SUPPORT FOR RESTRUCTURING THE BANKING SYSTEM

(ME-0227)

EXECUTIVE SUMMARY

Borrower and guarantor:	Nacional Financiera SNC, with the guarantee of the United Mexican States	
Executing agency:	Ministry of Finance and Public Credit (SHCP), the Bank Savings Protection Institute (IPAB) and the National Banking and Securities Commission (CNBV)	
Amount and source:	IDB (OC): Local: Total:	US$250 million US$0 US$250 million
Financial terms and conditions:	Amortization period: Grace period: Disbursement period: Interest rate: Inspection and supervision: Credit fee: Currency:	15 years 5 years 1.5 years variable 1 % 0.75% U.S. dollar under the Single Currency Facility

Objectives: The objective of the program is to support measures to establish the conditions for recovery and continued development in the banking sector. The specific objectives are: (i) to strengthen the legal and regulatory framework of the banking system; (ii) to transfer shareholding ownership of banks under the financial program restructuring to the private sector, in a transparent and expeditious manner; (iii) to support efforts to maximize the recovery of bank loans and assets resulting from restructuring and portfolio purchases carried out during the crisis; and (iv) to implement a viable system for financing and absorbing costs arising from the financial crisis.

Description: The program calls for a comprehensive set of actions fundamental to the government's medium-term sector policy. These actions cover policy priorities for the sector over the coming 12 to 18 months, under five areas of reform: (i) the macroeconomic policy framework; (ii) the legal and regulatory framework for the banking sector; (iii) the resolution of banks under the financial restructuring program; (iv) liquidation of the banking portfolio and assets under the IPAB

program transfer; and (v) adequate financing of costs arising from the crisis.

The Bank's country and sector strategy: The Bank's strategy for the financial sector has to date focused on supporting government efforts to reform and modernize the existing system of public development banks in Mexico. The Bank has financed programs for the modernization of NAFIN and Banobras (two of the most important development banks) and is preparing a second support operation for NAFIN's credit program (multisector credit program for US$300 million).

In recent months, the Mexican financial authorities have introduced fundamental reforms to the legal and institutional framework of the banking system. Those reforms include revisions to the protection that the State accords depositors and other creditors of the banking system (Bank Savings Protection Act), Commercial Reorganization and Bankruptcy Act, changes in the legal framework to strengthen the law governing guarantees, and new rules for bank capitalization.

These policy changes are intended to create a favorable legal and institutional framework for resolving the underlying problems of the banking system and they are opening new prospects for the Bank's participation in the sector. Participation in this process by the IDB, together with the World Bank and the IMF, is consistent with the Bank's strategic objectives for the country.

Environmental and social review: This program will have no environmental impact, since the activities called for are limited to institutional and legal reforms related to the financial sector. For these same reasons, the program will have no direct social impact.

Benefits: The reform program to be supported by proposed operation, which the government is pursuing in order to resolve fallout in the banking sector from the 1994-1995 financial crisis, is designed to strengthen the regulatory and institutional framework of the banking system. Over the medium term, these measures are intended to establish a soundly functioning banking system, improving solvency and efficiency among banking institutions as an essential element for the country's continued economic development. In addition, mechanisms will be set up to ensure gradual, orderly absorption of the costs stemming from the banking crisis.

Gradual withdrawal of the government guarantee for the obligations of commercial banks will generate a better incentive structure for the banking sector by transferring the risks associated with decisions by financial market participants to those making them. This will promote greater investor accountability and more discipline in the management

of credit institutions. The gradual nature of this reform will help users adjust to the change and will consolidate an institutional and regulatory framework that will lead to certainty for all financial market participants.

Enactment and implementation of the law governing guarantees and the bankruptcy law have led to greater certainty about bankruptcy proceedings, creditors and debtors' rights are now safeguarded, abuses can be avoided, and legal proceedings are less protracted.

Risks:

Financial risks: one of the major challenges facing the IPAB is to manage its debt properly. The immediate objective of the authorities is to limit the growth of IPAB's debt to the inflationary component of interest, while paying the real component in cash. This will require steady and strict financial management by IPAB.

Political risks: the feasibility of the government program for the banking sector depends to a large extent on continued political support. Although there is no guarantee that such support will continue, particularly in light of the upcoming elections, the government program reflects an agreement with the political parties that have the largest representation in Congress.

Operating risks: it is very important for IPAB's credibility and the reactivation of the banking system that the bank resolution process, be conducted in a timely, transparent and financially viable manner, particularly in its initial phase. The recent interest shown by first-class banks in the institutions now being offered for sale suggests that the government's strategy has been successful in attracting new capital into the system.

Special contractual clauses:

Disbursements will be made in two tranches of US$150 million and US$100 million, respectively, subject to fulfillment of the conditions precedent indicated in Section III B and C and summarized in Annex I (Policy Matrix). The disbursement procedures will be those for sector adjustment loans established in document GN-2001-2, approved by the Board of Executive Directors (see paragraphs 4.3 and 4.4).

Poverty-targeting and social sector classification:

This operation does not qualify as a social equity enhancing project, as described in the key areas of Bank activity described in the Report on the Eighth General Increase in Resources (document AB-1704).

Furthermore, this operation does not qualify as a poverty-targeted investment (PTI) (see paragraph 4.7). The borrowing country will not be using the 10 percentage points in additional financing (see chapter IV).

Exceptions to Bank policy: None

Procurement: Not applicable, as explained in paragraphs 4.3 and 4.4.

I. Frame of Reference

A. Background to the operation

1.1 The Mexican economy entered the year 2000 on a solid footing, after having overcome the serious obstacles that afflicted it during the crisis of 1994-95. Macroeconomic policies during 1999 were consistent with the program agreed by the authorities with the IMF. The overall fiscal deficit was below the programmed limit of 1.14% of GDP. During the year, the Bank of Mexico remained firmly committed to achieving its inflation targets. GDP grew by 3.7%, reflecting initially the recovery of exports and higher investment levels, although in recent months private consumption has made an increasingly important contribution (preliminary data suggest that GDP grew by 7.9% in the first quarter of 2000). The annual inflation rate declined to 12.3%, below the official target of 13% (and it had fallen further to 10.1% by March 2000). The new jobs generated by this expansion have helped to reduce open unemployment, with the consequent resurgence of domestic demand, particularly for consumer articles.

1.2 The adoption of a floating exchange rate has helped to overcome the external imbalances facing the country in recent years, and international reserves have reached a significant level. The balance of payments has been favorable every year since the 1994-95 crisis. Although the current account deficit for 1999 exceeded government projections at the beginning of the year, it was below the level for the previous year, when the economy was forced into significant adjustment following the crisis in East Asia and Russia. The performance in 1999 reflected, on one hand, the fact that investors were quick to realize that the problems in Brazil would have little effect on Mexico, because of the differing nature of the adjustments that Mexico had undertaken. On the other hand, oil prices rose sharply, nearly tripling between December 1998 and December 1999, and despite significant increases in international interest rates, the United States economy maintained an extraordinary and unexpected pace of growth that translated into higher demand for Mexican exports.

1.3 Maintaining strict fiscal discipline has been one of the cornerstones of the government's economic policy. This policy has been maintained despite rising revenues produced by higher oil prices, and has contributed to the economy's stability and to the resurgence of domestic savings. For 1999, the fiscal deficit fell to 1.1% of GDP. For the year 2000, consistent with their stabilization strategy, the authorities are continuing to apply strict control over public spending.

1.4 The Bank of Mexico maintained a conservative monetary policy during 1999, reflecting uncertainty in international capital markets and a firm commitment to achieve its inflation target. The money supply rose rapidly in 1999, in a context of lower inflation and greater market confidence. Currently, the monetary base is growing at the projected pace. Banking system credit to the private sector, however,

fell by 10% in real terms, in line with the trend recorded since 1995 (by March 2000, the decline had slowed to 8% on an annual basis). Domestic short-term interest rates fell by more than 1700 basis points to 16.5% in December, and the stock market index rose abruptly.

1.5 For the year 2000, the economic program calls for a 10% reduction in inflation, a real economic growth of 4.5%, and an overall fiscal deficit amounting to 1% of GDP. The authorities' sound economic management and the positive outlook for the Mexican economy have resulted in improved ratings for external Mexican debt by specialized rating agencies, and a portion of this debt has been accorded an investment-grade classification.

1.6 Despite its positive performance, the economy currently faces certain risks and difficulties. (i) The year 2000 will see elections in Mexico. In the past, election years have been characterized by turbulence on the financial markets. (ii) As a result of growing economic integration between the two countries, Mexico's economic performance is highly dependent on the behavior of the United States economy. In particular, if the growth rate of the U.S. economy does not show signs of a gradual correction towards its long-term path, this could produce higher interest rates than expected, along with drastic adjustments to market valuations, reduced capital flows to Mexico and lower Mexican exports. (iii) While efforts continued during 1999 to strengthen the banking system, this remains a major point of vulnerability. In the wake of the 1994-95 crisis, financial intermediation by the commercial banking system has declined substantially. At the end of December 1999 the balance of commercial bank financing to the private sector, in real terms, was only 56.9% of the corresponding figure for December 1994. Similarly, during 1999 domestic financing to the private sector recorded a real annual decline of 10.3%. The share of FOBAPROA-IPAB notes in total financing rose, reaching 34.4% in December 1999. If to this is added the balance of loan portfolios still held by intervened banks, 43% of total commercial bank financing in 1999 was linked to bank restructuring programs. Savings mobilization fell from 26% of GDP in 1993-94 to 22% in 1997, and 20% in 1999.

1.7 To deal with the unresolved problems of the banking sector, the government has designed and launched a sector strategy consisting of a coherent package of measures intended to strengthen the legal and regulatory framework for the sector, improve capital adequacy in financial intermediaries, sell off viable banks now in the hands of the government, and finance the costs deriving from the resolution of banks in difficulty. This operation results from a request to the Bank from the Mexican authorities for a program to support implementation of its sector strategy.

B. The financial crisis in 1994-1995 and its effects

1. Status of the system before the 1994-95 crisis

1.8 As part of its economic reform program, the government introduced financial liberalization measures culminating in 1991-92 with the reprivatization of the banking system. During the years when it had been nationalized, the banking system was weakened and there was significant disintermediation. Between 1982 and 1988 deposits from the private sector fell from 15% to 12% of GDP. Because of financing problems in the public sector, the reduced level of savings from the private sector went to financing the public sector, while credit to the private sector declined from 10% to less than 5% of GDP[1].

1.9 Despite these difficulties, when the banking system was reprivatized, the banks were awarded to groups that had little experience in the banking business, but were prepared to pay very high prices (in some cases the bids exceeded three times book value, and 20 times the previous year's earnings). With the opening of the economy, financial liberalization and economic stabilization, there was a sharp expansion in financial intermediation. The flow of savings from the private sector, both in domestic and foreign currency, jumped dramatically from less than 13% of GDP in 1988-89 to 20% of GDP in 1992, and to more than 24% of GDP in 1994. This trend in turn allowed a further increase in credit to the private sector. With the improvement in public finances, borrowing needs of the official sector declined, and as a result the banks swiftly expanded their lending portfolio to the private sector, quickly saturating the indebtedness capacity of the stronger borrowers and extending their exposure into riskier segments of the economy. Credit to the private sector in domestic currency surged from 5% to more than 23% of GDP between 1988 and 1994. Credit in foreign currency rose from 1% to 5.5% of GDP over the same period, financed to a large extent by interbank loans that left the banks with open positions. This increase occurred at a time when bank lending standards had been sharply relaxed and the legal and supervisory framework was weak. The proportion of nonperforming loans, which had been insignificant in 1988, rose to nearly 3% of GDP by the end of 1994. Clearly, the banking system was in a highly vulnerable situation by 1993-94, before the onset of the crisis.[2]

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[1] Data on bank credit to the private sector include only credits financed with funds raised by the commercial banking system. They exclude rediscounting operations (loans financed with resources from other intermediaries) and credit granted through asset repurchase transactions (carry-overs and synthetic financial instruments).

[2] A new indicator prepared by the CNBV for the trend in overdue loans, using a time-consistent methodology, shows that for 1994 the overdue portfolio represented nearly 17% of the total portfolio.

2. The economic crisis of 1994-95

1.10 Balance-of- payments difficulties precipitated the crisis of 1994-95, following the collapse of confidence in the wake of the unfavorable political events of 1994. The stabilization policies pursued by the authorities had resulted in a sharp increase in the inflow of short-term capital (portfolio investment): from insignificant levels prior to 1990, these rose to some US$30 billion a year in the course of 1993 and in the first quarter of 1994 (equivalent to about 10% of GDP). The collapse in confidence transformed these inflows into capital flight in the order of US$20 billion on an annual basis in the last quarter of 1994 and the first quarter of 1995 (more than 5% of GDP). These shifts produced sharp fluctuations in relative prices. The real exchange rate index fell by perhaps 40% between 1987 and 1993, and then doubled between the beginning of 1994 and early 1995. GDP contracted by more than 6% in 1995; the exchange rate was devalued nearly 100% in the first quarter of 1995; annualized inflation in the first four months of 1995 exceeded 100%; interest rates, which had fallen to less than 10% in early 1994 (28-day CETES) soared to more than 70% in April 1995; and real wages in manufacturing shrank by more than 20%.

3. The impact of the financial crisis on the banking system

1.11 The immediate impact of the crisis was a sharp collapse of the banking system's liquidity, particularly in dollars, as well as heavy losses by intermediaries through their uncovered foreign exchange positions. By the end of 1994, the private sector was also showing high levels of indebtedness, both in national and foreign currency, which were severely aggravated by the impact of devaluation and interest rate hikes. Thus many debtors were unable to service their bank loans, and the banking sector, which was already showing signs of weakness, faced severe problems of liquidity and solvency. As a result of higher interest rates, a devalued currency and the collapse of real estate prices, the nonperforming bank loan portfolio began to rise sharply in late 1994. The past-due portfolio in national currency jumped from 3.1% of GDP to 25% of GDP in June 1995, before declining to levels that averaged 16% for most of 1996, and closing that year at 12.5%.

1.12 The banks' ability to react to these developments was severely limited by the loss of value of the assets held as collateral, the ineffectiveness of legal remedies for the repossession of assets by creditors, and the opposition of strong organizations of debtors. A further element that no doubt played a significant role in setting the course for the crisis was the explicit guarantee that the Mexican government had given to all liabilities of the banking system, including interbank deposits: this produced perverse incentives and a high degree of moral risk for the banks' owners, managers and depositors, who in many cases acted under the assumption of zero risk and full protection.

1.13 The debtor problem was complicated to the extent that widespread default on obligations, by reducing intermediaries' liquidity, caused a further increase in interest rates and reduced the capacity of those intermediaries to provide fresh funding. As well, the initial default ended by aggregating the situation of the debtors themselves. This vicious circle became a serious obstacle to recovery.

4. Principal measures taken to deal with the banking crisis

1.14 To forestall a generalized financial crisis, the government adopted a series of measures backed up by an adjustment program, with financial support of US$50 billion from the United States Government and international agencies, including an IDB operation for US$750 million. Over the medium term, the strategy for overcoming the crisis was based on introducing various financial restructuring programs that would serve to contain the crisis and to maintain public confidence. At the same time, efforts were made to limit the fiscal and monetary impact of those measures on the government's economic stabilization plan. This last consideration, together with weaknesses in the FOBAPROA[3] regulatory framework (in particular its capacity to intervene, restructure and liquidate financial institutions) had a strong influence on the kind of measures adopted, which were characterized on one hand by a determination to keep the system's banks open and operating as far as possible, and on the other hand by deferring the fiscal impact of the costs of support transactions to the sector and limiting their effect on the monetary aggregates. A further characteristic of the government's reaction was its incremental nature, in the sense that the protection and funding required had to be supplemented several times to deal with problems that were found to be increasingly severe. The major programs introduced were as follows:

a. Support programs for the banking sector

1.15 In addition to the initial programs for providing liquidity in dollars and the Temporary Capitalization Program, which had a limited life and a very low fiscal cost, the government introduced "units of investment" (UDI) to facilitate the restructuring of the banking portfolio in constant-value units indexed to a fixed real rate, thereby alleviating the debt service burden. Other support measures were also introduced:

1.16 Capitalization and portfolio purchase programs. Under this program, FOBAPROA began in 1995 to acquire portfolio flows (classified and reserved) of banks facing capital shortfalls. As a counterpart, in most cases, the banks were to capitalize themselves (primarily through issuing convertible debentures) in an amount equal

3 The Bank Savings Protection Fund is a trust fund in the Bank of Mexico, the functions of which included administering deposit insurance and providing credit to banks to insure that they could meet their obligations.

to half the gross value of the portfolio purchased. The banks continued to administer the loans and to bear the losses resulting from the portfolio, up to 25% of the value in question. The remainder of losses was assumed by FOBAPROA. In payment, the banks received 10-year bonds issued by FOBAPROA, on which interest was paid only in a final lump sum upon maturity. Twelve banks (with approximately 80% of the system's assets) took advantage of this program, including the country's largest institutions, Serfin, Banamex and Bancomer. Overall, it is estimated that operations amounting to an original value of M$150.446 billion (US$15.836 billion) were transacted.

1.17 Bank restructuring program. Several banks were unable to meet the additional capital requirements and had to be intervened by the CNBV. In most cases the shareholders of these banks lost their capital and the managers were replaced. The following banks (approximately 12% of the system) were initially intervened under this system: Bancen, Banpais, Cremi, Union, Oriente, Capital, Interestatal, Obrero, Confía, Mexicano, Anahuac, Industrial, Pronorte and Sureste. Others, such as Atlántico, Promex, and Inverlat, received financial support from FOBAPROA. More recently Grupo Financiero Serfin, the country's third-largest bank, required financial support from IPAB[4]. In all these cases FOBAPROA, and subsequently IPAB, issued notes to cover the capital shortfalls of these banks or to permit the transfer of deposits to other banks within the system. To date, such securities have totaled M$369.411 billion (US$38.885 million).

1.18 **Banks in liquidation**. This group includes several banks that initially took part in the restructuring program, but were then found to be nonviable. Others were intervened with a view to winding them up. This group included the following banks: Capital, Cremi, Inverestatal, Obrero, Oriente, Unión, Anahuac and Pronorte. Ownership of some of these banks (Unión, Cremi, Obrero and Oriente) has already been transferred to IPAB. The corresponding process for Capital, Anahuac, Inverestatal and Pronorte is still underway. It is estimated that the total gross liabilities assumed by IPAB in this regard will amount to M$164.138 billion (US$17.270 billion).

b. Debtor relief programs

1.19 To alleviate the impact of high interest rates on the system's borrowers, FOBAPROA introduced a series of debtor relief programs. By means of these programs, the government agreed under certain conditions to assume a portion of the restructured debt service of households and businesses. Various programs were created to deal with the problems of different types of debtors. These included:

a. **Agreement on Immediate Support to Bank Debtors (ADE).** This agreement came into effect in September, 1995, and was intended to minimize the short-

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[4] Bank Savings Protection Institute.

term impact of high nominal interest rates on the debt service burden of households and small and medium scale enterprises. Nearly 1,900,000 bank borrowers have benefited from this program.

b. **Debt restructuring program** for concessionaires operating the nation's freeway system.

c. **Program of Additional Benefits to Housing Loan Debtors.** This program was launched in May, 1996, based on a system of progressive discounts on monthly payments over a period of up to 10 years, and amounting to as much as 30% of installments due during the first year.

d. **Financing Agreement for the Agricultural and Fisheries Sector (FINAP).** In July 1996, a program was introduced to alleviate the financial burden on farmers and fishermen through a discount of up to 40% on payments due over a maximum period of 10 years.

e. **Agreement on Financial Support and Development of Micro, Small and Medium-Scale Enterprises (FOPYME),** introduced in August, 1996, to help business enterprises carrying debts of up to M$6 million, with payment discounts of up to 30% over ten years.

f. **The Punto *Final* Program,** launched in January 1999, is intended to conclude the debt relief and restructuring process.

1.20 The cost of these programs was estimated in December 1999 at some M$171 billion (US$18.0 billion), of which about M$141 billion was financed from the federal budget, while IPAB assumed liabilities under these programs of M$30.509 billion (US$3.2 billion).

5. Results of government policies as of 1998

1.21 The government's strategy was successful in avoiding a massive collapse of the system and preventing a generalized banking crisis. Despite the severity of the 1994 crisis and the effects of the Asian crisis of 1997-98, public confidence was maintained and there was no wholesale run on the banks. The largest banks in the system, accounting for the majority of its assets (78%), remained in private hands. At the same time, government programs achieved a significant, although insufficient, recapitalization of the system. Since 1995, capitalization schemes have resulted in major injections of capital into the system (M$145.411 billion or US$16.7 billion to September 1999). Nevertheless, these efforts were not sufficient to bring Mexican banks up to international capital adequacy standards. Important progress was also made with the legal and regulatory framework, in improving the quality of prudential supervision and the information provided by the banks. A further result was the gradual elimination of restrictions on foreign investment in

the banking sector, and first-class international intermediaries have acquired control of several banks[5].

1.22 The cost of these government measures is related to the strategy used to address the crisis, in particular the incremental nature in which certain measures were introduced and the decision to defer the fiscal and monetary affects of government intervention. The audited financial statements of IPAB, which were recently published, show that the consolidated liabilities of IPAB at the end of 1999 amounted to M$601.341 billion (US$63.299 billion)[6] and gross liabilities at that date were M$722.465 billion (US$76.049 billion). The banks that took advantage of the various government programs absorbed only M$28.636 billion (US$3.0 billion) as their share of losses. IPAB will recover about M$121.495 billion (US$12.789 billion) through the sale of assets and portfolios. NAFIN (Nacional Financiera) and the Bank of Mexico for their part will contribute M$76.4 billion. Assuming that IPAB can recover the above figure through the sale of assets, the total fiscal cost of its coverage would still be M$537.26 billion (US$56.554 million). The total fiscal cost incurred to December 1999 would therefore be M$754.560 billion (slightly more than 16% of GDP), since it is estimated that transfers already made amount to M$141.0 billion.

Table 1.1
Cost of Support Programs for the Mexican Financial Sector 1995-1999

PROGRAM	Mexican pesos (millions)	US$ (millions)	Percent of GDP (%)
Total fiscal cost incurred to December 1999	**754,560**	**79,427**	**16.6**
Fiscal transfers completed	140,900	14,832	3.1
Obligations of Nafin and Banxico	76,400	8,042	1.7
Net liabilities	**537,260**	**56,554**	**11.8**
Value of IPAB assets at Dec. 1999	185,205	19,495	4.1
Total liabilities of IPAB	**722,465**	**76,049**	**15.9**
Capitalization and portfolio purchase programs	150,446	15,836	3.3
Restructuring programs	369,411	38,885	8.1
Liabilities of intervened banks	164,138	17,278	3.6
Payment donation program	14,008	1,475	0.3
Debtor program	16,501	1,737	3.6
Other liabilities (contingencies)	7,961	838	0.2

5 In December 1999 the CNBV estimated that 36.6% of total assets and 43.9% of bank capital was under the management and control of foreign investors. Once the Serfin and Bital operations are completed, these shares could reach 56.1% and 60.2% respectively.

6 Since the transfer to IPAB of certain banks in liquidation had not been officially finalized in December 1999, the liabilities of these institutions appear in the financial statements of IPAB at their value net of assets.

6. Major unresolved problems as of mid-1998

1.23 The government's strategy failed to address a series of structural reforms that were needed to strengthen and modernize the banking system and put it on a sustainable basis over the medium term. The Asian crisis of 1997 forced the authorities to postpone some reform measures and to reconsider the strategy they had been applying until that time. In mid-1998, there remained a series of sector policy issues that had not yet been resolved:

1.24 **The legal framework.** Prior to approval of the IPAB law, the government had been offering an unlimited guarantee for all bank liabilities, with the exception of subordinated debt and liabilities deriving from irregular transactions. This situation provided inadequate incentives for depositors as well as for managers and shareholders of intermediary institutions. On the other hand, the shortcomings in the legal framework governing the process of declaring bankruptcy and calling guarantees did not provide adequate protection for the interests of creditors and had in fact become an obstacle to the process of recovery, restructuring and liquidation of lending operations.

1.25 **Prudential regulation.** Bank capital adequacy rules fell short of international standards. Among the most glaring discrepancies were the inclusion in bank capital of such items as deferred taxes, overvaluation of fixed assets and subordinated convertible debt, and the failure to subtract capital investments in other businesses from the intermediary's own capital (which permitted the "pyramiding" of capital). *Rules governing portfolio qualification, accrual of interest and constitution of provisions* deviated from accepted international standards, in particular with respect to qualification and reserves for restructured loans and the fact that loans were classified primarily on the basis of the guarantees provided, rather than the capacity of the debtor to pay. *The transparency of financial information* was negatively affected by a chart of accounts that diverged in many respects from internationally accepted accounting principles, as well as by the concessions granted by the CNBV allowing special accounting records ("regulatory forbearance").

1.26 **Weakness of the banking system.** *Illiquidity*: a significant portion of bank assets consists of notes issued by FOBAPROA. These notes result from that institution's portfolio purchase transactions. They are long-term, non-negotiable instruments that generate no cash flow in terms of capital or interest (interest is capitalized). These conditions mean not only that the notes are totally illiquid on the market, but that their value is growing in real terms. *Poor portfolio quality*: in addition to the already high levels of nonperforming loans and assets received in payment, the loan portfolio as restructured under the various official programs carries a high risk of default. *Lack of capital quality*: since 1995, the capitalization schemes adopted by the authorities have encouraged heavy injections of capital into the system. Nevertheless, because the concept of capital includes such headings as deferred taxes and subordinated convertible debt, there has been a noticeable deterioration in

the quality of bank capital. By international standards, the Mexican banking system is undercapitalized in amounts variously estimated at between US$5 billion and US$15 billion. *Weakness of risk control and monitoring systems:* Mexican banks have not made the investments necessary to develop modern systems for evaluating and managing risk.

1.27 **Contraction of credit to the private sector.** Since late 1994 there has been a sharp drop in lending by the commercial banks and the development banking system. This phenomenon has led both to a contraction in total financing within the economy and an important shift in the intermediation process. Thus, while the importance of sources such as suppliers' credit and foreign bank lending has increased, that of the national banking system has declined. In addition, other agents have been meeting specific market needs to some extent, such as for consumer and housing loans. Although in previous years these alternative sources of credit have filled part of the space vacated by the banks, they are not in a position to replace the banking system permanently in terms of its intermediation function. Although the private sector was significantly indebted to the banking system prior to 1994, by 1999 the flow of commercial bank financing to the private sector represented only 22.6% of GDP (the lowest level since 1991), while the balance of commercial bank financing to the private sector, in real terms, was only 56.9% of the corresponding figure in December 1994. During 1999, domestic financing to the private sector recorded an annual decline of 10.3%, and the share of total financing represented by FOBAPROA-IPAB notes rose to 34.4%. If to this is added the balance of loan portfolios still held by intervened banks, 43% of total commercial bank financing in 1999 was linked to bank restructuring programs.

1.28 **Resolution of banks in difficulty**. At year-end 1998, there were 15 banks in difficulty, five of which were in the financial restructuring program and in the process of being sold, while the 10 others are being intervened and are in the process of resolution (liquidation or sale).

1.29 **Resolution of assets or loan portfolio (currently) under the IPAB transfer program.** In addition to the assets of the banks in the resolution program that remained under the control of the authorities, FOBAPROA received portfolios and other assets as payment for the support provided as part of the programs for bank capitalization and debtor support programs. Such assets total an estimated nominal amount of M$500 billion (US$52.63 million).

1.30 **Financing the costs of bank settlement.** The government strategy to defer the fiscal and monetary impact of the various programs to support the banking system and debtors meant that a strategy had to be devised to help finance such costs, amortizing them in the long term. In mid-1998, the authorities did not have the necessary instruments to do so.

II. THE NEW GOVERNMENT STRATEGY FOR STRENGTHENING THE BANKING SECTOR

2.1 With the impact of the Asian crisis on the Mexican economy largely overcome, the authorities, consistent with their initial response to the 1994 crisis, have adopted a new medium-term strategy for consolidating and strengthening the banking system. This strategy calls for gradual application of a series of coherent measures to upgrade bank capitalization and to bring the regulatory and supervisory framework up to international standards over the next five years. Most of the measures under this strategy have already been announced or the new rules have been issued, but their effective date has been deferred. The planned actions can be grouped into four broad areas of reform: (i) the legal and regulatory framework governing the functioning of the banking system; (ii) the resolution of banks that have been intervened; (iii) the liquidation of the portfolio and banking assets in the hands of IPAB; and (iv) adequate financing for the costs arising from the crisis. The proposed operation will support implementation of the new government strategy which is to address the situation of the banking system through substantive measures.

A. Updating the legal and regulatory framework to ensure proper functioning of the banking system

2.2 The basic aspects of this process involve reducing the state guarantee for the obligations of commercial banks; a general recapitalization of the system as a result of a redefinition of bank capital and of rules governing the constitution of provisions; and strengthening bank supervision, with priority to the concept of risk implicit in the banking business.

2.3 **Creation of IPAB.** With the entry into force of the decree whereby the Bank Savings Protection Law published in the *Diario Oficial de la Federación* on January 19, 1999 was enacted, the Bank Savings Protection Institute (IPAB) was created, and a new stage in the restructuring and recovery of the Mexican financial system was launched. The new legislation is the cornerstone of the government's strategy: it allows for adequate financing of the cost of rescuing the banking system and creates mechanisms for resolving banking problems over the medium term. IPAB has been given adequate and clearly defined powers and responsibilities to implement programs for financial support to ensure liquidity or to provide resources to reorganize banking institutions, or, if necessary, to proceed with their liquidation. IPAB will manage the bank savings protection system, will receive fees paid by commercial banks according to their current exposure and will eventually have to provide resources for the restructuring of intervened banks or to pay for the obligations guaranteed by IPAB. IPAB is a decentralized federal government agency, with its own assets and full legal capacity, and has the capacity to raise funds through the financial markets. Pursuant to Articles 7 and 19 of the above-

mentioned act on transitional measures, IPAB has taken over the liabilities of FOBAPROA. IPAB enjoys a high degree of independence, by virtue of the fact that four of the seven members of its board of directors are appointed by the Executive Branch of the federal government and must be confirmed by a two-thirds majority of the Senate. Its transparency is enhanced by the fact that it must report to Congress periodically on its activities whenever either chamber of Congress so requests, and its accounts must be audited by an external auditor and a commissioner appointed by the Executive of the federal government.

2.4 **Limits of coverage on deposit insurance.** The IPAB law provides for a gradual reduction in the total guarantee that the government offered for bank transactions. This reduction is to be accomplished through a transitional program that began on June 1, 1999 and will culminate on January 1, 2005. As of June 1, 1999, guarantees are longer provided for the following transactions, among other operations: liabilities stemming from subordinated loans; obligations with respect to intermediaries that are part of the financial group of which the respective bank is a part; operations not subject to the legal provisions, and obligations and deposits for shareholders or members of the board of directors and of officials in the two highest levels of the respective bank's hierarchy. As of January 1, 2001, obligations arising from financial derivative transactions on recognized stock exchanges will longer be covered. After January 1, 2002, protection will be withdrawn from obligations arising from deposits in guarantee, tax collection, contributions to the federal treasury and securities settlement accounts. Moreover, after January 1, 2003, the maximum guaranteed amount of obligations not excluded in previous stages will be the equivalent of 10 million UDI (approximately US$2.5 million) per individual or corporation. After January 1, 2004, guarantees will apply only to deposits of up to the equivalent of 5 million UDI (approximately US$1.25 million) per individual or corporation, and this amount will be reduced to 400,000 UDI on January 1 the following year. Thus, under the new Act, as of 2005 deposits will be guaranteed only to a limit of 400,000 UDI (approximately US$100,000) per depositor, for both individuals and corporations, regardless of the number and type of their obligations, in a single commercial bank. While this level of coverage remains high by regional standards, the elimination of absolute coverage will provide a powerful incentive to the banks to strengthen their financial situation over the course of the next few years.

B. Strengthening capital, prudential and transparency standards

2.5 The second aspect relates to updating banking legislation, regulation and supervision to bring it into line with generally accepted international principles. In this regard, major advances are planned for the short term, as described below.

2.6 **Improving the quality of bank capital.** In September 1999, the SHCP issued its Rules Governing Capital Adequacy Requirements for Commercial Banks, the principal objectives of which are: (i) to improve the quality of bank capital and

(ii) to induce greater transparency and disclosure with respect to banking operations. The new rules are consistent with international practice, and in particular with the recommendations of the Basle Committee. They will gradually reduce (from 80% in 2000 to 20% in 2003) the possibility of counting deferred taxes as part of basic capital. As well, intermediaries will have to make progressive deductions (20% in 2000, and 80% by 2003) from their basic capital for investments in closed companies (those whose shares are not publicly traded), as well as any excess over 15% of total shares held in open corporations (publicly traded). Other rules will be applied immediately, including the stipulation that subordinated convertible debt may not be counted as part of primary (Tier 1) capital: these instruments must be included in Tier 2 capital. In addition, subordinated convertible debt must be converted into capital before the end of 2002. At the same time, non-cumulative preferred shares will be limited to a maximum of 15% of primary capital. This rule also provides that primary capital must exclude specific loan-loss provisions, but it allows the inclusion of general provisions up to the equivalent of 1.25% of risk-weighted assets.

2.7 **New rules governing asset classification and provisions.** Commercial banks will have to apply the rules recently published by the CNBV for classifying credits resulting from credit card transactions (in effect since December 1999), and mortgage loans (in effect as of June 2000). These rules require the banks to apply approved statistical methods in calculating the anticipated loss and the required reserves. The model to be used implies a provision of 100% on overdue payments and at least 10% on the outstanding balance of the credit card portfolio. This adjustment means a doubling of current loan-loss provisions. A similar model, to come into effect in June 2000, will be applied to mortgage loans. For commercial credits, a model will be established for measuring the probability that a loan will move from one risk level to another, on the basis of the customer's credit history and capacity to pay. This system will be formally introduced in the first quarter of 2001.

2.8 **Updating of accounting principles.** The CNBV has introduced, effective January 2000, a new accounting system that updates the presentation of financial statements for banking entities and broadens publication and disclosure requirements for financial information, in line with internationally recommended methodology, in particular the rules contained in the Financial Accounting Standards (FAS) and International Accounting Standards (IAS). In particular, they introduce the concept of market price valuation (following the FAS 115 and IAS 39 model). They also introduce information disclosure criteria that include the obligation to assess the recovery probability of the loan portfolio (FAS 114 and 118), transfer of assets (FAS 125) and securitization operations (FAS 125) as well as transactions relating to derivatives (FAS 133) and dealings with related parties (connected lending, FAS 57 and IAS 24).

2.9 **Transparency and disclosure of information**. The new regulations established information disclosure and publication requirements. In particular, information must be disclosed on ownership structure and assets weighted by risk, and additional information is to be published on derivatives and transactions with related parties.

2.10 **Valuation of fixed assets**. The CNBV established as a requirement for all banks that all real property acquired or received as payment be independently and objectively assessed according to clearly established procedures. A large portion of these valuations have already been conducted.

2.11 **Investment accounting at market prices.** Legislation was recently issued authorizing the creation and functioning of firms that will publish prices for securities ("price vendors"). These entities fall under the supervision of the CNBV, and will provide daily evaluations of all market instruments. In the future, all banks must value their securities investments at the prices published by such firms. As well, securities classed as tradable or available for sale must be valued at market prices ("marked to market"), while transfers from the trading account to the account for securities held to maturity will require the express authorization of the CNBV, and implicit losses must be recognized at the time of transfer. An asset valuation reserve may be constituted as a charge to the earnings statement, against which losses incurred from such credit risks may be charged.

2.12 **Regularizing exceptions to rules enforcement (regulatory forbearance).** To promote transparency in financial reporting, a system of authorizations has been established under which regulatory dispensations will be granted to individual institutions only in cases where their situation might generate systemic problems and threaten financial restructuring operations. Banks must disclose any regulatory forbearance under which they are operating, and its impact on their financial statements, publishing once a year all the regulatory exceptions they may have been granted.

2.13 **Introducing risk management methodologies.** The CNBV has issued rules requiring intermediaries to introduce operating and organizational systems that ensure an adequate approach to risk evaluation, control and management. A rule came into effect in 1998 requiring the creation of internal controls for granting credits including, for example, proper assessment and approval systems. In addition, a new rule is under preparation that will require banks to meet minimum criteria in their internal control practices to ensure the proper functioning of banking operations.

C. Resolution of banks in difficulty

2.14 Currently there are 17 banks under intervention or special status. Some of these banks are operating normally, while others are in the process of being wound up,

and still others are being examined to determine the least costly solution. In this context, these banks may be divided into two groups, depending on their particular situation:

1. Banks in the process of being sold (constructing programs)

2.15 There are five banks in this group: Serfin, Bancrecer, Inverlat, Atlántico and Promex. These banks must be restructured and recapitalized before they can be sold. It is important to note that FOBAPROA operations in Inverlat, Atlántico, and Promex have not yet been completed and that consequently IPAB will have to evaluate them upon their completion according to the respective legal framework. In accordance with its legislation, IPAB has retained external auditors and contracted appraisal studies from internationally recognized firms of experts to advance the process of selling these five institutions.

2.16 **Serfin.** IPAB took control of this bank in July 1999, by subscribing to new shares in the amount of M$21.2 billion (US$2.2 billion), payable by means of one-year notes with capitalized interest. By March 2000, IPAB had moved forward with all aspects relating to the sale of this institution. An in-depth audit was conducted and the resulting information was made available to parties interested in acquiring the bank, in a special "data room" created for this purpose. The international auction process was completed on May 8, 2000, with Grupo Financiero Santander Mexicano winning the award. In late May, the sales contract with that financial group was entered into. The capital stock will be transferred in the coming months. IPAB channeled approximately M$50.094 billion in financial support to this bank.

2.17 **Bancrecer.** IPAB contracted an investment bank to conduct a technical study on the basis of which the viability of Bancrecer was established and the financial support it received was justified. After removal of the bank's former managers and shareholders, the entity was capitalized by IPAB in the amount of M$102.2 billion (US$10.7 billion) on November 3, 1999. The process of selling this institution is expected to be completed in the second half of 2000. To this end, a timetable has been established for executing the sale in accordance with the provisions of law and the regulations of the IPAB Act.

2.18 **Inverlat.** This bank was capitalized by FOBAPROA in July 1996, and was recapitalized by FOBAPROA. The Bank of Nova Scotia (BNS) took an equity position, at the same time acquiring the option to take control of the bank by subscribing to convertible debentures with the option of early conversion on July 31, 2000. The BNS also took over the management of Inverlat. The current agreement requires IPAB to maintain the capital ratio of Inverlat at above 8%, for which it has had to make additional capital injections that may run as high as M$12.9 billion (US$1.4 billion). On March 24, an agreement was signed to complete the transaction on the basis of audited financial statements to the end of

1999, reconciliation procedures were agreed, and the date for completing all negotiations was set for July 31, 2000.

2.19 **Atlántico.** In December 1997, Banco Atlántico, Bital, and the respective financial authorities signed an agreement laying the foundation for restructuring Atlántico and its subsequent purchase by Bital, whereby Bital undertook to rehabilitate Atlántico and merge with it. Bital thus took over management of Atlántico and in March 1998 Atlántico was capitalized by FOBAPROA. However, the sale has not been completed. Bital later argued that new contributions by FOBAPROA were necessary to complete the transaction. A special consultant has been retained to determine clearly the legal viability of actions taken to date, and to design measures that the authorities might take in future, including completion of the merger or formal intervention in Atlántico.

2.20 **Promex.** Promex, Bancomer, and the respective financial authorities signed an agreement for rehabilitation of the Promex bank (whereby Bancomer undertook to maintain the capitalization of Promex at 8% as a minimum). Bancomer thus took over the running of Promex under a management contract signed in May 1998. The governing body of IPAB recently approved negotiation of an agreement with Bancomer to complete and sell Promex once the legal and accounting audit required by law was completed.

2. Banks in the process of resolution

2.21 There are twelve banks in this group: Capital, Cremi, Industrial, Interestatal, Obrero, Oriente, Unión, Anahuac, Banpaís and Pronorte. IPAB, together with the CNBV, pursuant to its legislation, will constitute a "Committee for Redimensioning Intervened Banks" and its rules of procedure, in May of this year. That committee is to establish a coordinated strategy for wrapping up the CNBV's management interventions so that institutions can then be liquidated or sold by IPAB. IPAB is currently implementing a plan to centralize the management of these entities, while at the same time maintaining coordination with other government entities involved in this process (SHCP, BANXICO and CNBV). Although these banks currently conduct no transactions with the public, they do participate in the interbank market, primarily through Cremi.

D. Sale of assets subject to the IPAB Act

2.22 The nominal value of the assets of the various banks subject to the IPAB Act besides the capital stock held by the banks under the restructuring program amounts to nearly M$550.0 billion (around US$57.895 billion), of which some 22% is expected to be recovered through the program of selling them off and liquidating their assets. This program is expected to generate about M$20 billion (US$2.1 billion) per year over the next five years. In this connection, a series of auctions is to be held for the assets of these banks (including their movable and immovable

assets, loan portfolio and other assets received in payment), the first of which were conducted in late 1999.

E. Assuring the financial viability of IPAB

2.23 The strategy adopted by the authorities for ensuring the financial viability of IPAB is based on the following considerations: (i) maintaining the level of debt constant in real terms, initially, which will mean annual fiscal transfers of about 0.7% of GDP[7]; (ii) refinancing existing liabilities; (iii) completing the program for selling banks and assets; and (iv) making a start at amortizing the debt of IPAB, which should in principle be possible with a constant level of fiscal transfers amounting to 0.7% of GDP in coming years. In this way, the total cost of the financial crisis could be absorbed over the long term, in a manner consistent with macroeconomic stability.

2.24 Initial projections were prepared by IPAB on the basis of the following assumptions: (i) GDP growth of 4.5% for the year 2000, and a subsequent annual growth rate of 5%; (ii) a real interest rate of 7%; (iii) estimated recovery of assets to 20% of their nominal value (M$20 billion per year from 2000 to 2004); and (iv) annual transfers of 0.7% of GDP. Before submission to the Board of Executive Directors, IPAB will present its updated financial projections to the Bank, reflecting its financial strategy (including a balance sheet, a statement of income and expenses and a funds flow statement), with special attention to the following items: (i) income from fees; (ii) expected fiscal transfers; (iii) income from disposal of assets and sale of banks; (iv) note issues; and (v) debt service.

2.25 The fiscal support planned for the year 2000 starts from the basis that IPAB's debt (which is not to be increased in real terms) is M$722.465 billion, and assumes that the real interest rate for standard public debt is 7% and that the premium paid by IPAB is 1.15%. The corresponding real interest owing would then be M$59.1 billion. To finance this, M$20 billion is expected to be raised through sale of assets, and $4.5 billion from 75% of the deposit insurance premiums that IPAB charges the banks. The difference, or $34.6 million, corresponds to the fiscal transfer included in the budget for 2000.

2.26 Initial financial projections show that the Institute will have a moderate cash flow deficit during the present year, and considerable deficits in 2004, 2005 and 2006. IPAB expects to be able to refinance those deficits through a program of marketable note issues. This process has already begun, and the weekly auctions held since the first week of March have been conducted satisfactorily. Thus, of the M$13.5 billion (US$1.42 billion) offered to date, M$13.46 million (US$1.416 million) were placed after receiving bids for nearly four times the amount offered (M$44.918 billion). Given the size of the operations to be refinanced by IPAB, it is important to note

[7] These transfers would be enough to keep the nominal value of IPAB's liabilities at the end of 1999 (US$722.465 billion) from growing faster than the inflation rate.

that its financial viability is very sensitive to the assumptions about future interest rates, recovered amounts, and economic growth. The Bank reviewed the sensitivity analyses and has the information in the project files. Given recent trends in all the variables, IPAB is likely to remain financially viable.

F. Bankruptcy Act and regulations on loan guarantees

2.27 In order to provide a proper legal framework for the conduct of credit transactions, and in particular to strengthen the powers of the judicial system to enforce contracts between debtors and creditors, the government presented to Congress a draft law on guarantees and a draft law updating bankruptcy legislation (*Ley de Consursos Mercantiles,* the Commercial Reorganization and Bankruptcy Act). On May 12, 2000, the Commercial Reorganization and Bankruptcy Act was published in the *Diario Oficial de la Federación.* As for the law governing guarantees initially proposed, Congress decided instead to approve a decree that would amend the General Securities and Credit Operations Act, the Code of Commerce, and the Credit Institutions Act through additions to and deletions of certain provisions. These reforms represent a fundamental component of the Mexican government's strategy to facilitate the recovery of lending, the merger and liquidation of businesses, the market tradability of mortgage loans, and the execution of guarantees.

G. Current status of the banking system

2.28 In December 1999, there were 35 commercial banks in operation, with a total network of 6,891 branches, more than 26 million bank accounts (15.6 million current accounts, 7.3 million term deposit and investment accounts, and 3.7 million savings accounts) and more than 6 million credit cards in circulation. The net equity in the system amounted to M$134.56 billion (US$14.164 billion), and total assets amounted to M$1,377.184 billion (US$144.966 billion).

2.29 Recent years have seen a sharp reduction in financial intermediation by the commercial banking system. Nevertheless, there are now indications that the contraction of banking financing has been halted. For December 1999, the real annual trend in consumer credit ceased declining. In previous episodes, consumer credit had led the recovery of financing to firms and unincorporated businesses. During the last quarter of 1999, banking activity began to show signs of recovery. The total lending portfolio of the commercial banking system remained virtually unchanged during the quarter, declining by only 0.2% in real terms between September and December. This performance is explained by a growth in the domestic currency portfolio of 2.2% in real terms, which was offset by reductions in real terms of 5.8% and 3.8% in the foreign portfolios denominated in foreign currencies and in UDI, respectively. The decline in the UDI portfolio reflects amortization by various mortgage debtors, businesses and farmers seeking to take advantage of the discounts offered under the *Punto Final* debt relief program.

2.30 The nonperforming loan portfolio of the commercial banking system[8] fell by 8.4% in real terms, to a level of M$80.754 billion at the end of 1999. With this reduction, the banking system's index of nonperforming loans declined from 9.7% in September to 8.9% in December 1999, which was its lowest level in the last three years, i.e. since the new accounting rules came into effect in January 1997. Moreover, intermediaries continued to increase their loan-loss reserves. At the end of December 1999, those reserves amounted to M$87.027 million, exceeding the value of the nonperforming portfolio, which meant that the index of the banking system's provisions against nonperforming loans stood at 107.8% in that month.

H. Bank strategy and justification of the operation

2.31 The IDB's strategy for the financial sector has focused to date on supporting government efforts to reform and modernize the system of public development banks in Mexico. The Bank has financed programs for modernizing NAFIN and Banobras (two of the most important development banks) and is preparing a second operation in support of NAFIN's credit program (Multisector Credit Program, US$300 million). At the same time, the Bank has maintained an ongoing dialogue with the authorities over the future role of development banking institutions as an instrument of the government's economic policy.

2.32 The governemnt's new strategy in the banking sector marks a fundamental shift in government policy towards the sector. It is designed to create a favorable legal and institutional framework for resolving the underlying problems of the banking sector and they are opening new prospects for the Bank's participation in the sector. Participation in this process by the IDB, together with the World Bank and the IMF, is consistent with the Bank's strategic objectives for the country. This operation includes and specifies actions to address to the financial viability of IPAB with respect to the sale of intervened banks and their assets, refinancing the obligations of that Institute, as well as approval and implementation of regulations governing loan guarantees and bankruptcy procedures that go beyond the previous operating guidelines of the World Bank and the IMF.

2.33 Although the size of the proposed operation is small in comparison with the fiscal cost of the measures taken by the government, the IDB's participation is justified because of the enhanced credibility and transparency that the presence of international agencies will lend to the government's program, at a moment when Mexico is entering an elections period, a time that in the past has been characterized by instability and turbulence on the external front.

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[8] This does not include figures for Inverlat, Bancrecer, Unión, Cremi, Oriente, Obrero, Interestatal, Sureste, Capital, Industrial, Anáhuac and Promotor del Norte

I. Previous experience in the sector

2.34 The IDB and the World Bank supported the initial phase of the banking sector restructuring program, through two quick-disbursing operations for US$750 million and US$1 billion, respectively. These two operations were prepared in record time and under very difficult conditions, reflecting the profound crisis through which Mexico was then passing. In the case of the IDB, the objectives of the operation were to "stabilize the short-term situation of problem financial institutions, in order to forestall greater difficulties and to restore confidence in the security and soundness of the Mexican financial system", which was very similar to the objective of the World Bank operation. That operation was fully disbursed in 1996.

2.35 The objectives of those operations was to stabilize financial institutions and restore soundness to the sector in the short term. That objective was perhaps too ambitious. The depth of the economic crisis was much greater than was initially thought, and this led the authorities to take measures to defer the fiscal and monetary effect of the acute problems facing the banking sector, as part of a sector strategy that sought to resolve those problems over the medium term. Consequently, the objectives as initially formulated could not be met within the time frame planned for those operations. It was principally for this reason that the World Bank concluded, in its 1997 evaluation, that the performance of its loan operation had been unsatisfactory.

2.36 One of the lessons to be drawn from the World Bank's analysis is the importance of limiting the range of objectives for new operations. Restoring stability and solvency to the banking system is a complex process that cannot be fully addressed in a single operation. In a case like that of Mexico, it is more realistic to support the process with a series of successive operations with limited objectives.

2.37 Having reliable information on a timely basis is essential for proper monitoring of this operation. Current conditions in Mexico differ from those of four years ago. Although the information provided by banks and the CNVB still does not meet international quality standards, it has substantially improved. The presence of rating agencies and numerous institutional investors and international observers has led to considerably higher quality and greater timeliness of the statements and the information disclosed to the public.

2.38 The design of the operation recognizes that the process of normalizing the banking system began with the actions that the government took subsequent to the crisis, and that it will conclude, if everything proceeds as expected, only in the year 2005. The process will therefore have taken in total more than 10 years. The government currently has a clear strategy for achieving this objective and it has been implementing that strategy as quickly as economic conditions permitted. The objectives of the present operation are limited to actions within that overall strategy that are achievable within a time frame of less than 18 months, and they focus on very specific measures with respect to banking regulation and financial operations

by IPAB. All of these actions have already been announced, or are at an advanced stage of implementation.

III. THE BANKING SECTOR RESTRUCTURING PROGRAM

A. Program objectives

3.1 The objective of the program is to support measures to establish the conditions for recovery and continued development in the banking sector. The specific objectives are: (i) to strengthen the legal and regulatory framework of the banking system; (ii) to transfer shareholding ownership of banks under the financial restructuring program to the private sector, in a transparent and expeditious manner; (iii) to support efforts to maximize the recovery of bank loans and assets resulting from restructuring and portfolio purchases; and (iv) to implement a viable system for financing and absorbing costs arising from the financial crisis.

B. Program description

3.2 The program calls for a comprehensive set of actions fundamental to the government's medium-term sector policy. These actions cover policy priorities for the sector over the coming 12 to 18 months, under five areas of reform: (i) the macroeconomic policy framework; (ii) the legal and regulatory framework for the banking sector; (iii) the resolution of banks under the financial restructuring program; (iv) liquidation of the banking portfolio and assets under the IPAB transfer program; and (v) adequate financing of costs arising from the crisis. Program conditionality is summarized in the Conditionality Matrix found in Annex I, and detailed in sections III C and D of this document. Annex II contains the Policy Letter that describes the sector policy framework in which the program will be carried out. The operation has been structured in two tranches, the first for US$150 million and the second for US$100 million. The first tranche relates to measures undertaken prior to submission of the loan proposal to the Board of Executive Directors, as "conditions fulfilled prior to approval of financing"; conditions yet to be fulfilled or for which formal documentation remains pending as indicated in italics in section III C, and will be included in the contract as "conditions precedent to disbursement of the first tranche".

C. Conditions precedent to disbursement of the first tranche[9]

1. Macroeconomic policy framework

3.3 The government has been pursuing a series of measures to achieve stability in the principal macroeconomic variables. The authorities signed a standby agreement

[9] These consist of measures taken prior to submittal of this proposal to the Board of Executive Directors of the Bank and that will be included in the loan contract as "conditions fulfilled prior to approval of the financing"; conditions yet to be fulfilled are indicated in section III C below in italics and will be included in the loan contract as "conditions precedent to release of the first tranche".

with the IMF on July 7, 1999, for a period of 17 months at a value of US$4.123 billion. The IMF recently completed its latest semi-annual review, with satisfactory results. The principal components of macroeconomic policy call for maintaining the floating exchange rate, strict fiscal discipline, keeping the current account deficit on the balance of payments at sustainable levels, and meeting financing requirements with stable, long-term funding. In addition, Mexico has been granted an "investment grade" rating for its sovereign debt by one international risk rating agency, while the other agency has improved its classification with a positive outlook. Nevertheless, the government is taking a cautious approach to the coming elections period, at time that has traditionally been marked by instability and turbulence in financial markets. In this context, maintaining the macroeconomic program is essential for reducing the economy's vulnerability to shocks of this kind. Before disbursement of the first tranche, the macroeconomic framework at that time must be shown to be consistent with objectives of the program. *Prior to disbursement of the first tranche, it will be confirmed that the macroeconomic framework of the country at that time continues to be consistent with the program objectives.*

2. Legal and regulatory framework for the functioning of the banking sector

a. Improving the system of incentives in the banking sector and the mechanisms for resolving problem banks

3.4 On January 19, 1999, the Bank Savings Protection Act entered into force and established: (i) a decentralized federal government agency with its own assets and full legal capacity in charge of administering a savings protection program; (ii) a procedure to correct illiquidity and insolvency when such situations arise through preventive support or restructuring of the banks on a timely basis; (iii) the power to evaluate, restructure and transfer or proceed with the liquidation of banks in difficulty in an expeditious, transparent manner; and (iv) a gradual reduction over a period of five years in the government guarantee for certain bank obligations, in accordance with an established timetable. Consistent with this timetable, a series of transactions are now no longer guaranteed by the government (see paragraph 2.4).

b. Strengthening prudential rules and increasing transparency in the banking sector

3.5 **Standards governing bank capital adequacy and loan-loss provisions.** January 1, 2000, saw the entry into force of rules on capital adequacy requirements of commercial banks, issued by the SHCP and covering operations subject to risk, both market risk and credit risk, establishing among others the following provisions: (i) a limit on the value of deferred taxes that may be included in basic capital, not to exceed 80%; (ii) specific loan-loss provisions on the B- and C-classified portfolio are to be excluded from basic capital; and (iii) new issues of subordinated convertible debt are excluded from basic capital. Moreover, according

to the rules, basic capital is to be reduced by 20% of investments in the shares of entities with the following characteristics: (i) non financial entities; (ii) entities not quoted on the stock exchange; and (iii) if quoted on the stock exchange, the market value of shares quoted does not exceed 15% of the entity's capital.

3.6 **Introduction of qualification and reserves standards for credit card and mortgage loan portfolios.** The rules issued by the National Banking and Securities Commission (CNBV) came into effect on December 1, 1999, modifying the provisions concerning qualification and reserves for the consumer credit portfolio arising from credit card transactions. *As a condition precedent to disbursement of the first tranche, the rules establishing new qualification and reserves standards for mortgage loan portfolios must have entered into force.*

3.7 **Updating of accounting standards.** The CNBV has published and given effect to rules establishing a new system of accounting principles, consistent with generally accepted international practice, updating the presentation of bank financial statements and broadening the requirements for publication and disclosure of financial information, in the following areas: (i) valuation of assets and financial instruments; (ii) accounting for derivatives transactions; (iii) securitized assets; (iv) transfer of assets; (v) connected lending; (vi) probability of loan portfolio recovery; and (vii) criteria for concession of "regulatory forbearance"[10] and requirements for publication thereof.

c. Strengthening existing legal mechanisms for loan recovery

3.8 (i) On May 13, 2000, the Commercial Reorganization and Bankruptcy Act (*Ley de Concursos Mercantiles*) entered into force, substantially changing the system and procedures in cases of debtor insolvency; (ii) Congress approved amendments in legislation to establish a new system for the issuance and execution of loan guarantees. *As a condition precedent to disbursement of the first tranche, these legal provisions on guarantees must be published and must have entered into force.*

d. Resolution of intervened banks

3.9 IPAB has concluded the process of international competitive bidding for the sale of one of the five banks under the financial restructuring program, following procedures designed to achieve a maximum degree of recoveries by IPAB and an assessment of bidders' technical qualifications.

[10] "Regulatory forbearance" means particular or general authorizations granted by the CNBV to allow special or exceptional accounting practices.

e. Liquidation of portfolio and assets under the IPAB program

3.10 Pursuant to the IPAB Act, the Institute must manage and dispose of assets received from FOBAPROA (portfolio and other movable and immovable assets) in order to obtain maximum recovery in the shortest time possible. The act establishes that the procedures for disposal of assets must be consistent with the principles of publicity and efficiency that will ensure objectivity and transparency. IPAB has established a plan for selling these assets and portfolios, including the auctioning of lots that have been designed to attract the attention of local and international firms specializing in the management of problem assets. Operations have been carried out to sell assets and the loan portfolio under the IPAB program for the disposal of assets for an overall minimum nominal value of US$650 million, through procedures designed to ensure transparency and maximum recovery value for IPAB.

f. Ensuring adequate financing of the costs deriving from the banking crisis

3.11 As a condition precedent to disbursement of the first tranche, IPAB must present updated financial projections for the next eight years, reflecting its financial strategy and including a balance sheet, statement of income and expenditure and funds flow statement, with particular attention to the following items: (i) income from regular fees; (ii) expected fiscal transfers; (iii) income from disposal of assets and loan portfolios and from the sale of banks under the financial restructuring program; (iv) note issues; and (v) debt service.

3.12 **Compliance with the note issuing program.** *IPAB has begun implementing a program to issue and place securities on the market and/or to enter into contracts for financing, as needed based on the financial projections referred to in the preceding paragraph.*

3.13 **Total liabilities of IPAB not to increase in real terms.** For the year 2000, Congress has authorized budgetary transfers of M$34.6 billion (US$3.642 billion). For subsequent years the authorities expect to have to continue making budget transfers in similar amounts (0.7% of GDP) to prevent IPAB's debt from rising in real terms. The government will take the necessary measures to ensure that IPAB's debt does not increase in real terms. *Prior to the first disbursement, IPAB will demonstrate that the value of its total liabilities did not grow in real terms between December 1999 and the date of its most recent financial statements, with the exception of new debt acquired pursuant to the Bank Savings Protection Act.*

D. Conditions precedent to the disbursement of the second tranche

3.14 Disbursement of the second tranche of the loan will be subject to the conditions listed below, which are summarized in the Policy Matrix.

1. Macroeconomic policy framework

3.15 The government's macroeconomic policy must remain consistent with the objectives of the program. Prior to disbursement of the second tranche, it will be confirmed that this condition continues to be fulfilled.

2. Legal and regulatory framework governing the functioning of the banking system

a. Improving the framework of incentives in the banking sector and the mechanisms for resolving problem banks

3.16 There will be a continued gradual reduction in the IPAB guarantee of banking liabilities, in accordance with the established schedule, and in particular, legal provisions must have entered into force requiring that liabilities resulting from financial derivative transactions on recognized exchanges will no longer be guaranteed by IPAB.

3.17 In addition, any new financial support to ensure liquidity or restructure one or more financial institutions must have been granted according to the following criteria, as established under the Bank Savings Protection Act: (i) a technical study has been conducted on the viability of the institutions; (ii) the support is reasonably less costly than the option of paying deposit insurance and other guaranteed obligations; (iii) a restructuring program has been prepared for the resepctive institution or institutions; and (iv) in the case of capitalization, the shareholders of the institution in question must have absorbed its losses in the first instance.

3.18 Measures taken by IPAB to resolve banking entities in difficulty must be conducted using administrative and technical procedures in accordance with the legal framework described in paragraph 3.4.

b. Strengthening prudential standards and transparency in the banking sector

3.19 **Capital adequacy rules.** The timetable established for grandual fulfillment of the capital adequacy requirements for financial institutions must be maintained. In particular, rules must have entered into force whereby: (i) there is a limit on the value of deferred taxes that can be included in basic capital, to a maximum of 60%; (ii) basic capital is reduced by 40% of investments in shares of entities with the following characteristics: (a) non financial entities; (b) entities not quoted on the stock exchange; and (c) if quoted on the stock exchange, the market value of shares quoted does not exceed 15% of the entity's capital.

3.20 **Implementation of risk management methodologies**. The CNBV will require banks to meet certain basic requirements with respect to implementing internal

controls that will ensure proper execution of bank transactions, such as appointing officials responsible for verifying compliance with rules, establishing audit committees, appointing internal auditors, documenting procedures in manuals and ensuring information system security. As a condition precedent to release of the second tranche, the CNBV must have approved these new regulations.

3.21 **Introduction of rules governing commercial loan qualification and loan-loss reserves.** The CNBV must have issued rules establishing new provisions for commercial loan qualification and loan-loss reserves.

c. Improving existing legal mechanisms for loan recovery

3.22 The Federal Institute of Specialists in Commercial Reorganzation and Bankruptcy has been established, the members of its board of directors appointed, and the regulatory provisions necessary for its operation issued.

d. Resolution of intervened banks

3.23 IPAB has concluded the sale of at least a second of the five banks under the financial restructuring program through: (i) international competitive bidding or (ii) a procedure that includes technical assessemnt, auditing, and completion of the respective restructuring operation, pursuant to the Bank Savings Protection Act.

e. Liquidation of the portfolio and assets under the IPAB program

3.24 Transactions for the sale of assets or loan portfolios under the IPAB program for disposal of assets have been carried out for a nominal overall value of US$1.65 billion, following procedures designed to achieve transparency and maximum recovery value for IPAB.

f. Ensuring adequate financing for the costs resulting from the banking crisis

3.25 **Compliance with the note issuing program.** The IPAB program for issuing and placing notes on the market and/or entering into contracts for financing, is in execution and consistent with the needs established based on the financial projections.

3.26 **Total liabilities of IPAB not to increase in real terms.** Prior to the second disbursement, IPAB must demonstrate that the value of its total liabilities did not increase in real terms between December 1999 and the date of its most recent financial statements, except for new debt acquired pursuant to provisions of the Bank Savings Protection Act.

IV. FINANCING AND EXECUTION

A. Financing of the operation

4.1 The sector adjustment operation proposed in this paper will be supported by a quick-disbursing loan in the amount of US$250 million. The loan will be disbursed in two tranches, the first for US$150 million and the second for US$100 million, over a disbursement period not exceeding 18 months.

B. Loan implementation

1. Borrower and executing agencies

4.2 The borrower will be NAFIN (Nacional Financiera SNC), with the guarantee of the United Mexican States. The program will be executed by the Ministry of Finance and Public Credit (SHCP), IPAB and the CNBV. The **International Financial Agencies Department (DOFI) of the SHCP** will be responsible for preparing follow-up reports for the program. The three agencies participating in the program will coordinate the activities called for under the program and delivery of the necessary information.

2. Disbursement procedure

4.3 Resources of the quick-disbursing loan will be used to finance the overall cost, in foreign exchange, of eligible imports from member countries of the Bank. The new, simplified procedures for sector loan disbursement, established in document GN-2001-2, will be used. Disbursements will be made upon receipt of an application from the borrower, confirming compliance with the agreed policy conditions.

4.4 With respect to disbursements, the borrower will undertake: (i) to maintain separate accounts and supporting documentation for use in external audits or verifications as the Bank may request; and (ii) to maintain a separate bank account in which loan funds will be deposited. As well, in the Loan Contract the Bank will reserve the right to request the borrower to provide information on the use of loan funds, audited by independent external auditors acceptable to the Bank.

3. Inspection and supervision

4.5 Follow-up missions will be conducted by the Bank's project team, with technical support provided by the Country Office in Mexico. The Loan Contract will establish the commitment of the borrower and the executing agencies to cooperate as required in the work of inspection and supervision.

4. Ex-post evaluation

4.6 The project team has consulted the borrower, which has opted not to conduct a formal ex-post evaluation of the program. The Bank will conduct its own evaluation of the operation, however, to verify the extent to which its objectives were fulfilled. This evaluation will be conducted with the support of the evaluation units of the Bank, particularly with regard to determining which procedures and methodologies will be used. The cost of this evaluation will be covered by the Bank.

5. Environmental and social aspects

4.7 This program has no environmental impact, since the activities called for are limited to institutional and legal reforms related to the financial sector. For these same reasons, the program will have no direct social impact. The Environment and Social Impact Committee reviewed Profile II of the operation on February 11, 2000, and concluded that there was no need for an environmental assessment of the project.

6. Program conditionality

4.8 The Policy Matrix (Annex I) contains a summary of the conditions for release of the two loan tranches, which are detailed in sections III B and C of this proposal, and will be included in due course in the Loan Contract. In the **Sector Policy Letter (Annex II)** the authorities describe their commitment to the policies that will serve as the framework for implementing the program.

V. FEASIBILITY AND RISKS

5.1 **Program benefits**. The reform program to be supported by proposed operation, which the government is pursuing in order to resolve fallout in the banking sector from the 1994-1995 financial crisis, is designed to strengthen the regulatory and institutional framework of the banking system. Over the medium term, these measures are intended to establish a soundly functioning banking system, improving solvency and efficiency among banking institutions as an essential element for the country's continued economic development. In addition, mechanisms will be set up to ensure gradual, orderly absorption of the costs stemming from the banking crisis. This policy is beginning to bear fruit in the interest shown by first-class foreign banks in the sale of the country's third-largest bank (Serfin). Moreover, bids were recently announced for a possible merger of Bancomer (the second-largest bank) with another bank or financial group, leading thereby to a substantial increase in the capital of the consolidated group. These events reflect confidence in the eventual recovery of the banking business.

5.2 Gradual withdrawal of the government guarantee for the obligations of commercial banks will generate a better incentive structure for the banking sector by transferring the risks associated with decisions by financial market participants to those making them. This will promote greater investor accountability and more discipline in the management of credit institutions. The gradual nature of this reform will help users adjust to the change and will consolidate an institutional and regulatory framework that will lead to certainty for all financial market participants. In this connection, measures to improve transparency in market operation are particularly important. The quality and timeliness of the information now available to market participants has improved considerably and helps ensure efficient decision-making. At the same time, through the system for limited bank savings protection, small depositors are guaranteed protection.

5.3 Enactment and implementation of the law governing guarantees and the bankruptcy law have led to greater certainty about bankruptcy proceedings, creditors and debtors' rights are now safeguarded, abuses can be avoided, and legal proceedings are less protracted. These measures are helping to resolve a factor identified as one of the major roadblocks to reactivation of lending in Mexico.

5.4 **Financial risks:** one of the major challenges facing the IPAB is to manage its debt properly. The immediate objective of the authorities is to limit the growth of IPAB's debt to the inflationary component of interest, while paying the real component in cash. This will require steady and strict financial management by IPAB. It will therefore be essential to maintain a suitable strategy for its access to financial markets. In this respect, significant progress has already been made: (i) the Bank of

Mexico will become the financial agent for IPAB; (ii) IPAB is working with the SHCP on a coherent strategy for placing its notes in ways that will not compete unduly with other federal debt instruments; and (iii) mechanisms have been identified whereby the National Treasury would come to the aid of IPAB if the latter were unable to meet its financial obligations. Thanks to these actions, the first issue of IPAB notes on the local market was well received. Over the medium term, the financial viability of the Institute will depend to a large extent on success in keeping macroeconomic variables within certain parameters. In particular, the behavior of real interest rates will have a substantial impact on IPAB's cash flow. In this respect, progress has also been made, and in recent months domestic market interest rates have been declining (compared to the projected real interest rate of 7%), opening additional maneuvering room in terms of financial management. Maintaining this downward trend over the coming months will be essential for the success of the financial strategy.

5.5 **Political risks:** the feasibility of the government program for the banking sector depends to a large extent on continued political support. This support is essential for continuing reforms to the legal and regulatory framework and to maintaining the level of fiscal transfers that IPAB needs to prevent its debt from rising in real terms. Although there is no guarantee that such support will continue, particularly in light of the coming elections, the government program reflects an agreement with the political parties that have the largest representation in Congress. The solidity of this support was demonstrated by the approval of fiscal transfers of 0.7% of GDP for the year 2000, in the midst of a difficult fiscal situation. In this context, it is reasonable to expect that this commitment will be maintained regardless of the election outcome and that this will permit continuity of the policy that is now being applied to the sector.

5.6 **Operating risks.** it is very important for IPAB's credibility and the reactivation of the banking system that the process of bank resolution, particularly in its initial phase, should be conducted in a timely, transparent and financially viable manner. If the process is to be successful, significant volumes of private capital will need to be attracted, both to complete efforts to resolve viable banks and to complement the recapitalization of the private Mexican banks. These transactions will have to be concluded in an atmosphere of recession in the banking system, and great uncertainty for the region. The recent interest shown by first-class banks in the sale of Serfin and Bancomer, however, and the mergers now underway involving the country's largest banks, suggest that the government's strategy has been successful in attracting new capital into the system.

MEXICO: SUPPORT FOR RESTRUCTURING THE BANKING SYSTEM
(ME-0227)
POLICY MATRIX

of reform	Objectives	Conditions precedent to disbursement of the first tranche[1]	Conditions precedent to disbursement of tranche
onomic policy rk	Maintain the consistency of macroeconomic policy with the sector adjustment measures called for under the program.	Macroeconomic policy is consistent with the program objectives.	Macroeconomic policy is consistent with the p objectives.
d regulatory rk for operation nking sector	Improve the framework for incentives in the sector and systems for resolution of institutions in difficulty.	Legal provisions have entered into force and established: (i) a decentralized federal government agency with its own assets and full legal capacity in charge of administering a savings protection program; (ii) a gradual reduction over a period of five years in the government guarantee for certain bank obligations; (iii) a procedure to correct illiquidity and insolvency when such situations arise through preventive support or restructuring of the banks on a timely basis; and (iv) the power to evaluate, restructure and transfer or proceed with the liquidation of banks in difficulty in an expeditious, transparent manner.	There is a continued gradual reduction in the I guarantee of banking liabilities, in accordance established schedule. Any new financial support to ensure liquidity restructure one or more financial institutions is according to the criteria established under the (i) a technical study has been conducted on the the institutions; (ii) the support will be reasona costly than the option of paying deposit insura other guaranteed obligations; (iii) a restructuri is in place; and (iv) in the case of liquidation, t shareholders have absorbed its losses in the fir Measures taken by IPAB to resolve banking e difficulty are conducted using administrative a procedures in accordance with the legal provis established as a condition precedent to disburs first tranche.

ude conditions that were fulfilled prior to submission of the loan proposal to the Board of Executive Directors of the Bank, which will be set forth in the loan co s fulfilled prior to approval of the loan"; the conditions that have yet to be fulfilled are indicated in italics in section III.C of the proposal and will be stipulated i nder "conditions precedent to disbursement of the first tranche".

of reform	Objectives	Conditions precedent to disbursement of the first tranche[1]	Conditions precedent to disbursement of tranche
	Strengthen prudential rules and increase transparency in the banking sector.	The SHCP and CNBV have issued rules, which have entered into force according to the established timetable for: (i) strengthening the capital adequacy requirements of commercial banks; (ii) qualification and reserves standards for credit card and mortgage loan portfolios; (iii) establishing of accounting principles consistent with generally accepted international practice and requirements for the publication and disclosure of financial information; and (iv) establishment of criteria for concession of "regulatory forbearance"[2] and requirements for publication thereof.	The timetable established for grandual fulfillm capital adequacy requirements for financial ins maintained. The CNBV has issued: (i) prudent regulations to strengthen internal bank controls (ii) new regulations for commercial loan quali loan-loss provisioning.
	Improve existing mechanisms for loan recovery.	Legal provisions have entered into force that: (i) substantially change the system and procedures through the commercial reorganization and bankruptcy system; and (ii) establish a new system for the issuance and execution of loan guarantees.	The Federal Institute of Specialists in Commer Reorganzation and Bankruptcy has been establ members of its board of directors appointed, a regulatory provisions necessary for it to exerci authority issued.
n of banks under cial restructuring	Transfer to the private sector the banks under the IPAB financial restructuring program.[3]	IPAB has carried out international competitive bidding for the sale of one of the banks under the financial restructuring program, following procedures designed to achieve a maximum degree of recoveries by IPAB and an assessment of bidders' technical qualifications.	IPAB has concluded the sale of at least a secon banks under the financial restructuring progran (i) international competitive bidding or (ii) a p that includes technical assessemnt, auditing, a completion of the respective restructuring oper pursuant to the Bank Savings Protection Act.
on of the assets portfolios of der the IPAB	Maximize the amounts recovered from the portfolios and assets of banks under operations for restructuring and portfolio sales.	Operations have been carried out to sell assets and the loan portfolio under the IPAB program for the disposal of assets for an overall minimum nominal value of US$650 million, through procedures designed to ensure transparency and maximum recovery value for IPAB.	Transactions for the sale of assets or loan portf the IPAB program for disposal of assets have b out for a nominal overall value of US$1.65 bill following procedures designed to achieve trans maximum recovery value for IPAB.

forbearance" means concessions granted by the CNBV allowing special accounting records.

recer, Promex, Inverlat and Atlántico.

of reform	Objectives	Conditions precedent to disbursement of the first tranche[1]	Conditions precedent to disbursement of tranche
adequate for the costs from the banking	Ensure IPAB's medium-term financial viability.	IPAB has presented its financial projections for a period of eight years.	
		IPAB has launched a program to issue and place securities on the market and/or to enter into contracts for financing, as needed based on the financial projections presented.	The IPAB program for issuing and placing not market and/or entering into contracts for financ execution and consistent with the projections p
		IPAB has demonstrated that the value of its total liabilities did not grow in real terms between December 1999 and the date of its most recent financial statements, with the exception of new debt acquired pursuant to the Bank Savings Protection Act.	IPAB demonstrates that the value of its total li not increase in real terms between December 1 date of its most recent financial statements, exc debt acquired pursuant to provisions of the Ban Protection Act.

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México, D.F., a 25 de mayo de 2000.

Mr. Enrique Iglesias
President
Interamerican Development Bank
Washington, D.C.
U.S.A.

Dear Mr. Iglesias:

This letter of Sector Development Policy describes Mexico's current economic conditions and its on-going process of financial sector reforms in order to address the pending issues resulting from the severe 1994-95 banking crisis. The proposed reforms include modifying the incentives faced by the different economic agents, strengthening the legal and regulatory framework, continuing the improvement of the accounting principles, as well as completing the restructuring/resolution of the banks that were negatively affected by the banking crisis. To implement these reforms and manage the associated fiscal costs the Government requests financial assistance from the Interamerican Development Bank.

I. Macroeconomic Framework

The Mexican economy has continued to grow strongly in recent years, in spite of adverse external events such as the financial crises of Russia in late 1998 and of Brazil in early 1999, increases in world interest rates, and volatility of oil prices. Annual real GDP growth in 1999 was 3.7 percent, higher than the programmed goal of 3.4 percent. The average growth rate for 1996-1999 period is 5.1 percent per year. For the year 2000 real growth will probably be around 4.5 percent. Timely adjustments in fiscal and monetary policy, a flexible exchange rate, and continued trade liberalization both within NAFTA and with the rest of the world, have helped sustain economic growth.

Public expenditure reductions derived from the decline in oil prices (totaling 0.7 percent of GDP) kept the federal deficit at the target of 1.25 percent of GDP in 1998 and 1.14 percent of GDP in 1999, and we were committed to achieve non-financial federal public sector deficits of 1.0 percent of GDP in 2000. We have kept real public spending below the level of 1998. At the same time, social expenditures increased as a proportion of total budget. In the last two years social spending amounted to 60 percent of federal budget.

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The Banco de Mexico tightened monetary policy several times in 1998 to reduce the pass-through to inflation of the nominal depreciation of the peso. In 1999, continued tight money made inflation rate of 12.32 percent for 1999. Current trend of inflation on annual bases is already below the target of 10 percent for 2000, and is contributing to the stability of the exchange rate.

Manufactured goods exports and total imports have continued to grow at rates close to 10 percent, and total trade flows already more than doubled over the past five years since NAFTA entered into force. Our strategy of economic integration in NAFTA continues to attract a high level of Foreign Direct Investment, which finances over two-thirds of the current account deficit (2.4 percent of GDP in 1999). We have successfully implemented a debt management strategy to improve our debt service profile and to reduce our external public financing requirements.

We plan to continue the main elements of current macroeconomic policies, emphasizing fiscal discipline and reduction of inflation. We are strongly and publicly committed to keeping stability through the political transitions in the present year.

II. Financial Sector Reforms

We are taking measures to strengthen the banking system, which still poses an important element of uncertainty in our economy—both as a fiscal burden and as a challenge to sustainable growth and healthier private investment. As a background to explain our current strategy in the financial sector, let me indicate to you that in response to the 1994 crisis, the Government implemented a number of measures that were instrumental in averting the collapse of the banking system. These measures included: (i) a number of bank support programs, including liquidity support to provide banks with foreign currency with which to pay their foreign debts, actions to recapitalize the banks in exchange for the purchase of non-performing loans, the sale of a number of weak domestic banks to foreign investors, and programs to restructure, sell or liquidate banks intervened because their owners could not provide additional capital to meet the new regulations. These measures were implemented through the Bank Savings Protection Fund (FOBAPROA); (ii) debtors' support programs to help families and corporations to service and repay their debts; and (iii) reform of Mexico's banking accounting principles, banking regulations and supervisory and enforcement practices.

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The banking legislation approved in December 1998 allowed full participation of foreign equity investors in existing Mexican banks and created a new deposit insurance agency, the Institute for the Protection of Bank Savings (IPAB). The law that created the IPAB, **Law for the Protection of Bank Deposits (LPAB),** provides a legal framework and a clear timetable to improve incentives in the financial sector, and creates a mechanism for the transparent resolution of undercapitalized and insolvent banks. In addition, the regulatory authorities have initiated a profound program of regulatory reforms to strengthen the quality of the banks' capital, enhance accounting and disclosure standards, eliminate discretionary regulatory forbearance, and improve loan classification and provisioning rules. Recently, Congress approved a set of new laws that will strengthen the incentive system to honor debt obligations in Mexico and reduce the risks faced by banks in their lending operations. Some of the details of our new strategy for the banking system are explained below.

Creation of a Legal Framework to Improve Incentives in the Financial Sector

Introduction of a Limited Deposit Insurance System. Until the approval of LPAB, the Government guaranteed, without limits, all bank liabilities with the exception of subordinated debts and liabilities derived from irregular/illegal operations. LPAB establishes a program to reduce the guarantee on banks deposits in stages, according to the program which establishes the guaranteed obligations during the transition period issued by IPAB on May 31, 1999. This program establishes that by January 2004, the guarantee will exclude inter-bank deposits, and that by January 1, 2005 it will only cover bank deposits, credits and loans accepted by banks up to a limit of 400,000 UDIs (about US$100,000) per depositor. We expect that the elimination of the government guarantee on inter-bank deposits will be a powerful incentive for the banks to improve their soundness in the next two years.

Modernization of the Legal and Judicial Framework. To encourage banks to increase their capital and to establish necessary preconditions to resume lending it is essential to strengthen the legal certainty as well as the ability of the judicial system to enforce contracts between lenders and borrowers at a lower cost than at present. These reforms are also preconditions for attracting much needed foreign investment to the banking sector. On April 30, the Mexican Congress approved a group of important reforms to the Commerce Code, the General Law of Negotiable Instruments and Credit Transactions and the Credit Institutions Law. The application of this legal scheme will

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strengthen creditor-debtor relations; foster financial intermediation by reducing the uncertainty faced by lenders and consequently the cost of borrowing and broadening the access to private borrowers, largely excluded from bank credit; strengthen foreclosure procedures; enhance the provision of credit through the creation of an optional collateral mechanism and improve the transparency of legal framework for creditors and debtors. In addition, we intend to modernize the property and commercial registries to further facilitate the pledging of collateral and the implementation of the proposed legislation. In April 27th the Mexican Congress approved the new Bankruptcy Law, "Ley de Concursos Mercantiles". The objective of the new legal framework is to maximize the value of a firm in financial distress, to promote its viability and, when possible, to maintain its operation and the jobs it generates. The new legal framework establishes a lineal, transparent, swift and impartial process, thus creating greater legal certainty and security for both parties involved in the insolvency process. The role of the judge in the insolvency process was revised, keeping the judge's function as the main operator, but providing him with additional technical support in the areas of finance, management and accounting. This law creates a Federal Institute of Reorganization and Bankruptcy Specialists, which coordinates the provision of technical support in reorganization cases, and ensures that the specialists assigned to assist the judicial process in each of the three stages (visitation, conciliation and liquidation) meet ethical requirements in performing their task.

Strengthening Banking Regulation

Having an adequate regulatory framework is essential to avoid systemic crises. During the last five years, we have been working in this aspect, especially in the following areas: a) accounting standards; b) capitalization rules; c) credit rating and provisioning and d) risk management guidelines.

In September 1999, we announced a program of regulatory reforms to improve the health and stability of the banking system. The program seeks to: i) improve the quality of bank capital by establishing a stricter definition of eligible capital, more in line with the Basle Committee on Banking Supervision practices; ii) enhance transparency and disclosure; iii) achieve additional harmonization of regulatory accounting with generally accepted accounting principles and practices; and iv) eliminate discretionary regulatory forbearance. In this sense, we have taken a gradual approach in introducing the reforms, giving banks time to meet the new capital rules. The program started in January 2000 and it will be fully implemented by 2003, coinciding with the reduction in depositor protection schemes.

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Accounting Standards.

Derived from the updating of accounting criteria, in October 1999 the Mexican National Banking and Securities Commission (CNBV) issued Circular 1448 which came into force in January 1st, 2000. One of the most important changes was the introduction of new disclosure rules in the financial statements. The most important changes are the following:

- *Interbank loans:* maturity, interest rate and counterparts.

- *Investments in Securities and Derivatives:* it includes the following qualitative and quantitative information: risk management policy; risk analysis; and value at risk (VAR).

- *Related Parties:* it requires the disclosure of operations with related parties.

- *Loan Portfolio:*
  - Policies and procedures to grant control and recover the loans and the measurement and follow up of credit risk.
  - Identification of past due and non past due commercial credit portfolio.
  - Loans information (type; situation; denomination).
  - Historical behavior of past due portfolio.
  - Credit provisioning by type.
  - Concentration and characteristics of loans by sector, economic group and region.

- *Operations of Business Segments:* publication of financial information (assets, liabilities, income, costs, revenues and losses) of each business segment.

Additionally, many other modifications to the accounting regulation were made. Some of them are the following: introduction of the concept of reasonable value; definitions of the characteristics when considering the loss of control of an asset (assets transfer); accounting standards for asset securitization. Regarding derivatives, we introduced accounting standards for derivative credits and structured operations.

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Capitalization Rules

In September 1999, we issued the new capitalization rules for banking institutions. The main objective was to improve the quality of banks assets in line with the guidelines established by the Basle Committee on Banking Supervision.

The most important changes were the following:

- Limit the participation of deferred taxes (derived from fiscal losses and/or excess of provisioning) to 20% of TIER I capital gradually until the end of 2002. For 2000, 2001 and 2002 the limit will be 80%, 60% and 40% respectively.
- Exclude mandatory subordinated convertible debentures from TIER I capital. Presently, these instruments are included in TIER II capital in line with the Basle Capital Accord.
- Establish clear guidelines to determine whenever an asset is taken into account for capitalization, depending if the institution holds the control of the asset.
- Limit the equity investments of banking institutions in non-traded companies. These investments will be deducted from TIER I capital. We established a transition period until the end of year 2002 for those investments made before the entry into force of the new rules.
- Inclusion of non-cumulative capital securities in TIER I capital and cumulative capital securities in TIER II capital.
- Establish adequate mechanisms of capitalization for derivative instruments and the updating of capitalization ratios based on market risk.

Credit Rating and Provisioning

New standards for the provisioning and rating of consumer loans (credit cards) came into force in December 1999. On the other hand, new standards for the provisioning and rating of mortgage loans were issued and will came into force in June 2000. Additionally, we are working in the final stage of the new methodology for commercial loans which we expect to release at the beginning of the second half of 2000.

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The methodologies for rating and provisioning the consumer and mortgage loans have the following main characteristics:

- It establishes a minimum and homogeneous provisioning.
- They are designed to rate and provisioning massive credit loans.
- Designed according to the probability of non-payment.

- *Consumer loans:* In December 1999, we issued a new methodology for rating and provisioning consumer loans (credit cards). This methodology is based in the probability of non-payment using the historic analysis of debtors' payments (number of consecutive non-payments).

- *Mortgage loans:* In January 2000, we issued a new methodology for rating and provisioning of mortgage loans. This methodology is based in the credit history of the debtor, type of mortgage loan, the probability of non-payment and the relation between the credit amount and the guarantee value (loan-to-value, LTV).

Presently, we are working in the prudential standards to strengthen the internal control of the banks in accordance with international standards of Basle. We expect to issue this regulation by mid – 2000.

Additionally, we have issued a series of standards regarding risk management. The most important are the guidelines for credit processes, the guidelines for an integral risk management and the consultation of the database of the Credit Bureau.

During the first quarter of this year, banking institutions made adjustments to the values of fixed assets.

Regarding transparency and disclosure of information, since January 2000 we have been applying new requirements. Among the most significant requirements, we have adopted new criteria for granting special accounting registries (regulatory forbearance) conditioning them to disclose this information in any financial statement. At the same time, new transparency standards require the disclosure of the components of the capital and risk-weighted assets.

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Resolution of Undercapitalized and Insolvent Banks

The LPAB Law sets a clear framework for restructuring undercapitalized and resolve insolvent banks, whereby IPAB assumes payment of the guaranteed obligations of the failed institutions. There are three groups of banks that will require support from IPAB:

- *Banks in the Capitalization and Loan Portfolio Purchase Program.* These are banks that received FOBAPROA notes in exchange for 7 percent of their non-performing portfolios (Banamex, Bancomer, Banorte, BBV and Bital). The percentage of the total value of the FOBAPROA notes held by these banks amount to an estimated M$155.72 billion, as of March 2000. These notes capitalize interest and principal until maturity (3/8th of these notes mature in 2005 and 5/8th in 2006). IPAB will exchange the FOBAPROA notes for identical IPAB notes after approving the financial consolidation plans presented by these banks during 1999. It is required that the CNBV gives an opinion on the consolidation plans.

- *Banks under the Financial Strengthening "Saneamiento" Program.* Five banks had been sold under the old Financial Strengthening "Saneamiento" Program that received FOBAPROA notes under its restructuring program (Banpais, Bancen, Santander-Mexicano and Confia). These are banks that will have to be restructured and capitalized before selling or merging them with stronger banks. Two banks (Serfin and BanCrecer) have been taken over by IPAB to be capitalized prior to their sale. Two other banks (Atlántico and Promex) will be merged with other banks. An additional bank (Inverlat) has also been capitalized prior to its sale. The total value of the Financial Strengthening "Saneamiento" Program amount to an estimated M$375.55 billion, as of March 2000. The capital needs of BanCrecer, Atlántico and Promex are explicitly contemplated under the LPAB.

- *Banks that had been intervened by CNBV.* Two small intervened banks are likely to be sold (Industrial and Sureste) and eight banks will be closed (Capital, Cremi, Interestatal, Obrero, Oriente, Unión, Anáhuac and Pronorte). These banks do not take deposits from the public nor grant new credits anymore, and only three remain active in the inter-bank market (Unión, Cremi and Anáhuac).

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Quality Assurance of IPAB's Bank Restructuring Program. LPAB establishes strict audit and evaluation procedures by prestigious specialized professionals or firms prior to completion of any bank resolution transaction. The Law also ensures oversight of Congress, the SHCP and SECODAM over IPAB's bank restructuring transactions.

Financing of IPAB's Bank restructuring/resolution program. The Law provides for several sources of finance for IPAB including: (i) deposit insurance premia of 0.4% (ordinary quota) and 0.3% (extraordinary quota which is not currently applied), per year, on total bank liabilities (three fourths of which can be used to finance IPAB's bank restructuring program); (ii) new debt issued by IPAB for up to 6 percent of total bank liabilities to be raised to address an emergency in a particular bank; (iii) proceeds from the sale/recovery of assets received from FOBAPROA; and (iv) budgetary transfers from the Federal Government.

In order to be able to service IPAB's obligations the Mexican Government will proceed as follows:

- *Implementation of an aggressive program of asset sale/recovery.* The Law gives IPAB 5 years to dispose of the assets purchased by FOBAPROA under previous bank support programs. IPAB expects to be able to recover 20 percent of the book value of these assets. IPAB has prepared a program of asset sale/recovery through independent dealers with the aim of recovering most of the recoverable value within the next two years.

- *Issuing of new IPAB debt in the market.* Congress granted Institute for the Protection of Bank Savings with the ability of refinancing debt. Under Article 2 of the Income Law for 2000, Banco de Mexico will act as the financial agent to issue IPAB's debt. On March 1 2000, IPAB carried out its first weekly auction of Savings Protection Bonds (BPAs) for an amount of Ps. $1 billion.

  Fiscal regulatory treatment for BPAs is the same as for government bonds. Moreover, BPAs are negotiable in the secondary market and subject to repurchase transactions. The resources obtained from the bond issues will be used to cover contractual obligations and to improve the maturity profile of the Institute's debt. The success of this program will allow for a gradual reduction of the financial cost associated to saver support programs.

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- *Transfer of fiscal resources to IPAB so as to maintain its debt in real terms.* Budgetary transfers to IPAB of about 0.8 percent of GDP have been approved in the 2000 Federal Budget. This level of transfers will allow IPAB to cover the real interest payments on its debt. We expect that in the future fiscal transfers for IPAB will be sustained relative to GDP to stop IPAB's debt from growing in real terms.

Sequencing of the IPAB's Bank Restructuring/Resolution Program. In order to carry out a bank restructuring resolution program in an orderly fashion, IPAB has established a sequencing of bank resolution transactions. Thus far, we have included in our program the restructuring and sale of Serfin and Bancrecer; the sale of Inverlat; and the completion of the mergers of Promex and Atlántico. Going forward, IPAB's notes will be exchanged for performing notes to those banks in the capitalization program implementing the financial consolidation plans agreed with IPAB and complete the liquidation of the remaining intervened banks.

III. Interamerican Development Bank Support

The above synopsis demonstrates our commitment to a strong program of reforms of the financial sector, which includes the resolution of the remaining undercapitalized and insolvent banks. We believe that the Interamerican Development Bank's assistance (financial and technical) will be beneficial to the program.

Sincerely,

Angel Gurría

SHCP · HACIENDA

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ME-0227
Original: Spanish
Appendix I

PROPOSED RESOLUTION

MEXICO. LOAN No. ___/OC-ME TO NACIONAL FINANCIERA, S.N.C.

Program to Support the Restructuring of the Banking System

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with Nacional Financiera, S.N.C., as Borrower, and the Estados Unidos Mexicanos, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of a Program to Support the Restructuring of the Banking System. Such financing will be for the amount of up to US$250,000,000, from the resources of the Single Currency Facility of the Bank's Ordinary Capital, and will be subject to the "Financial Terms and Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.