BANCO DE MÉXICO

# A BRIEF SUMMARY OF BANKING IN MEXICO

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Banking is the process where one or several companies specialize in taking deposits from the general public in order to lend funds. Until 1864, Mexico had no banks, although credit transactions did take place. During the colonial period, credit was granted on a preferential basis by religious orders or trading guilds. The history of banking in Mexico officially began in 1864 with the opening in Mexico City of a British bank: The Bank of London, Mexico and South America. As a result of concessions issued by the local governing authorities, in 1875, Banco de Santa Eulalia opened its doors in the state of Chihuahua followed not long after by Banco de Hidalgo. It was not until 1881 during the presidency of Manuel González that Banco Nacional Mexicano was founded in Mexico City with capital from the Franco Egyptian Bank headquartered in Paris. In 1883, Eduardo L'Enfer obtained a concession for Banco Mercantil, Agrícola e Hipotecario, and in that same year, Banco Minero, Banco de Chihuahua and Banco Mexicano de Chihuahua were re-established in Chihuahua. Subsequently, as of 1888, other banks were established in that state as well as two issuing banks in the state of Yucatán and several more in Mexico City.

All of these banks had been set up under different contracts. The irregularity of bank concessions was reflected not in their number or frequency, but in the diversity of the terms and conditions used. After a failed attempt in 1890, in 1896, the then Finance Minister of Porfirio Díaz, José Ives Limantour, began drafting a new banking act aimed at standardizing the terms under which existing and future banks would operate. From the standpoint of bank specialization, the Law on Credit Institutions that was passed in 1897 considered three banking models: issuing banks (deposit and discount banks with the power to issue banknotes), mortgage loan banks, and commercial banks. Summing up, just before the outbreak of the 1910 Revolution, Mexico had the following banking structure: 24 issuing banks, including Banco Nacional de México and Bank of London, which were the only banks whose notes could circulate in Mexico. The notes of other issuing banks were only allowed to circulate in the state where they had been incorporated. Finally, this latter group included two mortgage banks and five banks for the capitalization of the industrial and agricultural sectors.

1. <u>The revolutionary period</u>

The Maderista revolution was basically a political revolution. From a banking point of view, the presidency of Francisco I. Madero was merely a continuation of the Porfirian legacy. Thus, during his administration a preference prevailed for the plurality of issuing banks. Madero's government, through the Finance Ministry, even tried to increase the number of issuing banks in order to extend the country's bank network. This scenario radically changed after the usurper Victoriano Huerta defeated Madero, triggering the so-called Constitucionalista revolutionary movement.

Huerta's military campaign against the revolutionaries soon took its toll on his finances, and so besides trying to obtain loans abroad, the regime also forced local banks to extend loans. Two loans were imposed on all banks: a first in 1913 for a total of 18.2 million, and a second in 1914 for slightly over 41 million pesos. Summing up, between February 1913 and April 1915, local banks granted loans amounting to almost 64 million pesos to Huerta, just over 59 million of which corresponded to the two abovementioned general loans while the rest was granted by specific banks.

That initial stage of the Revolution, which came to a head at the beginning of 1915, severely impacted banks. Bankruptcies were the result of three factors: the looting of banks during the struggle, damages to bank borrowers, and the abovementioned compulsory loans. Consequently, by the middle of 1914, banknotes outstanding plus demand deposits had a metal guarantee of only 26.5 percent, as compared with a legal requirement of 33 percent. Similarly, the problem portfolio had increased by more than 54 percent over the course of two years.

In August 1915, the government led by Venustiano Carranza tried to force issuing banks to adhere to the 1897 Banking Act or else be dissolved. Later on, in September 1916, this stance changed radically. The government declared the existence of such institutions illegal, and decreed that all notes outstanding should be fully guaranteed by metal and proceeded to dissolve them. Finally, in October 1917, the inevitable occurred after Venustiano Carranza's government resorted to bank seizure and forcible lending, which depleted banks' metal reserves. This period of seizure continued during the final days of Carranza's government in 1920 without banks being dissolved. Towards the end of his administration, Venustiano Carranza appeared to soften his stance and in 1919 announced that some seized banks could resume business in the future. However, this never happened, as a group of men from the state of Sonora, who included Álvaro Obregón and Plutarco Elías Calles among their ranks, would come to power in Mexico.

2. The reconstruction period

Article 28 of the 1917 Constitution stated that in Mexico a Single Issuing Bank controlled by the government would have the exclusive power to issue banknotes. As this laid the legal foundations for Banco de México —which would be created in 1925— it implicitly ruled out the possibility of private banks continuing to issue them. Consequently, any deposit and discount banks that had survived the Revolution would no longer be able to issue banknotes.

As for their future, in 1921 the government of President Álvaro Obregón decreed that former issuing banks would be returned to their owners and would shortly be able to resume business. Thus, of the 22 banks that had been seized during the Venustiano Carranza regime, 16 resumed business during the Obregón period, and only six were forced to close due to insolvency.

It was during the presidency of Plutarco Elias Calles (1924-1926) that the country's banking system got back on its feet and underwent further progress. Following sizeable budget cuts to provide capital for Banco de México, the central bank opened its doors in 1925. Having now an entity lying at the heart of the banking system, in 1926 a new bank law based on the specialization model was enacted, and classification of Mexico's banks was further perfected. Under this law, deposit and discount banks, mortgage banks, banks for the capitalization of the industrial and agricultural sectors and for fixed investment purposes, trust and savings banks, general depository institutions, and surety companies would be credit institutions. A new bank law enacted in 1932 further perfected this classification with the introduction of a very important concept: the national banking institution (the legal origin of development banks).

The following national banks existed under this law in Mexico towards the end of the 1930s: Banobras, Nacional Financiera, Unión Nacional de Productores de Azúcar, Banco Nacional de Comercio Exterior, Banco Ejidal, Banco Agrícola, and other smaller ones. As for private banks, many have been created since the middle of the 1920s, although mainly deposit and discount banks.

According to reliable sources, between 1932 and 1940 the total number of private banks in Mexico rose from 51 to 87. A 1940 snapshot of the sector reveals that of the total number of private banks that existed that year, 70 percent were deposit and discount banks. Banco Nacional de México, the Bank of London and Mexico, and Banco de Comercio, which had been created in 1932, stood out for the progress they had made within a relatively short period of time. Of the other 30 percent, eight were banks for the capitalization of savings (now savings and loans banks) –a concept that was eliminated from bank legislation several decades ago— eight specialized in trusts, another eight in savings, and only two in the capitalization of the industrial and agricultural sectors.

At the end of 1940 only two banks specialized in mortgage loans.

## 3. The conceived model

During the 1940s, the framers of Mexico's financial system had a fairly clear idea of the model they wanted. Their dream was to create a system with the following four features. First, they wanted a national financial system with hardly any or no participation from foreign banks. Likewise, they wanted a system of specialized financial institutions that had consistency between deposit and credit terms, and between loan liabilities and destination. But above all, they wanted a competitive banking system with strong market competition. They sought for a robust private financial system that would also be complemented by a broad development bank sector.

Mexico's aspiration to have a fundamentally national bank had been achieved in 1932 following the passing of the Banking Act that same year. Whether at that time in history Mexico needed a new law to regulate banks or not is debatable. What is clear is that the doctrine of nationalism that had been born out of the revolutionary movement imbued the banking reforms of 1932. After the Revolution and throughout the 1920s, several foreign bank branches had begun operating in Mexico. In 1932, Congress decided to reduce their operating scope to the normal transactions permitted to deposit and discount banks. All foreign branches, except for one, found this restriction excessive and, as a result, the following foreign banks left Mexico: Deutsche Bank of Latin America, Canadian Commerce Bank, Bank of Montreal, Equitable Trust Co., Anglo South American Bank, and National Bank, among others.

The 1941 Banking Act was perfected and deepened the classification of financial intermediaries. The guiding principle of this specialization was the same as that which had inspired previous bank laws beginning with the 1987 Act during the Porfirian period. Under the 1941 law, credit institutions would comprise deposit banks, financial and mortgage companies, and banks for the capitalization of savings. Specialized companies could be set up for savings and fiduciary operations or they could be run from special departments at any of the institutions mentioned in the previous paragraph. Auxiliary credit organizations included the following entities: general deposit warehouses, clearing houses, stock markets, and credit unions. Entities of that nature set up by the Federal Government would be considered national auxiliary credit organizations and institutions.

It was very evident to the drafter of the 1941 Banking Act that the Mexican financial system had too many banks and too few long-term lending institutions. This reflected a trend in favor of commercial loans to the detriment of loans aimed at promoting the capitalization of production units. In a bid to offset this imbalance, the 1941 Banking Act granted very broad operating powers to financial companies. As for deposits, these institutions were created to issue general and commercial bonds, but could also receive funds over shorter terms.

A very broad operating framework for financial companies resulted in many entities multiplying and achieving a fast rate of growth over the following years. In particular, the framework encouraged the shareholders of many deposit banks to set up financial companies, and deposit banks and financial companies with the same owners even loaned money to each other. Thus, the 36 financial companies that existed in 1941 had grown to 84 by 1945, or a growth rate of 130 percent over the space of only four years. As financial companies were able to draw funds almost on demand and their affiliates transferred them, in 1958 the authorities decided to include financial companies in the obligatory deposit or legal reserve regime.

Although financial companies grew the most during the Second World War, other auxiliary credit institutions and organizations also grew rapidly. Thus, from 1941 to 1945 the number of deposit banks rose from 67 to 97 and the total number of credit institutions from 101 to 311. Of that total, the number of fiduciary companies increased from 26 to 65, mortgage companies from 12 to 20, and departments and entities engaged in capturing savings from 10 to 34. As for the system of deposit banks, during the same period the number of branches and agencies four-folded, from 110 to 448. Within such a scenario of accelerated growth, assets of deposit banks, including their savings departments, expanded by 300%.

## 4. The creation of financial groups

In the 1950s, the trend in Mexico's financial system towards the universal bank prototype became more marked. Universal banking is generally understood to mean the provision of full financial services by a single entity or consortium. In practice, the universal banking concept may take the shape of a single institution that offers all those services, or consortiums, groups or financial groups. The latter was the organizational variant under which Mexico's universal banking regime was formed. Ideally, the heads of such financial groups should have been holding companies. However, this was not the case. It was deposit banks that gradually formed their financial groups, beginning with a financial company.

This process apparently went unobserved by the country's legislators and financial sector regulators. The 1941 Act, which had been inspired by the principle of specialization, remained in force while the financial system progressed towards a universal banking model through the gradual formation of financial groups. One of the first consortiums to progress towards this form of organization was Seguros La Latinoamericana, followed by Banco del País, Fianzas Lotonal, and Seguros La Continental, among others.

The general financial group model that took shape in Mexico preferably had a deposit bank at its head. A deposit bank was usually able to group together a financial company, a mortgage company, a savings department, and a trust department as its initial affiliates. The process would then continue exhaustively through the acquisition of an insurance company and a surety company, a general deposit warehouse, and a brokerage firm. This organizational model was subsequently completed with the inclusion of a financial leasing entity, and probably a factoring affiliate as well. Finally, the model did not preclude the option of acquiring other kinds of entities as affiliates, such as industrial sector and services companies.

Two trends in Mexico encouraged the creation of financial groups. The first was the grouping of institutions with different specializations or business lines in order to exploit complementary financial services and operating and marketing advantages and offer them in an integrated way. Another trend was towards the merger or integration of institutions belonging to the same sector, mainly deposit banks. This phenomenon, which took off in the United States and Europe during the 1960s, was mainly the result of incentives given to exploit economies of scale.

Most Mexican financial groups had already been incorporated and were open for business when, at a very late stage, the decision was made to legally recognize them. To that end, in December 1970 a provision to recognize the existence of these groups was passed "obliging them to pursue a coordinated financial policy and to establish a system of reciprocal guarantees in the event of capital loss." Under the new rules, a financial group was a conglomerate whose affiliates followed a coordinated financial policy with significant links in terms of assets.

Although this definition was not precise and gave rise to a lot of criticism at the time due to its vagueness, official recognition for already existing financial groups made rapid progress during the first half of the 1970s. Thus, in December 1974, the authorities announced that the existence of 15 financial groups had been recognized as of that date.

The authorities also announced that some medium-sized groups had merged with small groups operating in other states, fostering a more balanced development of banks. Of the 15 financial groups that were officially recognized towards the end of 1974, those grouped around the following stood out: Banco Nacional de México, Bank of London, Banco Comercial Mexicano, Banco del País, Banco de Industria y Comercio, and Banco Internacional.

## 5. Progress with commercial banking

Besides official recognition for financial groups, the other major banking reform adopted in Mexico during the 1970s was the creation of the so-called commercial banking. Mexico's adoption of the commercial banking system was a very gradual process that took place in three stages. The first stage was a limited legal reform consisting of a simple announcement in the December 1974 law of the concept's implementation in Mexico.  This was followed by a series of reforms to the Banking Act in December 1978. Finally, commercial banks were constituted under that legal framework.

Financial groups were an important historical precedent to commercial banks.  Most of these groups had been created with institutional elements that fitted the multiple (commercial) banking concepts: a deposit bank, a financial company, and a mortgage company. Likewise, and for some time, deposit banks themselves had savings and fiduciary operation departments. As these variants complemented deposit, financial and mortgage operations, the commercial banking law prohibited specialized institutions from undertaking these operations independently. The scenario was now ripe for structural development. Thus, a commercial bank was defined as a company authorized to undertake the following operations: deposits, savings, financial and mortgage intermediation, and trust transactions.

According to Miguel Mancera, based on obtainable economies of scale, commercial banking would be clearly superior to specialized banking as a formula for promoting financial sector efficiency. In line with this view, commercial banks would allow for a better use of installed capacity while at the same time eliminate redundant administrative services. Commercial banks would also enable Mexican banks to achieve a deeper penetration of foreign financial markets as a result of their greater qualitative weight in them.

Practical rules issued for incorporating multiple banks initially saw them as emerging from the merger of already existing deposit banks, financial companies, and mortgage companies. Any of the three could be the company seeking the merger (or merging company) and the rest would be the merged companies. Subsequently, in 1978, this criteria was made more flexible when it became possible to grant authorization for new commercial banks.

As mentioned, the merger process and the creation of new commercial banks began in December 1976 and concluded in April 1980. The first five commercial banks to be created were: Multibanco Mercantil de México, Banpacífico, Banca Promex, Banco de Crédito y Servicios, and Unibanco, in the latter case being Financiera de Fomento Industrial the merging company. The first large commercial bank was Comermex (January 1977), followed by Banamex (March 1977), Internacional (July 1977), Atlántico (July 1977), Serfín (October 1977), and Bancomer (November 1977). Of the 34 commercial banks that were created during that transition period, the last five were: Banco Obrero (September 1979), Banco Mexicano-Somex (January 1980), Banco Monterrey (January 1980), Banco del Centro (January 1980), and Banco Aboumrad (April 1980).

Commercial banks did not imply the disappearance of financial groups. They continued to exist and would only be dismantled after banks had been expropriated as part of a reorganization of the financial system in response to the reform.

6. Bank expropriation

In accordance with the corresponding expropriation decree, the then President José López Portillo nationalized banks on the basis of them having "obtained excessive gains from providing a granted public service; having created monopolies with money from the public; in order to stop credit from being available only to the upper classes and to make cheap and opportune credit available to most people; to ease the country's exit from the economic crisis that had been aggravated by the State's lack of direct control over the financial system; and, to keep the peace and be able to adopt measures aimed at correcting internal distress."

As these "required measures" clearly included the broad implementation of exchange rate control, the reasons given to justify the adoption of exchange rate control should also be mentioned. Economic austerity measures that had been applied to contain the crisis had not rendered results, mainly because of the amount of capital flight. The economic crisis that had prevailed until at least the middle of 1981 had been caused by two factors: less demand in foreign markets for Mexico's exports and more expensive and scarcer foreign credit.

As for banks, the corresponding decree stated that the following was being expropriated "in favor of the Nation": the installations, buildings, furniture, equipment, assets, safety boxes, vaults, branches, agencies, offices, investments, stock or stakes of other companies, securities, rights, and all other furniture and property belonging to the expropriated banks. There were also some exceptions to the rule. National credit institutions and mixed banks were excluded because they were already in government hands, as was Banco

Obrero, which belonged to the labor sector, and Citibank and offices representing foreign banks, as they were not owned by Mexicans. That is why the act did not refer to "nationalization", and foreign individuals and corporations were not expropriated either.

Once the expropriation of banks had been implemented, the following bank policy measures took effect until the end of November 1982 or the beginning of December 1982. The measures that were announced on September 4, 1982 were of two types: some dealt with the structure of interest rates and others to the exchange rate policy applicable to bank operations. Regarding interest rates it was stipulated that: 1) rates on new deposits would decrease by two percentage points per week over five weeks; 2) the annual rate on savings deposits would increase from 4 to 20 percentage; 3) lending rates applicable to performing loans for productive companies would decrease straight away by five percentage points; and, 4) rates applicable to entry-level loans decreased by up to 23 percentage points to 11 percent. As for foreign currency-denominated bank loans and deposits, the following was agreed: a) loans would have a "preferential" exchange rate of 50 pesos per dollar; and, b) deposits would have an "ordinary" rate of 70 pesos per dollar. At the time these exchange rate measures were adopted, the free market exchange rate was 100 pesos per dollar or higher.

What the cost of the application of these measures was to banks is hard to estimate. According to Carlos Tello, governor of Banco de México from September to December 1982, the measures lowered banks' income which was offset by increasing the legal reserve rate. Thus, while the so-called "conversion of mexdollars to pesos" along with the modification of bank borrowing and lending rates amounted to around 32 thousand million pesos, the effect of raising the legal reserve requirement rate amounted to slightly over 19.3 thousand million pesos. According to the then governor of Banco de México, the net result of this balance amounted to slightly more than 12.5 thousand million pesos, and the central bank accounted for it as liabilities.

## 7. Reorganizing nationalized banks

According to President Miguel de la Madrid (1982-1988), the expropriation of banks provided an opportunity to rationalize the structure of the financial system. This project involved three stages: first, the expropriation process would have to be completed by compensating the shareholders of expropriated banks. The second stage implied redefining the institutional concept of a bank and defining new borders between banking and the rest of the financial sector. A third stage led to the restructuring of the banking system in search of greater efficiency and competition while keeping banks profitable.

The López Portillo government expropriated banks but it was his successor, Miguel de la Madrid, who was responsible for compensating expropriated bankers and organizing and executing an unusual situation in Mexico: putting banks in the hands of the public sector. The most controversial aspect of the compensation was valuing the expropriated banks. How much was a bank worth? To resolve this problem several criteria were taken into account, but in the end the economic value was used (evaluating each bank's capacity to generate future earnings).

Compensation of former bank shareholders was completed in the fall of 1985. The two largest banks (Banamex and Bancomer) absorbed around 63% of the total compensation amount, and including the third bank, around 75 percent. All in all, based on eight tranches of compensation published between August 22, 1983 and August 23, 1985, the shareholders of 49 expropriated banks were compensated.

It is widely known that the then president elect, Miguel de la Madrid, did not agree with the expropriation of the country's private banks. It is also known that de la Madrid was not even consulted when the measure was decided on. Once in government, although Madrid did not agree to reverse the expropriation he did agree to mixed –30 percent of the shares owned by public investors— and competitive banking. It was largely for that reason that the regime decided to appoint prestigious professionals with the required training in financing to head the expropriated banks.

The other issue was related to imposing limits between banks and other financial activities. Two important measures arose from this challenge. The first was the decision to privatize financial and non-financial affiliates of expropriated banks. The second had to do with promoting a parallel financial system able to compete with banks that were now in government hands.

The legal reason for privatizing bank affiliates was that the decree had aimed at expropriating commercial banks only. Other reasons used to privatize bank affiliates were: to restore a balance to financial activities other than banking between the private and public sector and be congruent with the principle of a mixed economy, and foster private investment in the sector. The application of this policy basically derived from the privatization of banks' brokerage firms.

Particularly during the first few years of the de la Madrid regime there was a lot of interest in rebuilding the confidence that the expropriation of banks had undermined. This meant supporting the development of so-called parallel banks, especially brokerage firms. The strategy resulted in such firms monopolizing the management of public debt securities and limited banks' ability to participate in so-called non-traditional banking. At the same time, further progress was sought with banks' structural change. Thus, of the 60 banks that existed in 1982, by 1985, due to a careful merger process, there were 19: six nationwide banks, seven multiregional banks, and six regional banks. All of these changes took place amid an environment in which banks first managed to survive, strengthened their operations, and then expanded.

Despite the economic crisis which lasted from 1983 through the end of the de la Madrid administration, bank numbers for the period were not unfavorable. During the period from 1982 to 1988, bank deposits grew at an annual average rate of 4.3% in real terms. Financial savings, which in 1982 accounted for 32 percent of GDP, had reached 40 percent by 1988. Although small in international terms, the increase was almost 25 percent. Meanwhile, the loan portfolio as a percentage of GDP rose from 17 percent in 1982 to 25 percent in 1987.

8. Sale of banks

The process of downsizing the government sector began during Miguel de la Madrid's term in office. However, the largest and most controversial privatizations took place during the administration of Carlos Salinas de Gortari (1988-1994). It was during that period, between 1989 and 1990, that commercial banks were privatized.

The privatization of commercial banks which was completed during the Salinas administration first required several legal reforms. Article 28 of the Constitution had to be amended to allow for the participation of private investors in bank services and lending. Article 123 also had to be amended to adapt bank working conditions –permission to form unions— to a private regime. A new banking act also had to be passed and, as the next chapter discusses, new legislation on financial groups had to be implemented.

The sale of banks was one of the largest privatization processes to take place in Mexico because of the transaction amount and the corrective effects it had on economic agents' confidence regarding the conduct of economic policy, the development of the economy, and the allocation of productive resources.

Mexican banks were privatized in four stages. During the first stage, a collegiate body called the Bank Privatization Committee was created to undertake the privatization process. During the second stage, requests to participate in the process were received and bidders were selected based on several criteria. The third stage involved estimating the banks' value. The fourth stage covered the auctions in which banks were adjudicated to the best bids.

Although the first criterion was priority, there were three guidelines for privatizing the banks: obtain the largest amount possible from the sale of banks, contribute to improving the operation of the country's financial system, and keep bank share ownership in the hands of Mexican investors.

Authorizations issued by the Privatization Committee for participating in the corresponding auctions were non-transferable. Participating groups had to lodge a financial deposit and sign a confidentiality agreement. Following the corresponding auction, each buyer was given the opportunity to undertake an exhaustive audit of the bank it had acquired in order to apply any adjustments to the sale price.

As mentioned, the privatization of the 18 banks took place between June 1991 and July 1992. One of the reasons for such a rapid sale was not to give recently privatized banks competitive advantages. The first bank to be privatized was Multibanco Mercantil in June 1991. The last was Bancen in July 1992. The other multiple banks that were privatized were: Banpais (June 1991), Banorte (August 1991), Bancreser (August 1991), Banamex (August 1991), Bancomer (October 1991), BCH (November 1991), Serfin (January 1992), Comermex (February 1992), Banco Mexicano Somex (March 1992), Banca Promex (April 1992), Banoro (April 1992), Banorte (June 1992), and Banco Internacional (June 1992).

Once the bank privatization program was completed in the middle of 1992, the Ministry of Finance opened up the opportunity for new multiple banks to be created in Mexico. The response was immediate and within a relatively short period of time, 19 new private multiple banks began operating including Interestatal, Del Sureste, Industrial de Jalisco, Capital Interacciones, Inbursa, Quadrum, Pronorte, and Regional del Norte.

9. Evolving recovery

Mexico's evolution towards universal banking has been a long and uneven journey. At least two obstacles have hindered a smooth path. During a key period of history, banking legislation was so inadequate that in order to grow banks and credit institutions had to find ways around it. Such was the case in Mexico in the beginning of the 1970s with legislation on credit institutions dating from the 1920s. The second major obstacle was the 1982 expropriation of banks. The process of rebuilding financial groups got underway following the reprivatization of banks which was completed in 1982.

Following the reprivatization, the financial authorities retained their regulatory and oversight powers with respect to banks but the reprivatized banks and those that were subsequently created regained their operating freedom and the management of their shareholder base without interference from the authorities. Consequently, either through reprivatized banks or newly created banks, the reconstruction of financial groups took place fairly quickly.

Mexican contemporary universal banking is based on three laws: the Law on Credit Institutions, the General Act on Credit Organizations and Related Activities and the Law to Regulate Financial Institutions. The latter incorporated a far-reaching reform by introducing in Mexico the concept of a holding company at the head of each of the financial groups that were formed. Within Mexico's new financial group framework, holding companies consequently replaced multiple banks at the head of the groups.

Thus, based on the aforementioned regulatory framework, the Ministry of Finance sequentially issued authorizations to form new financial groups. Not all of them prevail to date. For example, the authorities revoked previously issued authorizations in order to create financial groups Arka, CBI, and Márgen. Another feature to note is that several of the authorized financial groups currently operating do not have a commercial bank.

Three main features distinguish the financial system that was created in Mexico since 1992. The first is the presence of several commercial banks which operate independently of a financial group. In fact, this is the case of 15 out of 40 commercial banks that currently exist in Mexico. The second feature is that regulations allow for the creation of financial groups without them having to possess a commercial bank. In Mexico, there are currently 17 cases of this type out of a total of 36 financial groups. Finally, as in the past, the largest and most powerful financial groups do have a commercial bank. In fact, in terms of the number of affiliates, the strongest financial group is no longer Banamex or Bancomer but Banorte.

As mentioned, the list of operating commercial banks includes the following 14 institutions which are part of a financial group: Banamex, BBVA, Bancomer, Santander, HSBC-México, GECapital, Ixe, Inbursa, Interacciones, Mifel, Scotiabank, Invex, Afirme, Mercantil del Norte, Banco del Centro, Bank of

America, J.P. Morgan, ING, Credit Suisse, and Barclays. Commercial banks not belonging to a financial group are: Regional de Monterrey, Bansi, Banco del Bajío, ABN Amro, American Express, Bank of Tokio-Mitsubishi, Comerica Bank, Ve por Mas, Deusche Bank México, Azteca, Autofin México, Compartimos, and Ahorro Famsa. Finally, the list of financial groups is: Afirme, Barregio, GECapital, Bank of America, Banorte, Barclays, Bancomer, Credit Suisse, HSBC, Inbursa, Interacciones, Mifel, Santander, Scotiabank-Inverlat, Ve por Mas, ING, Invex, Ixe, and J.P. (Chase) Morgan.

10. Banking crisis and resolution

Reprivatized banks had not been operating that long before the Mexican banking system was plunged into its worst-ever crisis.

Prior to this, evidence had shown that privatization generated very strong competition across banking sector segments. As might be expected, this strong competition triggered a decrease in banking concentration indexes in at least three areas: deposits, loan portfolio, and securities portfolio. Furthermore, during those early years of bank reprivatization there was no major change in the average number of branch employees, which decreased from 36 in 1990 to 34 in 1994.

Experts remained divided as to the origin of the severe banking sector crisis of early 1995. The near collapse was partially the result of poor moral solvency of some of the owners of privatized banks. It should be recalled that three of the problem banks —Unión, Cremi, and Oriente— had to undergo intervention by the authorities even before the December 1994 devaluation. The main impact on banks undoubtedly came from the balance of payments crisis which gave rise to the devaluation. During that period, banks' portfolio greatly weakened owing to the rise in interest rates and the fact that many borrowers were unable to continuing paying their loans.

The crisis had a major impact on all of the system's banks, albeit to different degrees. This meant the authorities had to take diverse actions to tackle the banking crisis. Those actions were initially aimed at resolving liquidity problems in order to subsequently focus on solvency problems. Concerning liquidity, the main mechanism was Banco de México's dollar-denominated loan window which aimed at preventing banks from defaulting on foreign currency-denominated debt.

As to solving solvency problems, the authorities implemented four types of programs: temporary capitalization of banks, intervention in banks that were in a more fragile situation to procure their recovery, a second capitalization program, and portfolio purchase and bank debt support programs. The first program involving temporary capitalization was aimed at preventing the capital of some banks with respect to their liabilities from decreasing below the legal limit. In order to close the capital shortfall gap, several banks were granted loans amounting to more than 7 thousand million pesos, all which was gradually paid back. The portfolio purchase capitalization program was put in place in 1995 and 1996, and agreements corresponding to the purchase were completed in 1997. In exchange for the purchase of past due loans, the authorities required the shareholders of intervened banks to make additional capital contributions.

Bank borrower support programs were implemented to help small debtors. The first program was introduced in April 1995 to provide relief for micro, small and medium-sized bank debts. Similar programs were implemented for entry-level mortgage debtors. This temporary policy was subsequently extended to medium-sized companies and agriculture and cattle breeding sector debtors.

Finally, as mentioned, intervention in banks with the biggest problems began in 1994. After the 1994 devaluation, four other banks were put under management intervention: Banpaís, Banco Obrero, Bancen, and Interestatal. In 1996 four more recently created banks were subject to intervention: Sureste, Capital, Pronorte, and Anáhuac. Finally, from 1997 to 2001, the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, CNBV) agreed to intervene in one bank per year: Confía, Industrial, Bancrecer, and Quórum. As a result of these interventions, banks were returned to a sound footing and subsequently merged.

## 11. Global banking

At the beginning of 1991, on the eve of the reprivatization of banks and when the North American Free Trade Agreement began to be negotiated, the possibility of allowing foreign banks to participate in the Mexican market raised favorable expectations in foreign financial circles.

When NAFTA was enacted at the end of 1993, the only foreign bank operating in Mexico was Citibank. Citibank's assets amounted to only 0.5% of banks' total assets. NAFTA market share limits were generally congruent with that reality and with the Mexican authorities' idea of deliberately limiting foreign banks' operations in the country. The initially contemplated period of transition would begin in January 1994 and end in December 1999. During that time the share of the market that each foreign bank could individually obtain would be below or equal to 1.5 percent. As to the global share of foreign banks, in the beginning it had to be below 8 percent and would gradually increase to a 15 percent ceiling at the end of the transition stage.

The plan within the framework of NAFTA was also that at the end of the transition period, raising the ceilings on the announced restrictions would be considered. However, in the event of the joint market share of foreign banks surpassing 25 percent of the total system, the Mexican government would be entitled to freeze growth in banks' foreign capital only once and for a period of less than three years during the four years following the end of the transition process. NAFTA also placed a 30% limit on the equity interest of foreign banks in Mexican banks.

Although this may seem restrictive, foreign banks soon began to enter the Mexican market. In 1994, four international banks began operating in Mexico. In April of that year, GE Capital opened its doors followed in November by Santander, J.P. Morgan, and Chase Manhattan. Such was the trend when the banking crisis erupted at the beginning of 1995, placing the system on a totally different footing.

With respect to the entrance of foreign banks in February 1995, limits on their market share that had been agreed on under NAFTA were raised. First, the maximum market share of a foreign bank affiliate was increased from 1.5 percent to 6 percent. The limit was generally raised from 8 to 25 percent. Furthermore, the limit on a foreign bank's equity stake in a local bank was raised from 30 to 49 percent. Once this new rule came into effect, a strong injection of foreign capital poured into three big banks: Bancomer, Serfin, and Bancrecer. Likewise, in May 1995, Banco Bilbao y Vizcaya (BBV) signed a letter of intent to buy Banco Mercantil Probursa.

In a second stage, several foreign bank affiliates began operating in Mexico and acquisitions of large equity stakes in local banks began to increase. Thus, while the share of foreign capital in the total banking sector was only 5 percent in 1994, by 1996 it had risen to 52.4 percent. Of that amount, 42.7 percent corresponded to the acquisition of equity stakes in local banks and only 9.7% to foreign banks' equity stakes in affiliates.

The third stage in Mexican market's opening to foreign banks took place at the end of 1998. The starting point was the trade opening schedule that had been negotiated in NAFTA. As a result, restrictions on equity stakes that would have been in place until 1999 were lifted a year earlier. It was during that period that the fully fledged entry of foreign banks to Mexico finally materialized.

The unrestricted entry of foreign banks in Mexico first got underway in August 2000 when BBV bought Bancomer. The following year, Citibank acquired Banamex, and in November 2002, HSBC bought Bital. Serfin had already been bought by Banco Santander and the same was the case for Inverlat, which was bought by Bank of Nova Scotia. As a result of these large transactions, the percentage of foreign capital invested in local banks continually rose. Thus, by the end of 2003 it already amounted to 82.3 percent and was distributed according to its origin as follows: Spain, 37.6 percent (BBV- Bancomer and Santander-Serfin); the United States, 27.6 percent (Banamex-Citibank, Bank of America, and others); Mexico, 17.7 percent (Banorte, Inbursa, and others); the United Kingdom, 10.1 percent (HSBC – Bital); Canada, 10.1 percent (Scotiabank–Inverlat); and others, (ING, Deutsche, Tokio, Dresdner, and Abnamro, among others).

## 12. What does the future hold?

Until October 2007, the overall outlook for Mexican banks was as follows. The commercial banking subsector is made up of 40 banks including the more traditional banks (Banamex, Bancomer, for example) and new banks (verbi-gracia, BanCoppel, and Banco Wal-Mart). Most of them are part of the existing 47 financial groups that exist to date. These groups, formed around their respective holdings, have other affiliates besides multiple banks.

Mexico has a dynamic banking sector that is growing. The most visible recent trend has been towards the entry of a larger number of market participants. Authorization of new commercial banks has derived mostly from a deliberate policy on the part of the authorities to allow for the creation of new banks in order to encourage greater competition within the sector. Not only does it seek to reduce the cost of banking services but also to tighten margins.

Strictly speaking, it is impossible to envisage the future. It is possible, however, to outline a picture of the likely future of banks based on the trends that have characterized it to date and the contemporary financial sector. A relative intensification or weakening of trends is difficult to foresee. As we have said, one such short-term trend has been the emergence of new banks. But over a longer time horizon the principle behind many of these trends derives from the influence of technological change on the development of banks in particular and the financial sector in general.

The trend in the Mexican banking sector in recent decades has been marked by very intense technological change. And such a trend could continue. Technological change has enabled banks to offer on-line products and services. In particular, it is reasonable to expect the ongoing emergence of new banking products. A former example is the development of so-called derivatives, which lower risks associated with financial transactions from unexpected modifications in at least three variables: exchange rates, interest rates, and credit risks.

Another recent trend that is very likely to continue is the so-called securitization of bank products. In other words, all standardized bank products to which a price can be assigned can potentially be sold in financial markets. While there are many, one example is the securitization of mortgage loans. Under this concept, loans of this kind can be sold to institutional or individual investors and therefore removed from banks' portfolios (off-balance sheet loans).

Another foreseeable trend is the ongoing reconfiguration of areas of specialization between banks per se (financial intermediation) and other financial intermediaries. One of many examples is the way in which banks, pension funds and insurance companies compete with each other for increasingly sophisticated investor segments with broad access to savings. This trend has been partly strengthened by the emergence of new financial intermediaries. We can cite, for example, hedge funds and venture capital companies (which offer savers investments in specific projects through stock ownership).

The last and very marked trend is towards the globalization of banking operations and financial systems. As for banks, the term globalization can refer to bank operations or their property. Regarding the former, we can cite cross-border transactions through which banks capture funds in one country and lend them in another or in several. This cross-border feature can also refer to providing banking services such as those related to fund transfers. Regarding capitalization, there are two variants. In the former, the shares of local banks can be bought by foreign investors or banks. In the second, foreign banks increase their share of new markets either by opening branches or by creating affiliates.

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