system capabilities. This made it difficult, initially, for some of the banks to comply with this aspect of the agreements. In many cases, audits of the banks' trusts holding the loans identified deficiencies in the banks' administration of these loans, including inaccuracies in the cash flows, inadequate reserves, and incomplete information regarding foreclosed and adjudicated assets. It appears banks remaining in loan portfolio purchase agreements have resolved information system issues as they are all now submitting reports, forecasts, and results against plan on a timely basis to FOBAPROA department.

The extensive time delays experienced in closing the agreements (measured in years) also violated the original terms. However, the major reason for that was the unrealistically short time frame, rather than the actions by the relevant parties.

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[108] Technical Committee Minutes, July 16, 1997

Generally, banks complied with the terms of the agreements they entered into. However, this was after agreement terms had been changed, and the changes had been approved by the Technical Committee. Generally, with some exceptions, where the commitment to inject new capital by a certain deadline was not met, the agreements were cancelled and reversed. The banks had trouble meeting the informational requirements of the agreements initially, but appear to have addressed this issue.

During the 1995 and 1996 period, when the agreements were first entered into, the focus of much of the FOBAPROA department was the audit of the credit portfolios, which directly involved reviewing certain loans. Subsequently, where reserve deficiencies were determined, FOBAPROA staff oversaw the substitution of certain loans, and negotiated loss sharing or incentive plans. During this time, the supervision of loan recoveries under this program by FOBAPROA could not be enforced as these purchases were not completed until much later, during mid 1997.

Banks had to redesign their systems and create a control and monitoring facility specific to the FOBAPROA loans. This prevented the FOBAPROA department from monitoring the loans until early 1998, and even later for certain banks. This problem became critical when detailed information was required to sell assets.

The CLPP agreements have information requirements which include a written report to the Technical Committee on the management of the trust's equity, on a monthly, bi-monthly and quarterly basis. However, many of these reports were unavailable until the agreements had been closed in 1997. The formalization of the FOBAPROA department monitoring of included loans did not commence until early 1998, even though much of the information was requested from the banks during the latter half of 1997. Since that time, the frequency, timeliness, and quality of the information received by FOBAPROA, and its use of it, have improved considerably.

For example, several audits were completed in the 1997-98 period:

- audit of purchased portfolios in each bank;
- audit of the concentrated checking account; and
- audit of mortgage loans.

The impact of the CLPP program was that capital was increased (as new capital was injected as a requirement). The requirement that capital be injected from various sources promoted foreign investment. The informational requirements to monitor and collect bad loans forced the upgrade of bank information systems. The requirement to administer and collect bad loans forced banks to focus on collection activities, and restructuring negotiations. The audit and review of loans allowed greater insight into the extent of the bad loan problem, and forced banks to extract, document, and include all relevant information regarding a debtor's financial situation. However, the initial agreements were insufficient in that almost every bank entered into a second or even a third loan portfolio purchase agreement. In many cases the CNBV demanded or encouraged banks to remain involved in the program to inject additional capital (e.g. Bital, Serfin).

Conclusions

The CLPP program while designed to provide incentives to increase capital in banks while providing support, was not initially designed for an application of this magnitude, which resulted in delays in its implementation. The banks were not able to comply with the program, until after terms had been amended to assist them appropriately. Certain banks were unable to comply with administrative requirements of the agreements, though these problems appear to have been resolved. The supervisory process was adequate for the CLPP program. The CLPP program appears to have had mixed results at various banks. For five of the twelve banks that participated in this program the level of additional capitalization was sufficient, while the remaining seven banks have continued to require additional reserves and capital, with the net result being that the effectiveness of the program was limited.

INTERVENTION AND REHABILITATION PROGRAM

The guidelines of this program focused on the capitalization and rehabilitation of banks. Consequently, each case was custom tailored to an individual bank. Taking into consideration the final bank solution after capitalization by FOBAPROA, there were three alternative outcomes to solve the problem of capital inadequacy: banks sold to a foreign shareholder, banks sold or merged with another Mexican bank, and banks where the branch network has been sold and the bank is being liquidated.

Compliance was not of an issue in this program due to the fact that it had to be done on a case by case basis.

The supervision of the Intervention and Rehabilitation programs varied by bank. The analysis here has been separated between intervened banks, and non-intervened banks.

Intervened Banks

For the evaluation of supervision of the intervened banks see "Evaluation of CNBV" section of the report.

The FOBAPROA department's involvement has been limited to financing of intervened banks and participation in the Recovery Sub-Committee. The ongoing monthly monitoring of recoveries appears to reside with CNBV.

Non-Intervened Banks

CNBV's approach to the supervision of non-intervened banks through recognizing problems, and encouraging bank management to consider various solutions, including capital injections rather than intervening. In some cases CNBV and FOBAPROA were active in encouraging solutions to problems (i.e. Banorte buying Bancen and Banpais, Bancomer buying Promex, BBV buying Probursa, Santander buying Mexicano). In some cases the failing non-intervened bank was allowed to continue operations. Examples are Atlantico and Promex where the expansion of these banks through the purchase of the failed banks branch networks was considered by CNBV as a last resort in order to strengthen bank's situation.

The impact of the intervention and rehabilitation program can be assessed only on a bank by bank basis. In a number of cases, a problem bank was either sold to a foreign shareholder or merged with another Mexican bank. In cases where a bank could not be salvaged, its branch network was sold to another bank.

Some concerns in respect to timeliness of resolution of the problem banks are addressed in the "Evaluation CNBV" section of the report.

Conclusion

The Intervention and Rehabilitation program was broadly set out in guidelines focused on the Capitalization and Rehabilitation of banks. For this reason, each case was custom tailored to individual banks. The programs, therefore, had such flexibility that no real framework could be said to have been in place except for the overall guidelines that the financial authorities followed (among others, minimizing fiscal cost, avoiding system risk, protecting depositors and ensuring the continuity of the system of payments).

Due to the lack of structure and the significant problems encountered at some of the banks with irregularities, fraud, problem loans etc., the effectiveness of the Intervention and Rehabilitation program is difficult to assess (against consistent criteria) as each bank's situation was different. Given that many of the deals have been suspended due to IPAB, the program has not been implemented on a timely basis.

Overall Evaluation

The overall banking system has been kept in operation over the past several years following the peso crisis, by means of a series of bank programs which have deferred addressing the underlying problem of a shortage of capital in the system.

Debtor Programs

During the period 1995 to 1998, several programs were created to assist and encourage debtors to repay their outstanding loans, which, in turn, would assist the banks in improving the quality of their portfolio and in maintaining their cash flows.

FRAMEWORK

The mechanisms for the debtor programs were designed before the implementation of the programs. The financial authorities adopted a specific protocol and timeline for each program. After signing the agreement, circulars were issued that outlined the operating rules, followed by the implementation of the program. However, due to the complex nature of the programs, the banks required clarification on certain points.

An important objective of the debtor programs was to create a culture of repayment among the debtors, which they did not entirely accomplish as indicated by the high delinquency rates throughout the period of the programs. One of the reasons was that some debtors became aware that programs with greater benefits will be offered over the future period of time, which encouraged them to wait for a better offer, rather than take advantage of the benefits currently being offered. This phenomenon was more visible during the period beginning with the announcement of the new programs to its implementation, when the debtors stopped paying thereby causing the delinquency to increase.

The support offered to the debtors was shared by the banks and the federal government, with the government paying the banks their portion of support via the Bank of Mexico (UDIs' cost) and FOBAPROA (discounts on interest and payments). The support via Bank of Mexico was covered in the form of government bonds, the term of which depended on the term of the restructured loan. FOBAPROA settled its share of support payments by obtaining a form of five year credit from the banks. Some of the banks expressed concern about the timing of the cash payments particularly for the five-year loans which are soon starting to mature.

SUPERVISION

Initially, the supervision of the debtor programs was compromised by the manner in which data was collected. The banks' calculations of support were faxed to CNBV and entered into the relevant computer application for analysis. This manual data entry was very time consuming and resulted in the banks receiving their support from the Bank of Mexico before it had been verified. Little analysis of the effectiveness of the first debtor programs was possible due to the lack or inconsistency of the data.

The method of data transmission from the banks to CNBV improved considerably with implementation of the SAC system, developed by CNBV for that purpose. Support calculations were sent electronically from the banks to CNBV, making the process more efficient and allowing for the correction of input errors prior to CNBV's analysis.

Analysis performed on the support calculations consisted of a variance analysis that included comparing previous periods information to the current period, comparing the information across banks and individually evaluating each bank against the entire system's information base. No preliminary examination was performed to verify the reliability of those calculations though non standardised means were used by CNBV to derive some comfort on the accuracy of the data. This seemed to happen due to the inadequate resources within CNBV to complete such testing as its resources were preoccupied with the time consuming tasks of input and sorting of data and assisting in development of the new system. In 1998 this was changed when the banks' external auditors began testing the underlying loans to provide further verification to the support calculations. However, the special audits to ensure banks' compliance of the debtor programs were not ordered until the end of 1998, three years after the introduction of the debtor programs.

COMPLIANCE

The results of review by the Reporting Accountants and supervision by CNBV, including the special audit by the external auditors, indicated that, in general, banks' compliance with debtor program rules has been acceptable. Several significant instances were noted including a large infraction discovered by CNBV, and one reported by the Reporting Accountants. These infractions were subsequently remedied. Minor infractions were detected by CNBV and followed up with the banks.

IMPACT

The debtor programs encouraged nearly one third of the debtors to liquidate their portfolio and many others to pay off a portion of their outstanding balances. In doing so the programs assisted mostly the small debtors that were the prime target of the programs. The overall delinquency was contained as a result of the incentives offered by the programs, although such incentives were not sufficient to cause a significant decline in the delinquency rate.

The programs could have potentially benefited a much larger percentage of debtors and could have achieved more success, but the limitations external to the programs and also those inherent in the Mexican financial system impacted the ability of the programs to achieve larger success. Moral hazard was increased due to the timing of the programs. Many of the loans were long past due prior to the crisis, therefore, there was little chance that the debtor programs would be able to make those debtors pay. The economic factors such as high loan to value of the collateral ratio discouraged debtors from making payments while the declining real wages reduced the debtors' purchasing power, and therefore, their debt servicing ability. Adverse publicity against the programs by debtor groups discouraged the debtors from paying. Finally, the legal system made it very difficult for banks to repossess the underlying collateral of the loans, so debtors had little to lose by defaulting on their loans. Considering the detrimental effects of the above factors, the debtor programs worked well to contain the past due loan ratios and preventing the situation from worsening. However, should real wages not keep pace with inflation, increased defaults may occur given a public perception that the government program is causing payments to increase. Ultimately, the UDIs program may not be considered a success.

Individual Debtor Programs

Some programs were more successful than others. The FINAPE program encouraged a large number of debtors to fully repay their loans and to contain the delinquency rate of the portfolio. The debtors in this economic sector were offered greater discounts compared to other sectors. This was beneficial to those suffering from factors such as droughts in 1997 and 1998.

The FOPYME program experienced a substantial amount of full repayment and a containment of the delinquency rate. This program was successful in helping a certain portion of the debtors pay out their loans, however, the delinquency rate for this program was higher compared to other programs.

These above two programs encouraged the financial institutions to grant new loans to the agricultural and commercial sectors.

As regards to the mid-size residential housing programs, their long term nature makes it too early to assess the impact on the loans. Unlike agricultural and commercial sectors, not a large number of debtors liquidated their portfolio primarily due to the longer period and relatively larger amount of loan (for an individual debtor) compared to the sectors discussed above. Efforts are being made to resolve problems like loan to value ratios by offering larger discounts, but it would be too early to give an opinion on the success or failure of these programs. The trend of inflation and real wages in the future will also impact the debtors ability to pay and thereby the success of the programs.

The minimum payments equivalent to rent program was not entirely successful. Although the program was well designed to help the debtors in liquidity crisis, to maintain their houses and mortgages, less than 3% of all mortgage debtors participated in this program. This could be attributed to the programs' complex nature which made it difficult for the banks to sell it to the debtors. The banks were also not keen on taking up this program as it involved low rent payments and their involvement in activities as rent collection.

The FOVI-type housing loans experienced an increase in the delinquency rate. Considering that payments for this program were based on the minimum wage for the geographical area rather than the actual house cost, there should have been a low delinquency rate for FOVI. However, this program also suffered from debtors' awareness that banks were limited in their ability to repossess the homes.

Sufficient information to determine the success of the earlier debtor programs, such as Planta Productiva and ADE is not available.

Conclusions

The debtor programs, by involving a cost to the banks assisted some, although not all debtors, to liquidate their portfolio and stay current. As a result, delinquency was contained and prevented from spreading which avoided the worsening of the banks' financial situation. In addition, payment of debt or its portion assisted in maintaining or improving the much needed cash flow of the banks.

The banks were provided incentives to provide new loans into certain weak sectors of the economy with the consequence that few debtors repaid these new loans. This policy appears counter productive as it should have been apparent from the outset that these loans could not have been repaid. Accordingly, FOBAPROA costs were increased.

Many banks offered additional benefits to debtors as incentive for repayment rather than proceeding to litigation, a costly process for the banks to undertake. This facilitated additional collections for the banks, substantially benefiting them at a significant cost to FOBAPROA. Had the government intended to benefit the debtors as a social policy they should have done so without using FOBAPROA as a vehicle at significant cost and provided direct cash benefits to the debtors.

VI FISCAL COSTS

INTRODUCTION

We have been asked to assess the fiscal costs of the bank and debtor programs that were implemented following the peso crisis in December 1994. In addition, we have been asked to include, in our summary, those costs incurred in connection with the toll roads program, even though this program was funded directly by the government and FOBAPROA played no part in its implementation.

For the purpose of this assessment, we reviewed the financial position of FOBAPROA as at February 28, 1998. These statements were included by FOBAPROA in its report in response to the request of Congress that it be provided with the actual and estimated costs that FOBAPROA had incurred and expected to incur in completing its funding of the bank and debtor programs.

In accordance with our mandate and in order to evaluate the costs of the various programs to June 30, 1998, we have reviewed the records of FOBAPROA and have obtained its input regarding changes in its financial position for the period covered by its report to Congress. FOBAPROA has not prepared a consolidated balance sheet at June 30, 1998, although it has prepared a statement of consolidated liabilities as at that date and has stated that the consolidated assets have not changed between February 28, 1998 and June 30, 1998.

FOBAPROA prepares its monthly balance sheet in accordance with its normal accounting policies, as agreed with its external auditors. The preparation of a consolidated balance sheet, which includes the assets and liabilities on the books of the intervened banks, is a special exercise required primarily for the purpose of calculating the total fiscal costs.

In order to complete this aspect of the evaluation, we relied on the work performed by the RA's and, in particular, the results of the procedures that were carried out at each bank involved in the FOBAPROA programs. We have also carried out independent enquiries and discussions with the regulatory authorities as part of this review. However, due to the difficulties encountered in obtaining consolidated figures, we relied on the information available and the audited FOBAPROA financial statements as at December 31, 1997.

In order to evaluate fiscal costs, access to certain financial records of the operating banks and all financial information from the banks in which the regulatory authorities had intervened, was necessary. With respect to the *de facto* intervened banks, full access to the required financial records has been restricted. In addition, in many cases, we were denied access to the financial analyses prepared by the banks concerning those costs which they anticipate will be incurred in connection with the bank and debtor programs. Although different reasons were given for the restrictions placed on our ability to obtain information, this limited access has prevented us from being able to verify and confirm some of the information which ordinarily would be reviewed in order to fulfil our mandate. In addition, such restrictions with respect to the information that was made available to us may have resulted in the overall estimates of fiscal costs of the FOBAPROA programs to be conservative.

In addition to the commentary below, there is a supplementary analysis of FOBAPROA's liabilities and assets also provided at the end of this report.

ESTIMATE OF FISCAL COSTS AS AT FEBRUARY 28, 1998 AND JUNE 30, 1998

For the purposes of this report all comments have been based on the figures summarized below. This includes adoption of the allocation of various assets and liabilities to specific headings, as noted in the various sections.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Liabilities of FOBAPROA	552,300	589,600	659,800
Assets of FOBAPROA	(218,700)	(238,100)	(251,600)
Net Liabilities of FOBAPROA	333,600	351,500	408,200
Net Disbursements paid out by FOBAPROA	80,600	85,400	85,400
	414,200	436,900	493,600
Non-FOBAPROA Programs:			
Present Value of Debtor Programs	112,800	119,700	119,700
Present Value of Toll Roads Program	18,800	20,000	20,000
	131,600	139,700	19,700
Total Fiscal Costs	545,800	576,600	633,300

The present value calculations for the non-FOBAPROA programs are prepared by the relevant financial authorities and not by FOBAPROA. FOBAPROA has estimated the total fiscal costs at February 28, 1998 as MN $545,800 million. This figure represents an over-estimate of costs by MN $15,700 million due to the failure to record a receivable in respect of debtor programs. FOBAPROA's figure increased to MN $576,600 million as at June 30, 1998, primarily due to interest accruing on notes issued in respect of loan portfolio purchases and sanaemiento programs at various banks.

Based upon our review of costs and a comparison with comparable figures produced by FOBAPROA on a bank-by-bank basis, we estimate an additional MN $56,700 million of fiscal costs. Our estimated total of MN $633,300 million for fiscal costs at June 30, 1998, represents MN $493,600 for bank programs and MN $139,700 million for toll roads and debtor programs.

The above estimates reflect our findings that FOBAPROA's liabilities are MN $70,200 million greater than FOBAPROA's own estimates, primarily in relation to Serfin, BanCrecer, Atlantico and Promex. However, this understatement of liabilities is partly offset by an understatement of assets, primarily due to over-provisions against the value of the portfolio purchase loan portfolios. The total understatement of assets is MN $13,500 million.

The procedures performed by the RA's and the additional work that we have performed through discussion with FOBAPROA and CNBV do not amount to a financial audit of FOBAPROA. Therefore, we cannot express any opinion on the financial statements of FOBAPROA, or on its financial position. In addition, as discussed above, FOBAPROA has not produced consolidated financial statements for June 30, 1998.

Given the limitations discussed in various parts of this report, and the uncertainties relating to some items such as future costs, we provide an estimate only of the net liabilities of FOBAPROA as at June 30, 1998.

Further, while the work was focussed on the fiscal costs as at June 30, 1998, it must be noted that certain of the FOBAPROA liabilities are in the form of interest bearing notes, such that the nominal liabilities of FOBAPROA will increase over time as interest accrues. Whether these liabilities represent an increasing or decreasing share of GDP will depend upon the ratio of FOBAPROA (IPAB) funding costs and nominal growth of GDP.

DISBURSEMENTS MADE BY FOBAPROA

The February 28, 1998 estimate of fiscal costs included not only the balance sheet items, but also costs disbursed or funding received without recourse, and hence no longer recorded on the balance sheet. FOBAPROA has provided a present value for these items, as at February 28, 1998, of MN $80,600 million. FOBAPROA has confirmed that there were no further disbursed costs to June 30, 1998. Part of the funding received was by way of cancellation of debts, rather than cash. FOBAPROA, in bringing historical costs to a present value is recognizing opportunity costs in respect of its funding. This should be distinguished from actual cash flows. We have used this accounting convention and further updated the disbursed costs using a CETES rate. The revised estimate of the fiscal cost of the disbursed funds is MN $85,400 million as at June 30, 1998.

We have tested the amount of the disbursement by obtaining schedules from FOBAPROA showing costs on either a cash or loan basis. The net cash outflow materially agrees to the disbursed cash as stated by FOBAPROA.

In order to determine the total fiscal costs of FOBAPROA, it is appropriate to add these disbursement amounts to the net liabilities of FOBAPROA.

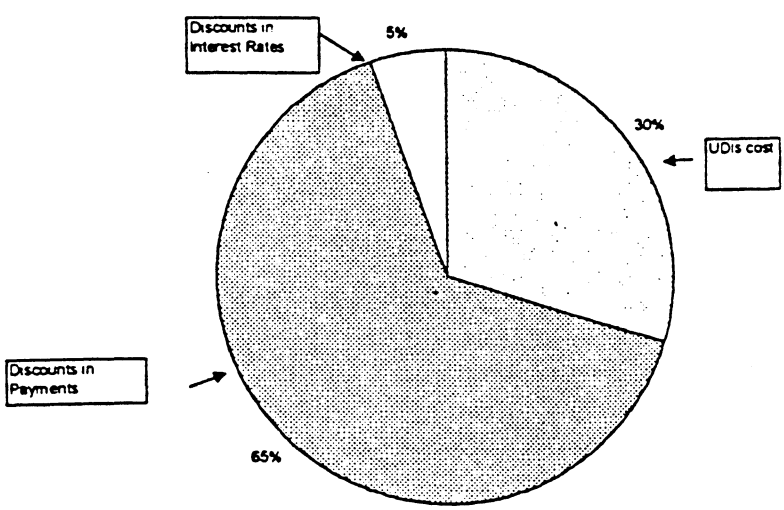
ESTIMATE OF THE FISCAL COSTS OF THE DEBTOR PROGRAMS

We have reviewed CNBV's most recent comprehensive assessment of the costs of the debtor programs. As explained below, only a portion of the debtor programs has been reflected on the books of FOBAPROA. The CNBV assessment involves a calculation of the present value of future payments to be made to banks in connection with each of the debtor programs. Among other things, the calculation requires assumptions regarding future interest rates, inflation, and the continuing participation rate of debtors over the life of the programs (some of which were established over thirty year periods). The CNBV assessment is dated as at December 31, 1997 and indicates a present value of MN $96,300 million. CNBV has updated the December 31, 1997, estimate to February 28, 1998, on the basis of increasing the present value of the estimates by the value of CETES, as well as sundry adjustments for participation rates.

CNBV has not been able to provide details of its updated calculation. The CNBV estimate is the best estimate available for the costs of the debtor programs as at February 28, 1998. This was MN $112,800 million as at February 28,1998.

The following graph illustrates the proportion of fiscal costs, as of December 1997, according to the type of cost.

Fiscal Cost by Type (as of December 1997)



Source: CNBV

We have reviewed CNBV's methodology for estimating debtor program costs, and find the methodology to be logical. Assuming that CNBV has been supplied with accurate and complete information by the banks, we have concluded that the December 31, 1997 estimate is reasonable.

We emphasize the volatility of this number in respect of two key variables; inflation and participation rates.

The projected cash flows involved in these programs are immense – some MN $2,000,000 million. Actual cash flows will vary with inflation and interest rates. In addition, these cash flows have been discounted over an approximate thirty year period and actual inflation and interest rates could radically change the present value estimate.

The banks have reported that the number of participating borrowers can change rapidly, particularly in response to signs of potential changes in or additions to the programs. Any reduction in debtor participation will reduce costs – but will also impact the banks, as the need would arise to provide for additional bad debts. In most of the programs, approximately 60-75% of eligible participants are paying their loans. This means that there is considerable potential for changes in costs if changes occur in the economy or in property prices.

To bring the February 1998 totals to June 1998, a monthly rate was applied based on the CETES rate for the months of March, April, May and June. Confirmation was obtained that CNBV uses the ninety-one day CETES rate in the calculation of costs that relate to programs that are capitalized quarterly. The ninety-one day CETES rate was applied to the discounts in payments and interest rates. For the UDIs costs, the CPP rate was used to arrive at the June 30, 1998 costs.

The decision to calculate the June 30 estimates for fiscal cost by applying these factors to the February numbers assumes that there have been no changes in the underlying variables. The following table shows the revised estimate of the fiscal costs as at June 30, 1998.

Program	Estimated Fiscal Cost (Thousands of Millions of Pesos)
UDIs Costs	35.2
Discounts of Principle	78.3
Interest Rate Discounts	6.2
TOTAL	119.7

In relation to trends in the costs of the debtor programs, it is particularly difficult to estimate the future cost of loans restructured in UDIs. Such an estimate depends on future real interest rates and the continued participation of debtors.

In addition, debtors with loans restructured in UDIs benefit from the temporary deferment of repayment of the inflationary part of the interest rate. However, if the economics and especially real wages do not improve by the time the debt servicing burden increases, some debtors will not be able to continue their participation in these programs.

Since early 1999, most of the debtor programs existing as at February 28, 1998 (and June 30, 1998) have been replaced by a new program, Punto Final. CNBV's estimates of the costs of all debtor programs as at January 1, 1999 are expected to be available in July 1999. Punto Final is likely to increase the costs of the debtor programs, since it offers to eligible debtors increased incentives to participate.

ESTIMATE OF THE FISCAL COSTS OF THE TOLL ROADS PROGRAM

As agreed with the Hiring Committee, this program has not been reviewed as part of the mandate. However, in order to provide an estimate of fiscal costs consistent with that received by the Congress as at February 28, 1998, we have used the MN $18,800 million amount provided by SCHP and updated it at CETES to MN $20,000 million as at June 30, 1998.

EVALUATION OF THE SOURCES AND USES OF FOBAPROA'S FUNDS AND LIABILITIES IN RESPECT TO BANK PROGRAMS

The following table presents a summary of FOBAPROA's sources and uses of funds for the period 1994 to 1998 (in millions of pesos).

	Dec 31 1994	Dec 31 1995	Dec 31 1996	Dec 31 1997	Dec 31 1998	TOTAL
SOURCES OF FUNDS						
Levies from Banks	117	1,742	2,137	2,611	2,989	9,596
Collection from Commercial Banks for Credits in US Dollars	0	24,091	0	0	0	24,091
Other Income	62	6,440	3,921	1,212	3,483	15,118
	179	32,273	6,058	3,823	6,472	48,805
Funding from the Federal Government	0	0	6,200	38,503	3,299	48,002
Credit from Nafin	0	5,444	6,614	331	0	12,389
Funding from the Bank of Mexico	0	394,925	1,081	24,469	48,078	468,553
Recovery of Advances	0	375	14,511	16,840	38,309	70,035
TOTAL SOURCES	179	433,017	34,464	83,966	96,158	647,784
USES OF FUNDS						
Amounts for Administration and Operation	1	15	49	100	194	359
Other Expenses	0	0	0	0	3	3
	1	15	49	100	197	362
Servicing and Amortization of Bank of Mexico Debt	0	31,134	1,960	26,067	45,784	104,945
Service and Amort. Of Nafin Debt	0	0	257	638	0	895
Purchase of Dollars from Bank of Mexico	0	0	0	0	580	580
Liabilities to Federal Government	0	0	0	0	436	436
Advancements under Bank Programs	0	398,175	31,749	45,620	57,305	532,849
TOTAL USES	1	429,324	34,015	72,425	104,302	640,067

Sources of Funds

During this period, ninety percent of the funding for the operation of FOBAPROA was provided by three sources. The Bank of Mexico provided approximately 72% of FOBAPROA's funding from 1994 to 1998 and the federal government provided approximately 7%. In addition, approximately 11% of FOBAPROA's funding came from recoveries of amounts previously paid out pursuant to the bank programs of FOBAPROA.

Uses of Funds

This table confirms that FOBAPROA program support consumed approximately 82% of the total funds from January 1, 1994 to December 31, 1998. The costs for servicing and amortizing obligations accounted for approximately 16% of the uses of funds from 1994 to 1998. The costs for operation and administration absorbed less than 1% of the total cash outflows.

LIABILITIES OF FOBAPROA THAT COULD BE CONVERTED TO PUBLIC DEBT

In addition to addressing the fiscal costs, we were asked to consider the extent to which the liabilities of FOBAPROA would be suitable for conversion into public debt. We have not been asked to determine whether or not any liability of FOBAPROA should be converted into public debt.

In this section, we analyze in general terms what items within the FOBAPROA liabilities could reasonably be converted into public debt, should Congress determine that this is appropriate. It is assumed that the conversion of FOBAPROA notes to IPAB notes represents an interim step in addressing this question.

In general, only amounts that have been, or are likely to be issued as notes will be suitable to conversion to public debt. Amounts which have not yet crystalized, or are dependent upon future events – for example the present value of future debtor program liabilities - are less easily convertible to a debt instrument. In addition, small program liabilities that are soon expected to reverse – such as the payments in kind program – are likely to have been retired before a general conversion scheme could be put into place.

Set out below are the main liabilities of FOBAPROA that could be convertible to a public debt instrument.

1. The Bank of Mexico facility in respect of Inverlat, which is expected to be approximately MN$ 40,000 million by March 2000, is expected to be translated partly into a note payable to GFI. This balance could be converted to public debt, payable to GFI, on terms to be negotiated.

2. The loan purchase notes of MN $171,600 million at June 30, 1998 already exist in note payable form and could be converted into public debt. At that time, conversion to pesos of foreign currency amounts, and the determination of a new repayment date may be appropriate. The issues relating to the structure of any new public debt is discussed later in this section.

3. With regard to Saneamiento, at the present time, only the notes issued of MN $99,100 million at June 30, 1998 are suitable to conversion to public debt. Any conversion can be used as an opportunity to harmonize the currency, term and interest rate characteristics of the debt.

4. In relation to the sale of branches, following any necessary legal formalities to transfer the liabilities to FOBAPROA, this debt is potentially available for conversion to public debt.

5. In relation to the existing liabilities of the intervened institutions, liabilities currently exist in a variety of forms and currencies and are hence not readily convertible to public debt. Many of the banks' creditors look upon these as liquid resources, however, conversion to public debt might be agreeable to such

creditors if such public debt could be easily traded at issue value in a liquid market. To achieve this, it would likely be necessary to combine several of the foregoing into a common form of public debt.

DISCUSSION OF TYPE OF DEBT INSTRUMENTS TO BE ISSUED TO REPLACE FOBAPROA LIABILITIES

The mix of interest bearing liabilities and the spread between FOBAPROA's U.S. dollar and peso interest rates produces an average funding cost for FOBAPROA at just below CETES.

There are a number of factors that must be considered when replacing FOBAPROA instruments with formal public debt instruments.

One of the considerations are the needs of the existing holders of the FOBAPROA notes and liabilities. At present, FOBAPROA note holders are holding a non-negotiable asset which normally accrues interest to maturity. This is adversely affecting the liquidity of the banking sector, raising costs and inhibiting loan growth. Holders need the replacement notes to assist them in meeting liquidity requirements.

The ability of the federal government to finance new public debt is also an issue and the effects of adopting the FOBAPROA obligations as public debt also need to be considered. It is expected that initially the new notes will simply be non-negotiable replacements for existing notes, so a funding issue does not arise in the short term. In addition, the public nature of the debate on FOBAPROA and the costs of the bank rescue has prepared the capital markets, both domestic and foreign, for the probability that some portion of the FOBAPROA obligations will be formally adopted by the government. Significant portions are already guaranteed by the government.

This report states that the ultimate costs are likely to be higher than the June 30, 1998 estimate due to the accrual of interest and the effect of inflation. In the current high interest rate environment, this increase in costs is likely to exceed growth in real GDP. Additionally, the present under-capitalization in the banking sector still needs to be remedied. Placing all these obligations in the market may have an adverse impact on the government's funding costs if perceptions of risk increase. Even though the government does not expect to be a large net issuer of debt over the next few years, as deficits are kept in check, it faces a considerable roll-over of debt since much of the present debt is in the form of relatively short-term paper, particularly for domestically held debt. The release of FOBAPROA related debt into this market will therefore need to be gradual to avoid destabilization of the federal government debt market. In particular, the maturity dates of any notes, whether publicly traded or not, will need to be considered to ensure that the government does not commit to onerous repayment obligations. Since public debt amortizations are due to remain relatively constant to at least 2007, this implies that gradual amortization of the FOBAPROA debt should be adopted. This will either mean the issue of notes with different maturity dates or the issue of notes redeemable at the government's option over a given period of time.

The notes must have predictable value if and when they are allowed to be traded on the public markets, or else the stability of the banking sector, as well as the government funding market, will be threatened. This suggests that notes be issued to the banks that mirror existing government debt instruments already in the market. They will also need to be issued on terms that reflect the existing FOBAPROA notes to avoid putting pressure on bank profitability or offering windfall profits to the banks.

Given the above, initially, the cost of funding is likely to be close to the existing terms of the FOBAPROA notes. However, by marking to market, in so far as the new notes may carry less risk than FOBAPROA notes, there will be a possibility that the banks will realize gains resulting from lower risks.

VII REPORTABLE TRANSACTIONS

INTRODUCTION

The purpose of this section is to describe, summarize and identify the potential costs associated with certain transactions entered into by the banks which participated in the FOBAPROA programs. The information regarding these transactions was obtained primarily by the Reporting Accountants during the course of their review of the banks.

These transactions are of three kinds:

(a) those loans that did not meet the original criteria established by the Technical Committee for loans that were to be acquired by FOBAPROA through the Capitalization and Loan Purchase of Bank Portfolio program ("CLPP"). In many cases, CNBV and FOBAPROA amended the terms of the agreement to accept these loans;
(b) those transactions in which the banks extended financing to parties with which they were related or affiliated (which, in many cases, raise questions about the collectability of such loans); and
(c) those transactions which have been reviewed or are under review by CNBV and/or certain banks either because they have been determined to be illegal or because they may be categorized as a violation of the laws and regulations affecting Mexican financial institutions.

These three types of transactions are collectively referred to as "Reportable Transactions". In accordance with the chart below, the Reportable Transactions identified aggregate approximately MN $72,700 million, a significant portion of which will result in substantial additional costs to FOBAPROA.

Summary of Reportable Transactions identified		MN $ Millions
A.	Loan transactions which do not meet the original criteria established for loans that were to be acquired by FOBAPROA through the CLPP program	
(a)	identified and agreed to between the banks, CNBV and FOBAPROA	24,000
(b)	identified by the Reporting Accountants that were NOT agreed to between the banks, CNBV and FOBAPROA	700
		24,700
B.	Transactions in which banks extended financing to parties with which they are related or affiliated	42,000
C.	Transactions which have been reviewed or are under review by CNBV and /or certain banks, which either have been determined to be illegal or may be categorized as a violation of the laws and regulations governing Mexican financial institutions.	6,000
Total		72,700

SCOPE AND RESTRICTIONS

This section should be read in conjunction with that part of the Methodology section of this report entitled "Communication." In addition, further restrictions on our scope are noted below.

The findings in this section of our report are limited to information obtained by us from the following sources:

- discussions with the Reporting Accountants and review of their reports and working papers;
- discussions with intervenors or officials of the banks participating in the FOBAPROA support programs and a review of certain documents provided to us; and
- discussions with officials from CNBV and a review of information provided by them related to specific transactions.

Due to these factors, we cannot provide assurance that our procedures have identified all Reportable Transactions falling under the specific criteria noted above.

Furthermore, we are not able to provide an opinion as to whether the Reportable Transactions described in this section are illegal, in breach of Mexican laws or banking regulations, or that they necessarily will lead to a cost to FOBRPROA. In this regard, however, it should be noted that a significant proportion of the Reportable Transactions were discovered following intervention by the regulatory agencies and that many of such loans have been determined to be uncollectable. It is, therefore, almost certainly the case that FOBAPROA will incur a loss from many of the Reportable Transactions described.

A. LOAN TRANSACTIONS WHICH DO NOT MEET THE ORIGINAL CRITERIA ESTABLISHED FOR LOANS THAT WERE TO BE ACQUIRED BY FOBAPROA THROUGH THE CLPP

The criteria established for cash flows from loans that would be regarded as eligible for acquisition through the CLPP program, initially excluded a number of different categories of loans. These loans were excluded, for the most part, because of concern regarding their value and collectability. The categories that were excluded are as follows:

- "E" loans;
- related party loans;
- discounted loans;
- loans under MN$200,000;
- personal loans;
- loans to bankrupt borrowers;
- loans in connection with which payments were suspended;
- loans requiring additional funding; and
- UDIs.

Subsequent amendments were made to the agreement, according to the terms of which the banks involved in the program sold the cash flows from their loans to FOBAPROA, that had the effect of allowing most loans to qualify, unless FOBAPROA specifically rejected them, including those loans that initially failed to qualify in accordance with the list of excluded loans. The effect of these changes was to permit the sale of loans to FOBAPROA that were of less quality and doubtful value thereby placing a greater financial burden on FOBAPROA than would otherwise have been the case.

We have quantified the categories of loans (described above) which did not meet the original qualifications set by FOBAPROA but were later accepted, as follows:

	MN$ Millions
"E" Loans	1,200
Discounted loans	5,800
Loans under certain threshold amounts	150
Personal loans	700
Loans where payments were suspended	3,200
Loans to related parties	4,800
Loans requiring additional funding	400
UDIs	775
Other, including loans with inadequate security or documentation and loans in litigation	6,975
Total	24,000

The amounts noted above are based on the price FOBAPROA paid when it agreed to reduce its criteria and acquire an interest in the loans. In some cases, the loan has been repaid, resulting in no cost to FOBAPROA. We also note that certain portfolio purchase transactions were reversed subsequent to June 30, 1998 and the loans returned to the bank. These reversals occurred at intervened banks and represent only a recategorization to the FOBAPROA costs.

In addition, the Reporting Accountants have identified other loans that were acquired by FOBAPROA which did not meet any of the original criteria under the agreements, but apparently were not identified as such by CNBV, FOBAPROA or their appointed auditors. These loans amount to MN $700 million.

B. Related Party Transactions

Many loan transactions have been identified which, although they were not the subject of the CLPP program, have or may eventually become a cost to FOBAPROA through the rehabilitation program. Many of these transactions have been identified as such by CNBV. Under this program, FOBAPROA has absorbed all of the assets and liabilities of certain banks. To the extent that it is unable to recover the full amount of the loan portfolios in question, FOBAPROA's resources will be called upon to make up the difference. Many of these loan transactions are with parties which had some relationship with the banks from whom they were borrowing funds, either by virtue of being shareholders or officers, directors or advisors or companies which were part of the group which owned the bank. Many of these loans were granted without any appropriate reference to the capacity of the debtors to repay.

(a) Shareholder Loans

A large number of loans to shareholders made for the purpose of underwriting their acquisition of shares were evident from our review of several banks. To the extent that such loans were made without recourse to the borrower or where the only security is the shares themselves, serious doubts regarding their collectability arise.

For example, in the case of one particular bank, according to information we received from CNBV, in 1991 a group of purchasers acquired 100% of the bank's shares from the federal government of Mexico at a price of approximately MN $800 million. CNBV later determined that loans totalling approximately MN $600 million had been issued by the bank to 714 shareholders for the acquisition of the bank's shares and that such shares were pledged as collateral for the loans in question. According to CNBV, this was an inappropriate banking practice which is now prohibited by law.

In 1993 a group of shareholders of this bank purchased a block of shares in a group which owned another bank at a price of approximately MN $1,600 million. The sales proceeds were largely applied against the outstanding loan balances of MN $1,300 million that the vendors owed their own bank. It was later determined by CNBV that loans granted by various banks had been used by the purchasing group to fund the acquisition of the group's shares.

Loans to Directors, Officers, and Advisors and Group companies

Reportable Transactions involving directors, officers and advisors were identified in several banks.

Loans in this category appear to have been granted on the basis of the relationship of these individuals to the banks in question and were typically granted on an unsecured basis. Credit studies and analyses could not be found in many files, or such studies, if prepared, did not contain such information as should have been available to support the granting of the loans.

Interest accruing on these loans was frequently capitalized rather than paid. In some cases, additional loans were issued to borrowers for the purpose of paying interest on the initial loans.

In a number of cases, no payments of principal or interest were ever made. In some of these cases, the expected recovery by FOBAPROA is nil. In other cases, the loans were restructured. While collateral was obtained as security for a number of restructured loans, such collateral was frequently inadequate to secure them.

An example of the extent and type of related party lending is the following which occurred at one particular bank. After CNBV intervened the bank in 1994, an investigation revealed that the bank had issued credits totalling MN $14,000 million to fifty-nine borrowers that were intermediaries or "channel" companies under the influence and direction of the bank's chief executive officer. The loans had been issued without a proper credit study and the funds had been diverted to the benefit of the chief executive officer and certain companies which he controlled. According to CNBV, the total loss on these transactions was in excess of MN $3,700 million.

Another example of related party lending leading to a loss to the bank, and hence to FOBAPROA, was a transaction in which the chief executive officer and a group of investors, financed primarily by such officer's bank, acquired a foreign company for approximately US $500 million. Various holding companies were created to hold shares in the acquired company with the chief executive officer in question holding indirectly 23% of these holding companies. Most of the loans issued by the bank related to this transaction are of doubtful collectability.

Another example of extensive lending to parties related to the banks which will result in substantial losses to FOBAPROA, occurred at a bank authorized to open in June 1993. By mid 1995, CNBV had identified serious problems involving excessive related party lending, some of which was used to finance the shareholders' purchase of shares in the bank. CNBV requested that the shareholders provide funding to repay these related party loans and when this request was not fulfilled, CNBV intervened the bank in May 1996. Most of the ultimate cost to FOBAPROA of this intervention is due to the apparent uncollectibility of the related party loans.

In another example, the bank loaned funds to a factoring company which was controlled by the same group which controlled the bank over the period from 1993 to 1996. All loans issued were unsecured. A full recovery is not expected resulting in a potential cost to FOBAPROA on this transaction of MN $1,182 million.

We understand that, in Mexico, a relatively small number of integrated economic groups (approximately 10 to 12) are responsible for a substantial amount of business activity. These integrated economic groups typically operate through many companies and in many industry sectors, including the financial services industry. These economic groups owe significant amounts to banks which participated in the FOBAPROA programs. Many of these economic groups hold or held ownership positions in certain of the banks reviewed. In many cases, the Reporting Accoutants have classified loans to certain of these economic groups as having doubtful credibility and, hence, they will likely lead to a cost to FOBAPROA.

For example, at one non-intervened bank, loans were made to groups which held shares in the bank, including certain of the economic groups noted above. At June 30 1998, these shareholder groups owed the bank several thousand million pesos. Some of these loans were made to members of these economic groups in order to purchase shares in the bank. Most of the loans were made between 1992 and 1995 and are unsecured or inadequately secured. The loans include personal loans made to members of the group and loans made to finance the operations of companies included in the group.

Loans made to certain of the economic groups were transferred to FOBAPROA by banks participating in these programs. As well, a number of the intervened banks also hold loans of doubtful credibility from certain of these economic groups.

We are aware of certain allegations set out in the popular press and in interviews attributed to Carlos Cabal Peniche that some US $25 million was made available to a political party in the period 1992-1994 by way of certain trust accounts at Banco Union. Further, we understand that it is alleged that Banco Union indirectly funded these amounts by way of loans that were subsequently written-off.

In this regard, we received from a third party copies of reports purported to have been prepared by Banco Union at the request of CNBV which describe such transactions. We are not able to independently confirm or deny the accuracy of the allegations.

We have requested but have been denied access to all of the records, and specifically the trust records associated with these payments, on the basis that the transactions are currently under criminal investigation.

C. Illegal Loans

A number of Reportable Transactions have been identified by CNBV and/or certain banks as potentially illegal. Illegal acts are described in the *Law of Credit Institutions* and relate to the activities of employees, officers and debtors. CNBV has issued crime opinions relating to these acts. According to CNBV, the elements required to prove an offence are as follows:

(a) an illegal act;
(b) a loss to the lending institutions resulting from the act; and
(c) evidence that such institution has taken all legal steps to recover its loss.

The nature of illegal activities described in the *Law of Credit Institutions*, and the subject of certain of the crime opinions, include:

- debtors providing false information to banks to obtain loans. The false information usually includes financial statements, appraisals and statements of assets;
- employees and officers knowingly accepting false information from debtors in the credit granting or loan restructuring process;
- employees and officers authorizing transactions knowing that the transactions would result in losses to the banks;
- debtors who did not use loans for their intended purpose;
- alteration or falsification of records, including financial statements, by employees and officers; and
- receipt of benefits by employees and directors to act in a certain manner or to refrain from acting in a certain manner.

A brief description follows of the types of activities occurring within certain banks which led to CNBV issuing crime opinions.

A former executive of a bank obtained an unsecured loan from the bank providing false data regarding the amount of his assets and liabilities, including false data concerning the ownership of real property. The loss to the bank was over MN $300 million.

Two officers of a bank recommended to the bank's credit committee that the bank authorize loans to a service business. In their recommendation they accepted collateral from the borrower that they knew was false and of no value to the bank. The debtor defaulted on the loan resulting in a loss to the bank of over MN $20 million.

The general director of a bank authorized a payment in kind from a related party regarding goods appraised at a value exceeding the real value of the goods. The debtor was released from the related loan obligation. The bank subsequently realized a loss on the assets of over MN $150 million.

Several former officers of a bank authorized loans to a company which did not have the capacity to repay. The company was allowed to divert the funds to the benefit of a bank executive. The loss to the bank was over MN $300 million. The Attorney General has seized property from a third party and issued an arrest warrant. If the Attorney General is successful in its prosecution of this matter, the bank may receive some of the seized assets as compensation.

One former officer of a bank falsified the financial statements of the bank to conceal losses and a significant decline in the net equity of the bank. The bank was subsequently intervened six months later.

In total, we have identified approximately MN $6,000 million in such transactions.

SUMMARY OF DEFINITIONS AND ABBREVIATIONS

ABM	Mexican Bankers Association (Asociación de Banqueros Mexicanos)
ADE	Immediate Support Agreement for Bank Debtor Programs
AUP's	Agreed Upon Procedures
A.T.M.	Automatic Teller Machines
Adscrito	ADRs (American Depository Receipts)
Bankruptcy Law	Law of Bankruptcy and Suspension of Payments
Blocks	Term used to describe review areas requested of Mackey by the Hiring Committee
BANORAS	National Public Works Bank (Banco Nacional de Obras y Servicios)
BARCON	Debtor Protection Organization
Bank of Mexico	Central Bank
BIS	Economic paper #46 published in October 96 by the Bank for International Settlements
BBV	Banco Bilvao Vizcaya
Basle Capital Accord	Economic Paper – Basle Capital Accord issued by the Basle Committee on banking supervision.
The Basle Committee	Basle Committee on Banking Supervision
Brady Bonds	Restructured emerging market US$ denominated debt utilized to replace "E" loans within FOBAPROA trust
CETES	Mexican Treasury Bills (Certificados Tesarios Especiales)
CLPP	Capitalization and Loan Purchase of Bank Portfolio program.
CNB	National Banking Commission (Comisión Nacional Bancaria)
CNSF	National Insurance and Bonding Commission (Comisión Nacional de Seguros y Fianzas)
CNBV	National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores)
CNV	National Securities Commission (Comisión Nacional de Valores)
CONDUSEF	Financial Services Users Protection Commission
CONSAR	National Commission for Retirement Savings System
Consurso	Procedures for insolvencies arising from non-business activities
Central Bank	Bank of Mexico
Congress	Congress of the United States of Mexico
CPP	Average Percentage Cost of Funding by Banks (Costo Porcentual Promedio de Captación)
Crime Opinion	Investigative report prepared by CNBV for the court regarding suspected illegal activity.
DAC	Corporate Assets Management Group within the FOBAPROA department
DGDS	Department of the General Director of Banking and Savings
DOF	Federal Official Journal (Diario Oficial Federal) Gazettes
De-facto	In fact, but not legal form
"E" Loans	Past due loans for which a 100% is required.
FAMEVAL	Support Fund for the Securities Market (Fondo de Apoyo al Mercado de Valores)
FDIC	Federal Deposit Insurance Corporation
FINAPE	Debtors' Support Program for Agriculture and Fishery
FOBAPROA	Fund for the Protection of Bank Savings (Fondo Bancario de Protección al Ahorro)
FOGADE	Deposits Guarantee Fund
FONAPRE	Preventative Support Fund for Various Banking Institutions
	Replaced by FOBAPROA
FOPYME	Debtor Program for Small and Medium Sized Firms (Acuerdo de Apoyo Financiero y Fomento a la Mircro, Pequeña y mediana empresa)

FOVI	Debtor Program for Residential Loans
Financial Group	A financial conglomerate including two or more financial service entities
Financial Authorities	CNBV, SHCP and the Bank of Mexico
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
Hiring Committee	A Committee created by the Congress of Mexico to engage Mr. Michael W. Mackey in the evaluation and performance of FOBAPROA
IMF	International Monetary Fund
Inter alia	Among other things.
Intervention	Process to take legal control of a bank
Intervenor	External individual put in place by CNBV to manage a bank
IPAB	The Institute for Protection of Bank Depositors (Insituto para la Protección al Ahorro Bancario)
Ley Reglamentaria del Servicio Público de Banca y Crédito	Law of Banking and Credit Public Service, repealed 1990.
LCI	Law of Credit Institutions
MACROS	Categories analysed in an appropriate supervisory regime
MBA	Mexican Bankers Association
MIS	Management Information System
MN	New Mexican pesos
Moral Hazard	Occurs when members of the financial system take on increased risk due to guarantees. Losses will be protected.
NAFIN/NAFINSA	Development bank with whom the commercial banks discounted their loans as part of the debtor programs. (Nacional Financiera S.N.C.)
NAFTA	North American Free Trade Agreement
PACEM	Debtor Program for States and Municipalities
Planta Productiva	Debtor Program for Production Plants
PIB	Gross Domestic Product (Producto Interno Bruto)
PROCAPTE	Temporary Capitalization Program (Programa de Capitalización Temporal)
Punto Final	"Full Stop" Scheduled to be the Final Debtor Program
RA's	Reporting Accountants
Rentas	Home rental debtor program
SAC	Database programs designed by CNBV to receive and manage information from the banks. (Sistema Automatizado de Capture)
SITI	Computer system by which banks transfer information to CNBV
SAF	Database program designed by CNBV – Financial Analysis System
Saneamiento	Recovery, healing
SHCP	Ministry of Finance and Public Credit (Secretaria de Hacienda y Crédito Público)
SOCORES	Restructuring Joint Investment Societies – created to assist in loan collections
Sindico	Trustee, receiver
TIIE	Mexican inter bank interest rate
TSE	Toronto Stock Exchange
Tripartite Group	Internationally represented group of supervisors and regulators set up in 1993 to consider ways of improving the supervision of financial conglomerates
Technical Committee	Decision making body of FOBAPROA haing representatives from SHCP, CNBV and Bank of Mexico
UCABE	Coordinating Unit for Bank Enterprise Agreements for the restructuring of large syndicated loans.
UDIs	Investment Unit – currency unit tied to CPI (Unidad de Inversión)
VAT	Value Added Tax
VVA	Valuation and Sale of Assets – program for the recovery of assets.
Vivienda	Debtor Program for Residential Mortgages

FISCAL COSTS - SUPPLEMENT

SUPPLEMENTARY ANALYSIS OF FOBAPROA LIABILITIES AND ASSETS

The following provides a more detailed analysis of the component parts of the FOBAPROA balance sheet, which is the basis for the net liabilities of FOBAPROA included in fiscal costs. For each of the liabilities and assets, we provide an explanation of the balance and where appropriate, a commentary to support our estimate where it is different from that of FOBAPROA.

ESTIMATED FOBAPROA LIABILITIES

The total consolidated liabilities of FOBAPROA according to its estimate, as at February 28, 1998, is MN $552,300 million. As is apparent from the table below, this is made up of both direct liabilities of FOBAPROA as well as indirect liabilities for which it may be responsible by virtue of its obligations under the bank interventions. It should be noted that with respect to the direct and indirect liabilities, liabilities of FAMEVAL, (a parallel agency of FOBAPROA dealing with brokerage houses), have been included in FOBAPROA's consolidated balance sheet.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
A. Direct Liabilities			
1 - Bank of Mexico	46,500	49,900	49,900
2 - NAFIN	8,000	8,500	8,500
3 - Payables: Capitalization Program	160,400	171,600	171,600
4 - Payables: Saneamiento	202,100	216,100	284,200
5 - Payments in Kind Program	12,900	14,200	14,200
6 - Debtor Programs Liabilities	15,700	18,100	18,100
7 - Other Liabilities	1,900	3,700	3,700
Total Direct Liabilities	447,500	482,100	550,200
Indirect Liabilities			
1.- Notes re sale of branches of intervened institutions	20,100	20,200	20,200
2.- Other liabilities of intervened institutions	82,300	85,300	85,300
Subtotal	102,400	105,500	105,500
3 - Contingent Liabilities of Intervened Institutions	2,400	2,000	4,100
Total Indirect Liabilities	104,800	107,500	109,600
Total Liabilities	552,300	589,600	659,800

A. Direct Liabilities

1. Bank of Mexico

The direct liabilities of FOBAPROA to the Bank of Mexico may be summarized as follows:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
FOBAPROA UDIs Facility	15,000	15,900	15,900
Inverlat Recapitalization Facility	27,900	30,300	30,300
FAMEVAL UDIs Facility re BURSAMEX	3,600	3,700	3,700
Total Bank of Mexico	46,500	49,900	49,900

As at February 28, 1998, FOBAPROA was indebted to the Bank of Mexico in the amount of MN $46,500 million for funds borrowed on three facilities.

The FOBAPROA UDIs facility was opened in 1996 and repaid in April 1998. This line of credit was subsequently converted to pesos and was used as a general funding account.

The Inverlat recapitalization facility is an interest bearing loan to fund Grupo Financiero Inverlat SA de CV by acquiring subordinated debt instruments, pursuant to an agreement with The Bank of Nova Scotia. The increase represents a new note for MN$ 1,200 million plus accrued interest.

The FAMEVAL facility relates to the rescue of a stock brokerage, Bursamex, which is a company in the same financial group as Sureste. As a non-banking institution, a discussion of the use of these funds falls outside the scope of this review.

2. NAFIN

FOBAPROA's liability to Nacional Financero (NAFIN) is shown below:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
World Bank/Banco Interamericano	8,000	8.500	8.500

This UDIs facility for an amount equivalent to US $1,750 million represents funding to the federal government from international banking institutions to assist Mexico in coping with the effects of the peso crisis. The facility is at 4% interest, and the UDIs are revalued according to changes in the retail price index. The facility has been used for general funding.

3. Payables: Capitalization Program

Set out below are the notes that FOBAPROA has issued in respect of this program:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
BBV	11,900	12,900	12,900
Serfin	58,300	62,100	62,100
Banorte	5,500	5,900	5,900
Banamex	34,600	37,000	37,000
Bancomer	36,600	39,300	39,300
Bital	13,500	14,400	14,400
Total Capitalization Program Payable	160,400	171,600	171,600

These amounts are payable by FOBAPROA to the banks concerned for the cash flows from the loans that have been transferred to trusts of which FOBAPROA is the beneficiary, together with interest accrued since the date of issue. Generally, the liabilities of FOBAPROA under the capitalization program are in the form of ten year notes, denominated in pesos and dollars, issued mostly in 1995 and 1996, which offer the beneficiary bank interest rates tied to CETES, TIIE or Libor. The increase to June 30, 1998 represents, primarily, additional accrued interest.

The work performed by the RA's in respect of these liabilities has included the confirmation of the existence of the notes and the reconciliation of the principal amounts to the values of the corresponding loan portfolios. Based upon the work performed, the value of the notes appears to be stated materially correctly by FOBAPROA.

4. Payables: Saneamiento

The liabilities per FOBAPROA in respect of this program are set out below:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Notes:			
Banpais	21,200	23,300	23,300
Bancen	19,500	20,100	20,100
Santander-Mexicano	29,800	29,200	29,200
Confia	26,900	26,500	24,800
Total Value of Notes Issued	97,400	99,100	97,400
Estimated Liabilities:			
Sureste	600	Nil	600
Atlantico	17,200	20,300	30,350
Promex	15,700	20,000	28,000
Inverlat	5,000	5,000	11,950
BanCrecer	65,000	71,000	96,350
Pronorte	200	200	150
Anahuac	1,000	500	500
Serfin	Nil	Nil	17,600
Industrial	Nil	Nil	1,300
Total Estimated Liabilities	104,700	117,000	186,800
Total Saneamiento Payables	202,100	216,100	284,200

The Saneamiento program covers a range of activities relating to the financial recovery of banks. Much of FOBAPROA's Saneamiento activity is funded by notes, including:

the creation of loan trusts, similar to the capitalization program, except that the purpose is normally to acquire bad debts to clean up the balance sheet of the relevant bank, and there is no requirement for the bank to put in new capital or share losses;
the creation of non-loan trusts, also funded by notes; and
the purchase of debentures or other capital instruments.

Notes issued may be payable in both pesos and dollars.

The increases are primarily due to increased estimated liabilities for Serfin, BanCrecer, Inverlat, Atlantico and Promex and relate to the additional costs of on-going Saneamiento programs.

Payments in Kind Program

Summarized below are FOBAPROA's liabilities in respect of this program:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Various Banks	12,900	14,200	14,200

This program was rarely used. It permitted banks to sell foreclosed assets to FOBAPROA in trust on repurchase agreements. The liabilities recorded above are five-year notes issued in 1995. At the end of the five-year period, it is anticipated that the banks will redeem the notes and accrued interest and take back the properties.

The program is reflected as a contra on the balance sheets of both the banks and FOBAPROA. It is not expected that this program will result in any fiscal cost.

6. Debtor Programs

Summarized below are the liabilities recorded in FOBAPROA's balance sheet in respect of these programs.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Various Programs	15,700	18,100	18,100

FOBAPROA is only involved in the debtor programs to the extent that it acted initially as a conduit to pass funds from the government to the banks when the first debtor programs were introduced. As a result, at any given balance sheet date, FOBAPROA finds itself with a liability to the banks on a program by program basis for the amount of the funds accrued to the banks under the schemes, and an offsetting receivable from the government. The net result is that there should be no fiscal cost to FOBAPROA in connection with the debtor programs. The situation would be better reflected if these entries were deleted from FOBAPROA's balance sheet.

As at February 28, 1998, FOBAPROA did not record in its assets the receivable due from the government, with the result that the fiscal costs have been overstated by this liability recorded in connection with the debtor programs. FOBAPROA subsequently confirmed this oversight.

The overall fiscal costs of the debtor programs have been addressed in a separate section of this report.

7. Other Liabilities

FOBAPROA's direct sundry liabilities are summarized below:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry	1,900	3,700	3,700

This amount relates primarily to BBV and Serfin and represents both direct and indirect funding at the respective dates.

B. Indirect Liabilities

FOBAPROA accounts for liabilities in respect of six of the intervened banks in a similar manner to a holding company producing consolidated accounts with its subsidiaries. These particular banks have normally received little or no direct funding from FOBAPROA and obtained their funding which was guaranteed by FOBAPROA, from the markets. FOBAPROA does not apply a consistent criterion in this accounting, since some similar banks, i.e. Anahuac, are accounted for under Saneamiento with only the net liability recorded in FOBAPROA's books. The financial statements of these banks are consolidated with FOBAPROA's accounts, eliminating items that net off, for example, loans between FOBAPROA and the intervened bank. We have not been given detailed analyses to check the June 30, 1998 consolidated liabilities. No statement of consolidated assets has been produced as at this date. As discussed in the introduction to this section, consolidated information is not normally prepared.

1. Notes regarding Sales of Branches

Set out below are FOBAPROA's liabilities in respect of sales of the branch networks of the intervened banks.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Cremi	8,900	9,000	9,000
Oriente	2,100	2,000	2,000
Union	6,800	6,800	6,800
Obrero	1,800	1,800	1,800
Interestatal	500	600	600
Total Notes	20,100	20,200	20,200

In the case of some intervened banks, it was determined that the branches would be sold to another bank. A note for the liabilities assumed, net of assets sold was issued by the selling bank. This note was guaranteed by FOBAPROA.

These guarantees represent a contingent liability of FOBAPROA, however, since the vendor banks were insolvent at the time the guarantee was given, there is no doubt that the vendor bank notes payable represent real liabilities of FOBAPROA.

The work performed by the RA's included a review of the existence and value of the notes and due diligence in relation to the issue of the note. No material misstatements of the value of the notes has been identified.

2. Other Liabilities

The chart below sets out, on an consolidated basis, the other liabilities of the six intervened banks for which FOBAPROA is responsible. The six intervened banks are Union, Cremi, Capital, Interstatal, Obrero and Anahuac.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry Banks	76,300	79,300	79,300
Provisions for Operating Costs	6,000	6,000	6,000
Total Other Liabilities	82,300	85,300	85,300

The RA's have reviewed these amounts that largely relate to interbank funding since, and the increases are generally due to interest and operating costs.

3. Contingent Liabilities

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry Banks	2,400	2,000	4,100

These small amounts have been reviewed as part of a review of the assets and liabilities of the intervened banks by the RA's. This represents provisions for existing and potential litigation and therefore cannot be verified with accuracy.

We have accrued a further MN $ 2,100 million in additional estimated future operating costs related to the wind down of intervened banks.

There are additional unknown contingent liabilities inherent to FOBAPROA's role as a deposit insurer. FOBAPROA is contingently liable for potential support to other banks in the system.

ESTIMATED FOBAPROA ASSETS

The total consolidated assets of FOBAPROA, according to its estimate as at February 28, 1998, are MN $218,700 million. As previously discussed a MN $15,700 million receivable from the federal government in respect of debtor programs should also be added to these assets. This part of the fiscal costs section discusses the balances as at February 28, 1998 and any changes to those values as at June 30, 1998, based upon our comparison of fiscal costs by bank against information provided by FOBAPROA.

Set out in the table below is a summary of these assets, distinguishing between direct assets of FOBAPROA and its indirect assets, which are the assets of the six of the intervened institutions which are accounted for on a consolidated basis.

As discussed earlier, FOBAPROA did not produce a consolidated statement of assets as at June 30, 1998. We have therefore relied upon FOBAPROA's view that no material change will have taken place in these values, except in respect of the items identified in our work. The only significant exceptions we have noted relate to incomplete saneamiento transactions in relation to BanCecer, Atlantico and Promex, where FOBAPROA has updated its estimate of liabilities and assets. Such updates were computed at TIIE rates in accordance with the law.

We have also relied on the recent independent audit of FOBAPROA for assurance regarding that information provided to us in respect of our comments below. Accordingly, we emphasize that these are estimates and that a detailed reconciliation of some asset categories has not been performed.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
A. Direct Assets			
1. Cash and Similar	19,800	19,800	19,800
2. Investments in Shares and Securities	8,200	8,200	8,200
3. Loans to Banks	3,000	3,000	3,000
4. Loans acquired via Capitalization/Loan Purchase	47,200	47,200	57,400
5. Loss Sharing re Capitalization/Loan Purchase	34,100	34,100	34,100
6. Assets in Sanaemiento Institutions	46,700	46,700	47,700
7. Debtors from Sales of Institutions	5,200	5,200	5,200
8. Payments in Kind Program	12,900	14,200	14,200
9. Other Assets	7,200	7,200	7,200
Total Direct Assets	184,300	185,600	196,800
B. Indirect Assets			
1. Loans	26,100	26,100	28,400
2. Securities	5,000	5,000	5,000
3. Other Assets	3,300	3,300	3,300
Total Indirect Assets	34,400	34,400	36,700
Total Assets per FOBAPROA before Debtor Programs	218,700	220,000	233,500
C. Debtor Programs	15,700	18,100	18,100
Total Assets	234,400	238,100	251,600

A. Direct Assets

1. Cash and Similar

Set out below are FOBAPROA's cash balances:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Cash and Similar	19,800	19,800	19,800

Most of the cash shown as at the balance sheet date has been already allocated in respect of various programs. FOBAPROA maintains very active accounts with total debits and credits over the period from December 1994 in excess of MN$ 660,000 million. We have reviewed FOBAPROA's cash flow statements and concur with the amount stated.

2. Investments in Shares and Securities

The table below summarizes FOBAPROA's sundry investments. They have arisen as part of Saneamiento's activities.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Serfin	3,300	3,300	3,300
Inverlat	3,500	3,500	3,500
Banpais/Seguros Banpais	200	200	200
Federal Government Bonds	1,200	1,200	1,200
Total Sundry Investments	8,200	8,200	8,200

These investments in shares and securities mostly relate to debentures and shares acquired as part of the saneamiento process. Serfin's ongoing financial difficulties make it seem unlikely that any value will be recoverable from its shares or subordinated debt.

FOBAPROA will retain an investment in Inverlat, following the completion of a deferred sale to The Bank of Nova Scotia and it appears that some value will be available to FOBAPROA.

The value of the Banpais shares has been confirmed by the RA's.

The federal government par bonds (Brady Bonds) have been marked to market. These bonds were acquired from the HongKong & Shanghai Banking Corporation as a liquidity support measure. They have subsequently been used to pay down some of the NAFIN loans recorded as direct liabilities of FOBAPROA.

Accounting for any additional costs of Serfin and Inverlat is a matter for FOBAPROA. We have discussed these costs as additional payables under Saneamiento. In its own accounting, FOBAPROA may reflect such costs by writing down assets instead of, or as well as reporting increased payables. The effect on the net liabilities of FOBAPROA will be the same.

3. Loans to Banks

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Banpais/Banorte	400	400	400
ING regarding Serfin	4,100	4,100	4,100
Sundry	600	600	600
Less Provisions	(2,100)	(2,100)	(2,100)
Net Loans to Banks	3,000	3,000	3,000

These amounts relate to a loan advanced to support the sale of Banpais to Banorte and to the ING financing for Serfin. MN $32,334 million of loans to the intervened banks have been previously fully provisioned against and then eliminated on consolidation.

4. Loans Acquired via the Capitalization and Bank Loan Portfolio Purchase Program

The table below summarizes the net loan flows from this program:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
BBV	9,544	9,544	9,244
Serfin	40,501	40,501	40,501
Banorte	4,224	4,224	4,424
Banamex	26,819	26,819	28,619
Bancomer	26,389	26,389	32,389
Bital	8,238	8,238	10,738
	115,715	115,715	125,915
Less Provisions	(68,515)	(68,515)	(68,515)
Net Loans Acquired	47,200	47,200	57,400

As described elsewhere in this report, FOBAPROA has acquired an interest in the cash flows from portfolios transferred into trusts at banks participating in the CLPP program. FOBAPROA has estimated the recoverable value of its interest using a formula based upon the book value of the underlying loans in the portfolios. In some cases, the portfolios now include property, shares and other assets acquired as a result of settlements or litigation.

FOBAPROA produces its own conservative estimates of value independently of the provisions actually made by the trust.

The RA's have estimated values using the following methodology and the results of this is an increase in the valuation by MN$ 10,200 million.

We have conducted extensive reviews of these portfolios, with the assistance of the RA's who carried out procedures in the banks. The methodology of the review for loans, which comprise most of the portfolios, is common to the review of all portfolios whether acquired under capitalization, saneamiento or as a result of intervention. The methodology had the following characteristics:

All loans over MN $20 million were reviewed. Where information was available to enable loans to be grouped by borrower, or by groups of borrowers, the MN $20 million cut-off applied to group exposure.

Based upon an industry-accepted methodology, a sample was randomly selected for review from the remaining portfolio and the results of the review have been extrapolated across each portfolio.

Reviewed loans were examined for compliance with the portfolio purchase agreement, which normally reflected Mexican accounting rules. Loans were also examined, both at the date of their transfer into a portfolio and at June 30, 1998 to assess their likely market value. For non-portfolio purchase loans, only the June 30, 1998 valuation was considered. The methodology developed was specific to the circumstances of Mexico, but in general terms produces results similar to US GAAP.

The RA's conducted specific tests and methodologies in relation to the valuation of real property collateral to arrive at estimated market values. In some cases the estimated market values were significantly below the collateral values used by the management of the banks which often reflected general inflation accounting principles rather than the likely values of the assets.

Other aspects of the loan files were also examined to assess whether the loan was properly granted and whether appropriate records were maintained, so that an assessment of the quality of the credit granting and recovery process could be made at each bank. Assurance of the adequacy of these procedures was also reviewed by examination of legal enforcement activity and subsequent compromises reached with debtors.

The results of the compliance and other elements of the loan reviews are noted in the evaluation of the bank programs elsewhere in this report.

5. Loss Sharing re Capitalization and Bank Loan Portfolio Purchase Program

As discussed in the evaluation of the CLPP program, banks transferring an interest in portfolios to trusts normally agreed to share in any shortfall between the value of the notes issued by FOBAPROA and the value of recoveries, together with interest accrued. Loss sharing is recorded as an asset in FOBAPROA's accounts, as follows:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
BBV	1,000	1,000	1,000
Serfin	8,500	8,500	8,500
Banorte	800	800	800
Banamex	5,200	5,200	5,200
Bancomer	5,900	5,900	5,900
Bital	2,300	2,300	2,300
Subtotal	23,700	23,700	23,700
Promex	1,100	1,100	1,100
BanCrecer	5,000	5,000	5,000
Atlantico	2,200	2,200	2,200
Other Sundry Amounts	2,100	2,100	2,100
Subtotal	10,400	10,400	10,400
Total Loss Sharing	34,100	34,100	34,100

The balance sheet at February 28, 1998 also included loss sharing amounts in respect of loans which have now have been treated as Saneamiento loans.

Loss sharing obligations will offset the liabilities of FOBAPROA in respect of the notes issued to fund the purchase of each portfolio, regardless of the financial condition of the bank concerned.

Where our work indicates that a bank is likely to require significant future assistance, and, therefore, may not be able to bear the cost of loss sharing, we have included this as an estimated future liability of FOBAPROA, rather than challenging the value of the receivable from that bank under this program. This is the case for Serfin, BanCrecer, Promex, and Atlantico.

6. Assets in Sanaemiento Institutions

FOBAPROA's Saneamiento activities have resulted in it acquiring various assets and the rights to benefit from flows from certain loan portfolios. Set out in the table below is the estimated value of assets available to FOBPAPROA as a result of such activity:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Santander-Mexicano	22,532	22,532	25,532
Bancen	3,444	3,444	4,844
Banpais - FOBAPROA Trust	13,078	13,078	13,078
- Related Party Trust	11,218	11,218	7,618
Atlantico/Bital	7,445	7,445	7,445
BanCrecer	65,000	65,000	65,000
Promex	4,000	4,000	4,000
Subtotal	126,717	126,717	127,517
Less Provisions	(80,017)	(80,017)	(79,817)
Net Saneamiento Assets	46,700	46,700	47,700

These assets, primarily loans, have generally been acquired as part of the creation of good bank/bad bank at intervened institutions or as part of a disposal strategy at those banks that have been subjected to significant restructuring. The value of these loans has been estimated by FOBAPROA using a formula similar to that used for the CLPP program. The methodology used to assess these assets is set out Section 4.

7. Debtors from Sales of Institutions

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Confia	1,700	1,700	1,700
Atlantico	1,800	1,800	1,800
Promex	1,700	1,700	1,700
Total Debtors	5,200	5,200	5,200

Amounts are still due, or expected to be receivable in respect of Atlantico, Confia and Promex. The Confia amount was paid in October 1998. The balances due in respect of

Atlantico and Promex relate to uncompleted transactions and such amounts were still due as at June 30, 1999.

8. Payments in Kind Program

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Various Banks	12,900	14,200	14,200

These assets, normally property, were acquired from banks in trusts on five-year repurchase agreements. A corresponding liability has been recorded, and it is expected that the trusts will be unwound at the conclusion of the five-year period without any fiscal cost.

9. Other Assets

Set out below are sundry assets directly owned by FOBAPROA.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Estrella Blanca	700	700	700
Serfin	4,500	4,500	4,500
Sundry	2,000	2,000	2,000
Total Other Assets	7,200	7,200	7,200

These sundry assets and balances have arisen as a result of saneamiento. The Estrella Blanca receivable was received as payment for an Obrero loan. The Serfin receivable is of questionable value, given the current financial troubles faced by that bank.

B. Indirect Assets

FOBAPROA's accounting for the intervened banks is explained in detail in the corresponding liabilities section. The banks included in this asset section are Union, Cremi, Capital, Interestatal, Obrero and Anahuac.

1. Loans

Summarized below are the loans to non-FOBAPROA institutions of the intervened banks.

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry Banks	26,100	26,100	28,400

The gross portfolio is MN $70,306 million, but has been reduced by provisions for doubtful accounts.

The RA's have adopted the standard loan review methodology as set out above. Based on their work, it is estimated that the value of these loans is MN $2,300 million greater than stated by FOBAPROA as at June 30, 1998.

2. Securities

Summarized below are the securities investments of the intervened banks:

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry Banks	5,000	5,000	5,000

These assets represent the adjusted book value of debt for equity exchanges carried out by the banks to recover their loans. The gross value is MN $21,678 million, but this has been reduced by consolidating entries and a further provision of MN $2,000 million.

These assets have been reviewed by the RA's at the intervened banks and assessed at recoverable value.

Other Assets

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Sundry Banks	3,300	3,300	3,300

This sum represents repossessed property and fixed assets on the balance sheets of the intervened banks. FOBAPROA recorded a MN $2,000 million provision against the book value of these assets as reported by the banks.

These assets have been reviewed by the RA's at the intervened banks and assessed as to recoverable value.

C. Debtor Programs

	FOBAPROA's Estimate at February 28, 1998 MN$ Million	FOBAPROA's Estimate at June 30, 1998 MN$ Million	Our Estimate at June 30, 1998 MN$ Million
Federal Government	15,700	18,100	18,100

As discussed above in the review of the liabilities of FOBAPROA, these accounts receivable should be shown on the balance sheet as an offsetting asset equal to the liability recorded in connection with the debtor programs.