

# **CORPORATE STRENGTHENING OF FINANCIAL INSTITUTION**

**(ME-0126)**

## **EXECUTIVE SUMMARY**

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

**GUARANTOR:** United Mexican States

**EXECUTING AGENCY:** Nacional Financiera S.N.C. (NAFIN)

**AMOUNT AND SOURCE:** IDB: US\$250 million  
US\$100 million  
(dollar window)  
US\$150 million (OC)  
Local counterpart funding: US\$250 million  
Total: US\$500 million

<b>FINANCIAL TERMS AND CONDITIONS:</b>	<b>OC</b>	<b>US\$</b>
Amortization period:	15 years	10 years
Disbursement period:	4 years	2 years
Interest rate:	variable	variable
Inspection and supervision:	1%	1%
Credit fee:	0.75%	0.75%

**OBJECTIVES:** The main purpose of this operation is to contribute to Mexico's economic recovery by helping to strengthen the financial sector. Its specific objectives are to: (i) promote modernization of private financial intermediaries; (ii) to assist the corporate strengthening of NAFIN; and (iii) to stimulate productive investment by the business sector.

**DESCRIPTION:** The program will have three components: (a) a loan for modernizing private financial intermediaries; (b) technical assistance for the corporate strengthening of NAFIN; and (c) a multisector loan to finance investments by private companies.

Component A calls for up to US\$100 million for the modernization of private financial institutions and will complement measures by the financial authorities designed to strengthen the financial sector by offering medium-term loans at market rates to banks, financial leasing and factoring companies, and credit unions that carry out internal modernization programs. The eligibility criteria have been carefully designed to ensure that the eligible banks will have the proper incentives to expedite their modernization, which will

help reduce any possible fiscal losses. The resources will be used by participating intermediaries to upgrade their operating and management capacity.

Component B provides up to US\$20 million for corporate strengthening of NAFIN through a process of broad and in-depth institutional change. The changes contemplated have been divided into four thematic headings which comprise the conceptual frame of reference for the component: (i) strategy development; (ii) redesign of procedures; (iii) risk management; and (iv) organization and human resources. A complete cycle of activities will be carried out under each of these headings, beginning with a thorough analysis of the institution and proceeding through the identification and implementation of specific reforms, including the acquisition and/or development of data processing programs. In carrying out this component it is especially important that proper coordination be ensured by establishing a high-level committee to be assisted by a strategy advisor.

Component C calls for a multisector loan of up to US\$377.5 million to provide resources for which all sectors of activity will be eligible, provided they meet certain size restrictions. This component will involve several innovations in comparison with the earlier program (loan 693/OC-ME). The interest rate charged to subborrowers will be freely negotiated rates agreed upon by eligible financial institutions and their clients. The interest rate charged by NAFIN will vary depending on each intermediary's degree of credit risk (as determined by duly qualified private rating agencies) and according to the terms structure of the loan, so as to ensure a positive yield curve.

The allocation of program resources will initially be made in dollars, without excluding the possibility of placements in local currency later on during the program. NAFIN will continue to use the auction method for its short-term placements.

**ENVIRONMENTAL  
CLASSIFICATION:**

The Environment Committee, at its meeting of March 21, 1995, classified this project as a Category III operation.

**IMPACT ON POVERTY:**

The program will help to stabilize and reactivate the economy and private investment in Mexico. As a result, it is expected to create new job opportunities which will also indirectly benefit the low-income population.

**BENEFITS:**

The program will benefit the Mexican economy by providing long-term financial resources for two sectors of vital importance to its recovery. The financial sector will be able to increase the competitiveness of its services by offering higher quality products at lower cost, and Nacional Financiera will be able to focus its support in both sectors using principles of transparency and efficiency. Private-sector companies will gain access to credit enabling them to make the investments required to take full advantage of free trade and the economic integration achieved by Mexico.

**RISKS:**

**Macroeconomic stability.** The program requires a stable macroeconomic environment which will allow development of proper financial markets, including interest rates that remain moderately positive in real terms. Mexico's current monetary and fiscal policies, together with the structural reforms under way or planned, constitute a solid foundation for creating such conditions, and the Mexican government's commitment to these measures is unmistakable.

**Stability of the financial sector.** Under its program to restructure the financial sector, the Mexican government has taken the steps necessary to place the financial sector on a sounder footing. The risk factors involved in that program, which has progressed satisfactorily to date, were fully analyzed in the respective loan document. Because its success is essential to that of the program proposed, the latter includes strict criteria for the selection of participating intermediaries, such as ratings by private credit rating agencies. Similarly, the analytical capacity of NAFIN is being strengthened through the hiring of an expert in banking analysis under component B.

**Feasibility of bringing about substantive changes in NAFIN.** The administrative and policy changes that may be required to achieve the objectives of the component to provide corporate strengthening of NAFIN could encounter sufficient resistance - both inside and outside the institution - to hinder its execution. In that case, the component could end up financing marginal changes only, while having no impact on the fundamental issues. This risk is negligible at present since the senior management of NAFIN is fully committed to the proposed program. In addition, the program includes frequent opportunities for review and monitoring of its progress.

Lack of internal coordination in NAFIN. Successful execution of the corporate strengthening component will require a high degree of coordination and organization. The program calls for creation of a project execution group reporting directly to the Executive Committee and dedicated full time to the coordination of activities, as well as the hiring of a strategy advisor with extensive experience in this type of institutional change.

Reduced demand on the part of intermediaries. The market interest rates to be charged, along with the eligibility requirements mentioned earlier, reduce the attractiveness of the lending component of the program. In the initial phase, and until consolidation of the financial sector as such is achieved, there is the risk that the few institutions which meet these requirements will not be interested in working with the program. However, the term of the loans, the currency in which they are denominated, the fact they are available effectively without guarantee, and the streamlining of administrative procedures are expected to help diminish this risk.

**THE BANK'S  
COUNTRY AND  
SECTOR STRATEGY:**

The financial sector provides the services that facilitate a country's savings and investment process. The recovery and competitiveness of this sector is vitally important for increasing domestic savings, which in turn is an essential condition for achieving sustainable economic growth. Investment by the business sector depends on the availability and competitiveness of services offered by the financial sector. Therefore, the Bank's strategy stresses strengthening the financial sector to achieve the following objectives: (i) to promote the competitiveness and efficiency of financial intermediaries; (ii) to develop a system for proper regulation and supervision of the sector; (iii) to expand the supply of financial services, particularly those targeting small businesses and microenterprises; and (iv) to encourage new and varied mechanisms for attracting long-term savings and effectively channeling them into productive investments.

The financial sector restructuring program, which was approved in June 1995, represents a significant advance towards achieving these objectives. The proposed operation is a logical continuation of that support, based on an ongoing and constructive dialogue with the Mexican authorities. It will supplement the activities carried out under the restructuring program, strengthening operational and

institutional aspects with respect to the country's private sector financial institutions and development banks.

**SPECIAL  
CONTRACTUAL  
CONDITIONS:**

Prior to the first disbursement of the loan: (i) NAFIN must reach agreement with the Bank on the method for determining interest rates for components A and C; (ii) the finance committee of the NAFIN board of directors must approve the Operating Regulations previously agreed upon with the Bank and the model loan contracts for components A and C; (iii) NAFIN must hire the technical advisor for component A, according to the terms of reference previously agreed upon with the Bank; and (iv) for purposes of the Operating Regulations of component C, NAFIN must declare at least two credit rating agencies eligible pursuant to the standards of qualification previously agreed upon with the Bank.

Prior to the first disbursement for component B: (i) the executive committee of NAFIN must approve the plan of operations for the component previously agreed upon with the Bank and must take the appropriate steps for its implementation; and (ii) NAFIN must hire the strategy expert according to the terms of reference previously agreed upon with the Bank.

Prior to the first disbursement for component C: (i) NAFIN must adjust the portfolio management system to the requirements of the program; and (ii) NAFIN must agree with the Bank on a plan of action for environmental protection.

**EXCEPTIONS TO BANK  
POLICY:**

This program supplements the loan for the financial sector restructuring program and constitutes part of the Bank's response to Mexico's macroeconomic crisis. In order to speed up the recovery and accelerate economic and social growth, up to 24 percent of the loan proceeds may be used during the first year following approval of the loan to finance debt rescheduling by eligible enterprises.

## I. FRAME OF REFERENCE

### A. Macroeconomic situation and outlook

- 1.1 **Background.** Despite the rebound in economic growth and a reduction in the rate of inflation in 1994, a strong increase in aggregate demand led to a ballooning of the current account deficit under Mexico's balance of payments. In addition, an increase in interest rates on international markets and a variety of tragic events on the domestic front contributed to greater uncertainty in the exchange rate on the part of market decision-makers who began a massive withdrawal of resources which has continued throughout the year.
- 1.2 To stem the capital flight, the Mexican government increased its offer of *tesobonos*, short-term Treasury notes indexed to the United States dollar exchange rate, significantly shifting the structure of its internal debt. This enabled authorities to maintain a stable level of reserves between April and October. By the end of 1994, the attempt to defend the exchange rate had depleted Mexico's reserves, forcing the authorities first of all to broaden the band in which the peso was allowed to float (mid-December), and shortly thereafter to abandon the exchange rate band system altogether in light of the low level of reserves, allowing the peso to float free.
- 1.3 **Adjustment measures.** The initial response to the crisis was to adopt a stabilization program in January 1995 which included: (i) a fiscal program designed to produce a budget surplus equivalent to 0.5% of GDP; (ii) a 10% increase in public sector prices and rates; (iii) a 7% increase in wages, with a 3% reduction in taxes for workers in the low-income brackets; and (iv) the continuing privatization of state property, including railroads, satellites, seaports, airports, and telephone operations.
- 1.4 At the beginning of February, the Government of Mexico arranged for a stand-by loan with the International Monetary Fund (IMF) in the amount of US\$17.8 billion. The program called for the tightening of monetary policy, with an expansion of up to MN\$10 billion in net domestic lending by the Bank of Mexico. The resources provided under this agreement are part of a stabilization package of close to US\$50 billion created for refinancing the country's short-term foreign exchange obligations, to which the United States, Canada, and the Bank for International Settlements contributed significantly.
- 1.5 However, the performance of Mexico's economy during the first two months of 1995 revealed a need for additional stabilization measures in order to offset the effects of declining government revenues owing to the slowdown in economic activities and the increase in interest payments as a result of the high interest rates. The new measures adopted in March 1995 consisted of even

greater fiscal discipline in the form of reduced public spending and an increase in tax revenues.

- 1.6 Recent developments and outlook. The stabilization program began to take effect in the second quarter of 1995, stabilizing the economy and at the same time reducing external imbalances.
- 1.7 As a result of the effective depreciation in the exchange rate and the effort to boost exports in order to compensate for the decline in internal demand, Mexico's exports grew by 28% in dollar terms during the first six months of 1995, while imports dropped 6.5%. The trade balance posted a surplus of some US\$3 billion over this same period, a dramatic turnaround from the trade deficit of nearly US\$9 billion recorded in the first half of the previous year, and the current account deficit under the balance of payments plummeted from US\$13.8 billion to US\$620 million. Meanwhile, thanks to the international financial support it received, Mexico was able to reduce its balance of *tesobonos* outstanding from US\$29 billion at the close of 1994, to nearly US\$3 billion at the end of August of this year. The combined effect of these two factors was to release the pressure toward further depreciation of the exchange rate.
- 1.8 The authorities maintained a tight grip on monetary policy which resulted in a 22% contraction in the monetary base in real terms and a 37% reduction in the M1 money supply between June 1994 and June 1995. Reflecting the scarcity of resources caused by capital flight and the tightened monetary policy, interest rates gradually rose and, in the case of 28-day Mexican Treasury bills, reached 75% in April before declining to 35.1% in August. It should be noted that despite the high nominal interest rates resulting from inflation, the real interest rate remained negative during the first four months of the year. Only in May, when there was a sharp drop in inflation, did the real interest rate become positive, averaging 13.2% for the period from May to August.
- 1.9 In the first six months of this year, public spending was down in real terms by over 6% compared with the same period in 1994. Revenues were down by nearly 1% in real terms, due primarily to what amounts to an 18% drop in tax proceeds resulting from the slowdown in economic activity and a decline in family incomes, both of which lowered income tax yield, whereas proceeds from oil rose by 33% thanks to strong international markets and to the effects of the devaluation.
- 1.10 During the first half of 1995 Mexico's GDP shrunk by 5.8%, private consumption fell by more than 12%, and investment was down by some 27%. Given this decline in economic activity, open unemployment continued to rise, reaching 6.6% in mid-1995, considerably higher than the 3.7% average recorded for 1994.

- 1.11 Recent developments within Mexico's economy point to a drop in production for 1995 in excess of 4%, accompanied by a steep reduction in the current account deficit under the balance of payments. Inflation is also expected to continue to slow, perhaps reaching a cumulative level of some 45% by the end of the year.
- 1.12 The labor, farmer, and business sectors, the Government of Mexico, and Banco de México have recently agreed to set up an alliance to stimulate economic recovery and employment. Through the implementation of a variety of measures and incentives by the sources of economic reactivation (public and private investment, exports, and private consumption), the authorities hope to achieve an economic growth rate of 3% in 1996, with inflation held down to close to 20%.

**B. The financial sector**

- 1.13 The macroeconomic crisis has had a significant impact on Mexico's banking institutions. Two immediate adverse effects were the foreign exchange losses suffered by the banks due to their having maintained a net deficit foreign-currency status, and the drop in value of financial investments as a result of the steep hike in interest rates and the decline in capital markets which followed the collapse of the peso. In addition, the banks on the one hand were under considerable liquidity pressure, which added significantly to the cost of attracting funds, and on the other hand faced steady erosion in the quality of their loan portfolios.
- 1.14 These events have severely affected the equity position of institutions, causing a major crisis in a sector already suffering from serious weaknesses. The loan document for the financial sector restructuring program (PR-2041) - submitted to the Bank's Board of Executive Directors on June 21, 1995 - contains an exhaustive analysis of the causes and features of this situation and of the measures that the Mexican government has taken to stabilize the financial sector, the main elements of which include strengthening of bank supervision, enforcement of regulations and restrictions, establishment of the interim capitalization program (PROCAPTE), and the indexed debt refinancing program known as UDI.
- 1.15 Since that time, additional action has been taken to supplement these measures. The Bank Fund for Savings Protection (FOBAPROA) has carried out four portfolio-purchase operations, requiring increases in the capital contributions of private members. These operations have had a significant impact on the capitalization ratio of the system, leading to consolidation of the financial groups and an infusion of foreign capital. The net increase in capital among commercial banks during the first half of 1995 has totaled some US\$1.3 billion.
- 1.16 However, only one-third of the increase is in paid-in capital, while the remaining two-thirds represents junior debt instruments. The Government of Mexico will take additional steps to increase the



proportion of paid-in capital, since the interest payable on junior debt constitutes a direct drain on the net income of the banks.

- 1.17 The high nominal interest rates have led debtors to organize themselves into groups that have pressured the Mexican government to prepare a program for restructuring of the debt. The percentage of loans in arrears reached 15.7% of total loans outstanding at the end of July, having grown by 12% per month during the period from January to May. Despite successful efforts to increase loan loss reserves, (a 62% increase over the period January-July), the value of past-due loans not covered by such reserves at the end of July was nearly equal to total equity.
- 1.18 In order to contain the financial deterioration of the banking system, and in view of the scant demand raised by the Investment Unit program launched earlier, the Mexican government has recently created a program to offer debtors committed to settling their arrears an opportunity to refinance their loans at reduced rates. This program begins with a transparent subsidy applied to the interest rate on qualified loans for a period of one year. To ensure that this assistance primarily benefits smaller borrowers, eligibility for the program is limited to commercial, consumer, and housing loans up to a specified amount. The Mexican government hopes that it will help to contain the erosion of the banking system's loan portfolio.
- 1.19 During the previous administration, Mexico's development banking institutions underwent a major transformation in which they restructured their approach to second-tier financial intermediation, including the massive discounting of loans granted by private financial intermediaries. With a goal of promoting growth among small and medium-sized businesses through provision of financial resources, the institutions increased the current portfolios with private intermediaries from US\$7.4 billion at the end of 1990 to approximately US\$23.3 billion in 1994, 87% of which represented commercial bank loans, accounting for 16% of the total loan portfolio under Mexico's commercial banking system.
- 1.20 To deal with the crisis, the Mexican government decided to slow this growth, inasmuch as it had been determined that in 1994 it had contributed significantly to the macroeconomic imbalances. During the first half of this year, the loan portfolios of Mexico's development banks (second-tier operations) have been reduced by 38% in real terms. The size of this reduction, which exceeds the target set with the IMF, reflects the absence of demand for credit in the first six months of the year and the shortage of additional resources.
- 1.21 It is hoped that the combination of measures taken by Mexico's government will gradually stabilize the financial sector in the second half of the year, enabling the sector to respond adequately to the economic recovery beginning in 1996.

C. The Bank's strategy for the financial sector and the program

- 1.22 Lack of domestic savings has been identified as one of the clearest causes of the macroeconomic crisis. In fact, Mexico's domestic savings rate is estimated to have dropped 3% to 4% of GDP between 1990 and 1994. Accordingly, the Mexican government has targeted increasing the domestic savings rate as one of the primary objectives of its National Development Plan.
- 1.23 The financial sector provides the services required to facilitate the savings and investment process. The revitalization and sustainable strengthening of this sector is a sine qua non for increasing domestic savings and attaining sustainable economic growth. Investment by the business community is dependent upon the timing and competitiveness of the financial services offered. Accordingly, the Bank's strategy focuses on strengthening the financial sector to achieve the following objectives: (i) to promote the competitiveness and efficiency of financial intermediaries; (ii) to develop a system for proper regulation and supervision of the sector; (iii) to expand the supply of financial services, particularly those targeting small businesses and micro-enterprises; and (iv) to encourage new and varied mechanisms for attracting long-term savings and effectively channeling them into productive investments.
- 1.24 In seeking to achieve these objectives, the Bank approved the financial sector restructuring program (loan 869/ME-OC) in June of this year. Under the program, which was cofinanced with the World Bank, the financial authorities of Mexico have taken important steps to stabilize the country's financial sector, and substantial progress has been made with respect to objectives (i) and (ii) above. Program execution is proceeding satisfactorily, with the second and final disbursement expected to be made in the first quarter of 1996.
- 1.25 The objective of the restructuring program is to increase confidence in the soundness of the financial system through proactive management of current problems and, in the medium term, by improving the efficiency and transparency of its institutional and regulatory framework. The steps that the Government of Mexico agreed to take under the program include preventive measures to contain financial losses and assist banks that require restructuring, and structural measures designed to correct, in the medium term, the weaknesses that contributed towards precipitating the current situation. Among the latter are the strengthening of banking supervision and prudential regulations, adoption of international accounting standards, improvement of the legal framework for securitization of assets and guarantee transactions, review of explicit deposit insurance programs, and analysis of opportunities for enhancing the transparency and efficiency of development bank operations.

- 1.26 The studies contracted under the restructuring program in the area of development banking include a review of the characteristics and the prospects of the subsector, which is part of the Bank's strategy. The main points covered in these studies are the interest rates, eligibility criteria, and maximum levels of risk exposure that the development banks should establish.
- 1.27 One interesting topic included in the studies is the incipient market for credit rating agencies in Mexico. This segment has the potential to contribute vital information to market participants and thereby reduce the gap between the information held by issuers of securities and that available to investors in capital markets. Mexico has both local firms in this field and affiliates of the major international rating agencies.

D. Experience from the previous operation with NAFIN

- 1.28 In 1992 the Bank approved a US\$250-million loan to Nacional Financiera S.N.C. (NAFIN) for a global credit program to provide US\$500 million for small and medium-sized enterprises (loan 693/OC-ME). The operation provided support for NAFIN's strategy during the period 1991-1994. NAFIN and the Bank have engaged in a joint effort to analyze their recent experience in order to take into account the relevant lessons in designing the operation proposed in this document.
- 1.29 NAFIN's strategy for 1991-1994. In 1991, NAFIN began a rapid transition towards a new primary focus for the institution. In the context of the opening up of Mexico's economy, it adopted a strategy of strengthening private enterprise by supporting small businesses in order to help this sector develop its capacity for responding swiftly to the new parameters of competitiveness. Consequently, NAFIN shifted its programs from direct support for medium to large companies to indirect support for microenterprises and small and medium-sized businesses.
- 1.30 Implementation of the new strategy focuses on lending programs. In order to provide massive amounts of financial resources quickly, NAFIN decided to operate through private intermediary financial institutions (IFIs), i.e., at the second-tier level. During the first years of this period, NAFIN sought maximum expansion of lending, inviting every type of IFI to participate in the intermediation of its loans. Incentives were established for the creation or expansion of non-banking intermediaries, some of which specialized in lending to small business.
- 1.31 The second-tier lending programs also sought to place a cap on the cost of loans to subborrowers, on the assumption that IFIs tend to charge excessive spreads. NAFIN therefore fixed the interest rates to be charged to subborrowers based on its own estimates of reasonable spreads.

- 1.32 To supplement its lending, NAFIN developed additional programs that strengthen the nonfinancial service infrastructure available to small businesses, recruiting thousands of institutions and enterprises (universities, centers of learning, consulting firms, etc.) for its training programs. During the period in question, NAFIN also initiated or participated in other supporting activities, experimenting with risk capital funds, guarantee programs, information and counseling centers, business development centers, and more.
- 1.33 The continuous, fast-paced expansion of credit beginning in 1991 was financed through a renewed, modernized, and sophisticated approach to fund-raising. Over the period, NAFIN developed an admirable strategy for mobilizing resources, taking the lead in arranging national and international offerings by Mexican entities, including bonds in the principal currencies, commercial paper, and derivatives, and securitization of the second-tier portfolio. It managed to attract a continuous stream of international investors, lowering effective margins on United States Treasury bills and stretching deposit periods.
- 1.34 Transforming its operations in this manner confronted NAFIN with important structural and organizational challenges. Given the speed with which the quantitative results were expected from the new programs, NAFIN added or changed functions in existing areas without assessing whether or not these were consistent with the overall efficiency of the institution.
- 1.35 Quantitative results (1991-1994). The second-tier portfolio grew from US\$2.377 billion to US\$9.263 billion over the period, channeled through some 500 IFIs, including banks, financial leasing and factoring companies, credit unions, and development institutions, which in turn provided support to some 137,000 enterprises in 1994.
- 1.36 Whereas NAFIN's equity grew by only 10% in real terms, its liabilities doubled. External indebtedness itself grew by a factor of 2.5, and internal debt by a factor of 3.8.
- 1.37 Qualitative evaluation. The quantitative results indicated above signal the success of NAFIN's strategy in the short term. However, the risks associated with this strategy should be carefully analyzed.
- 1.38 Financial risks. The quality of the second-tier portfolio began to erode in 1994, and the percentage of nonperforming loans had risen to 8% by August 1995. Arrears were concentrated among the nonbanking intermediaries (83% of total arrears) and within that category, among credit unions in particular. These IFIs experienced rapid growth during the period due almost entirely to financing from NAFIN, which allowed access to its resources lending up to a debt-to-equity ratio of 40 to 1. Many credit unions were formed with the primary

objective of obtaining resources from NAFIN. The National Banking and Securities Commission (CNBV) has had to intervene in four credit unions to date, and the situation is such that additional interventions of this sort are expected. Moreover, a number of cases of fraud were discovered by the authorities in 1994 involving one financial group, for which loan loss provisioning for 100% of its portfolio had to be provided.

- 1.39 The use of ever more sophisticated and diversified instruments for attracting funds, together with the structural changes wrought in asset portfolios, have increased the need for financial risk management. Managing the risks involved in liquidity, terms, currency, the assets-to-liabilities ratio, and credit risk in general - with respect to portfolios and counterpart derivative transactions - requires management and control techniques that NAFIN has not developed with the necessary dispatch.
- 1.40 Institutional issues. NAFIN has implemented its strategy on the fly, learning as it goes and adding functions and staff without any overall concern for operational efficiency. This has forced its departments to each seek its own objectives and goals, with excessively hierarchical structures, duplication of activities and functions, and inefficient distribution of workloads. In addition, the training provided is unrelated to the actual challenges facing managers, and in many cases the benefits provided to key personnel are clearly inadequate. Benefits are in fact awarded more on the basis of seniority than merit.
- 1.41 In second-tier portfolio management, attention remained focused on subborrowers as the recipients of loans, with the result that proper creditworthiness criteria were not included among the selection criteria for intermediaries. There were no exposure criteria that differentiate banking institutions based on levels of risk. Loan processing was divided among many units and required an excessive number steps involving numerous individuals, with no overall coordination or supervision. Moreover, although there was still no group of credit specialists to review the quality of the portfolio, criteria have now been established to rate it. The previous system resulted in inadequate risk analysis with respect to intermediaries and inconsistencies in the portfolio rating.
- 1.42 Systems and technology. In general, each department develops its own system without adequate user participation, with slow implementation of standardized programs throughout the institution, and inadequate equipment. As a result, the systems are not integrated, users are dissatisfied, and there are more maintenance requests than the systems staff can handle. This lack of integration is very costly since it raises the likelihood of errors and makes it difficult to generate accurate management reports in a timely fashion.

- 1.43 **Conclusions.** An important general lesson can be learned from the above: the institution has carried out a rapid change in operations without making the necessary internal adjustments at the same pace. This conclusion is reflected both in its financial costs and level of risk, and in its institutional and organizational inefficiencies.
- 1.44 The lack of comprehensive controls to limit financial risk can be seen in the erosion of its assets. The adoption of strict eligibility criteria and limits on risk exposure for each IFI would reduce the possibility of losses. A further conclusion that can be drawn is that a proactive strategy for strengthening the country's financial sector as such would help reduce potential threats to its portfolio.
- 1.45 A frequent topic of discussion between the Bank and NAFIN has been interest rates. The Bank is convinced that the IFIs are actually charging market rates by applying a number of other fees, even though the margin of intermediation itself is regulated by NAFIN. The evidence for this view will be analyzed under the financial sector restructuring program by means of an empirical study which includes interviews with the IFIs and a sample of enterprises. The study is being carried out by the Ministry of Finance, and its findings will be available in the first quarter of 1996. Meanwhile, NAFIN has changed its schedule of interest rates on several occasions and has lifted restrictions on the spread with respect to its foreign currency placements, applying instead an auction system under which resources go to the highest bidder.
- 1.46 Mexico's macroeconomic crisis underscores the volatility of international markets, a risk inherent in NAFIN's expansion strategy which depends on its capacity to attract foreign funds. This experience will prompt swift adoption of more sophisticated risk management techniques in the handling of its assets and liabilities.
- 1.47 The institutional inefficiencies referred to above have become obstacles to the modernization of NAFIN. Accordingly, what is needed is a complete redesign of NAFIN's operating procedures and organizational structure.
- 1.48 **Recent measures.** In 1994, NAFIN began to recognize the risks inherent in its strategy and to take various measures designed to mitigate them. Among the most noteworthy are the issuance of new rules setting strict eligibility criteria for nonbanking IFIs, the commissioning of independent diagnostic studies on the credit unions, and initiation of studies on restructuring. In addition, NAFIN has begun to make organizational changes in the departments responsible for portfolio supervision and monitoring and is improving asset and liability management techniques. These measures - now redoubled because of the macroeconomic crisis - have

reduced the likelihood of further deterioration in the institution's financial position in the short term.

**E. Financial situation of NAFIN**

- 1.49 Based on the information presented above, the main lessons on NAFIN's recent history can be drawn. It is important to note, however, that generally speaking, NAFIN is in a sound financial position that will enable it to meet the financial challenges of the coming years adequately. Its current and projected net worth - at 8.6% of the core capital (tier 1) and 14.7% of the expanded capital - exceeds the internationally accepted standards of the Basle Committee. Moreover, NAFIN has created reserves that are 10% greater than the total portfolio in arrears. Liquidity indicators currently show satisfactory levels and NAFIN has privileged access to domestic borrowing markets. It has also demonstrated that it has the institutional and operational capacity to manage the proposed program efficiently (see Annexes IV and V for an exhaustive financial and institutional analysis of NAFIN).

**F. Timing of the program**

- 1.50 The proposed operation will further the Bank's strategy and constitutes a logical continuation of its support, having been designed on the basis of a continuous and constructive dialogue with the country's authorities.
- 1.51 The measures taken under the financial sector restructuring program lay the foundation for stabilization of the financial sector and help strengthen the capital base of the system. However, despite the various incentives established by the authorities, the capital base of the system remains weak. Although financial groups have been increasing the capital of the institutions, the loan portfolio has deteriorated even more rapidly during the greater part of 1995. The banks that have been able to increase their capital need to consolidate their position on the market. Significant investments must therefore be made in the modernization of their operations if they are to offer quality services at competitive prices on the open market. <sup>1/</sup>
- 1.52 The proposed program provides the means for promoting this type of investment (the component for modernization of financial institutions). It is justified mainly as an additional tool for the authorities to limit the potential fiscal costs of the banking crisis. It is expected to help the participating banks and other

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<sup>1/</sup> This need is greater in Mexico than in other countries because the banks lagged behind considerably in technological development during the 12 years of nationalization, although in 1994 they began to recover partially.

financial institutions increase their operating efficiency, thereby overcoming their current difficulties faster.

- 1.53 The modernization component addresses a need for financing that may have a catalytic effect in 1996, since it will precisely be supporting those banks that have taken the basic measures and need to consolidate their position. Given the substantial progress achieved in the financial sector restructuring program, including the completion of diagnostic studies, and the close coordination between NAFIN and the CNEV in this regard, the necessary information is available to make a prudent selection of the institutions.
- 1.54 NAFIN has a major impact on the performance of the Mexican economy. The proposed program offers an opportunity to help redirect the operating policies of NAFIN based on the lessons derived from the analysis of earlier experiences and in full agreement with the senior authorities of NAFIN concerning the need for a thorough restructuring of the institution. The program will help further strengthen the financial sector and improve the transparency and efficiency of NAFIN operations, emphasizing quality, selectivity, and market discipline.
- 1.55 The Bank's resources are particularly vital to NAFIN at this time. Owing to the volatility of the international capital markets, it is only able to attract international funds on terms of three to five years, the cost which has risen substantially (400-500 basis points over the United States Treasury rate). The lending component of the program will probably attract cofinancing on the order of US\$250 million.
- 1.56 The Bank reviewed with NAFIN the alternative of creating a guarantee facility to provide partial or full backing for a future international issue by NAFIN. While the Bank's guarantee could increase NAFIN's access to international money markets at attractive rates in the short term, this alternative appears ill-advised for the following reasons. The reduced access to international markets by Mexican issuers is temporary and will improve in step with the stabilization of Mexico's economy. NAFIN is a recognized name on international markets with a sound financial position (despite the shortcomings discussed) and the necessary experience to access these markets on its own. And the markets might interpret such a move as a sign that NAFIN and the other Mexican issuers are beyond recovery. Indeed, an operation of this sort could jeopardize future Mexican issues inasmuch as future investors could require the same type of guarantee or, alternatively, exact a higher cost of issues not accompanied by such guarantees.
- 1.57 The alternative of a back-stop facility instead of the multisector loan component was also reviewed. It would consist of a contingent line of credit to support the placement of medium- and long-term paper issued by the IFIs or the enterprises on the securities market. Although it could be considered for a future operation, it



did not appear advisable at present due to the volatility of the Mexican market, which has substantially reduced the possibilities of placement by even the most outstanding and largest IFIs companies.

## II. THE PROGRAM

### A. Objectives

- 2.1 The main purpose of this operation is to contribute to Mexico's economic recovery by helping to strengthen the financial sector. Its specific objectives are: (i) to promote modernization of private financial intermediaries; (ii) to support the corporate strengthening of NAFIN; and (iii) to stimulate productive investment by the business sector.
- 2.2 The features of the program were designed on the basis of the experience gained in the previous operation, with a view to remedying the weaknesses identified.

### B. Description

- 2.3 The program will have three components: (a) a loan for modernizing private financial intermediaries; (b) technical assistance for corporate strengthening of NAFIN; and (c) a multisector loan to finance investments by private companies.
- 2.4 (a) **Modernization of financial institutions.** As indicated above, the financial authorities have undertaken a series of measures designed to limit potential fiscal losses through support for strengthening of the financial institutions. While incentives and pressure were established under the financial sector restructuring program to increase the equity of the institutions and ensure the short-term stability of the sector, this component will help expedite consolidation of the progress achieved, thereby increasing the efficiency and competitiveness of the institutions.
- 2.5 This component offers medium-term loans (up to seven years) at market rates to banks, financial leasing and factoring companies, and credit unions that carry out internal modernization programs in order to increase their efficiency and consolidate their position on the market. The eligibility criteria (see chapter III) have been designed so that the eligible banks will be those small- and medium-sized banks that have made progress in institutional stabilization and can demonstrate satisfactory improvements in their equity structure. The features of the modernization projects will be defined for each intermediary on the basis of its particular needs, in order to maximize the impact on corporate profitability.
- 2.6 In the case of banks, the modernization projects may target such areas as the treasury office, preparation and implementation of a strategy plan, redesign of certain operational procedures, or the development of new products. Several such projects may thus be carried out concurrently, through the hiring of specialized consulting firms. The projects include an initial diagnosis and

analysis of opportunities for improvement and redesign of the respective procedures with qualitative goals set for cost reduction and/or implementation of specific measures. The costs of the consultants vary substantially depending on the nature and scope of each project, in some cases up to US\$1 million. The projects often involve the procurement of computer hardware and software, which will require the hiring of specialized firms for software development. The cost of technology may total several million dollars.

- 2.7 The investments in the case of financial leasing and factoring companies will be similar to those made by banks. The modernization projects for credit unions will mainly be part of comprehensive stabilization plans prepared jointly with NAFIN and the CNBV to support the credit unions that have the potential for consolidation.
- 2.8 (b) Corporate strengthening of NAFIN. NAFIN, with the support of the Bank, has carried out a series of diagnostic studies, with the initial objective of identifying opportunities for increasing its operating efficiency. These studies identified problems in its operations and organizational structure, the characteristics of which are described in chapter I of this document. Previously, the board of directors of NAFIN had decided that there was need for a comprehensive program of corporate strengthening which would enable it to improve sound decision-making and implementation of the necessary reforms in an integrated manner, and thus to respond effectively to the requirements of the National Development Plan. This component will finance the activities of the modernization project launched by NAFIN.
- 2.9 As a result of the above-mentioned diagnostic studies, four areas were identified and together comprise the conceptual frame of reference for the component: (i) strategy development; (ii) redesign of procedures; (iii) risk management; and (iv) organization and human resources. A complete cycle of activities will be carried out for each area, beginning with an in-depth study, identification and implementation of specific reforms, and including acquisition or development of data processing programs. Although these activities have been divided into four areas, close coordination between them will be provided to ensure the necessary feedback.
- 2.10 Strategy development consists of two components. First, long-term strategic plan will be devised beginning with the identification of strengths and weaknesses, opportunities and dangers, based on studies on demand, the competitiveness of financial services and products, and international experience. The results will be used to establish the mandate of the program, its strategic orientation, market niche, and products and services. The second component consists of preparing a comprehensive technology plan for computer systems that will determine the programming of NAFIN's systems for the coming years. The plan will take into account the guidelines

of the strategic plan. Current systems projects will be adjusted to the plan.

- 2.11 The second area, redesign of procedures, focuses on the principal operational procedures used by NAFIN so as to significantly improve operating efficiency. This will involve carrying out complete reengineering to overhaul lending procedures and methods of attracting capital, including development and implementation of support systems such as the portfolio system and the loan management system. In addition, support will be provided for restructuring of the business development program and creation of an environmental unit, subject to the conclusions of a more in-depth analysis.
- 2.12 Under the third area, risk management, an in-depth analysis of NAFIN's financial risks will be carried out; the methods used to provide overall management of these risks will be improved; and the necessary procedures and computer systems will be implemented. As a preliminary step, a comprehensive risk management system, a bank control system, and a program for monitoring of counterpart risks (primarily among intermediaries) have been identified.
- 2.13 The fourth area, organization and human resources, will involve reviewing NAFIN's organizational structure and decision-making powers, seeking a more efficient distribution of the latter, with fewer levels of authority and clearly identified responsibilities at each level. As well, a career development plan will be created and put into place, including recruitment procedures, incentives, and performance evaluation, and a training program in management skills will be devised and carried out.
- 2.14 Annex II contains a summary of this component of the program. The data systems listed are preliminary in nature since the process involved is a dynamic one in which the results of the analyses and diagnostic studies carried out, especially the strategic and technology plans, may vary substantially from the working hypotheses initially developed. Program activities will be carried out in chronological sequence in order to ensure suitable feedback between the four areas and to make optimal use of resources.
- 2.15 The success of this component depends to a large extent on maintaining excellent internal coordination and frequent feedback between the project team and management. These aspects have been taken into account in designing the structure for implementing this component (see chapter III).
- 2.16 (c) Multisector loan. The loan component involves several innovations with respect to the other program (loan 693/OC-ME). The interest rates charged to subborrowers will be freely negotiated between the eligible financial institutions and their clients. The interest rate which NAFIN charges intermediaries will vary as a

function of the credit risk assigned to each intermediary and the term of the loan, in such a way as to ensure a positive yield curve. The intermediaries that receive higher ratings from rating agencies will obtain the best rates of interest. NAFIN has decided to apply this principle to all its medium- and long-term placements in foreign exchange. In addition, NAFIN will expand its policy of establishing exposure limits for each intermediary, henceforth including banks as well.

- 2.17 Accordingly, this component will permit progress in the critical areas of interest rates, eligibility criteria, and exposure limits, consistent with the experience gained from the previous operation and with the studies to be carried out under the financial sector restructuring program.
- 2.18 Program resources will be allocated initially in dollars. Depending on the preliminary results of the method for setting interest rates under the program, NAFIN will revise its current rate-setting system used for all its discounting programs. For short-term placements, it will continue to use the auction method. If, during execution of the program, NAFIN wishes to use these resources for peso-denominated loans applying the principles of the program, the Bank will send an administration mission to determine the specific changes to be made in the credit regulations and analyze the financial operations required to provide the necessary exchange risk coverage.
- 2.19 NAFIN may not guarantee subloans under the program, either directly or indirectly.

C. Scope of the program

- 2.20 (a) **Modernization of financial institutions.** This component targets banks and other intermediaries that carry out modernization projects as part of a general approach to resolving the problem of capitalization. The eligibility criteria have been rigorously defined to ensure proper selection of the participating institutions (see paragraphs 3.10 to 3.12). In addition, percentage caps on financing by institution and minimum cofinancing requirements have been established (see chapter III). Of the 28 banks, 50 factoring companies, 50 financial leasing companies, and 250 credit unions, an estimated 11 banks, 15 factoring companies, 15 financial leasing companies, and 50 credit unions are expected to participate, applying on average for some 80% of the maximum financing allowed. According to these assumptions, demand for financing under this component will amount to about US\$110 million. Accordingly, a total amount of US\$100 million has been allocated to it. All of the resources provided under this component are expected to be committed within a period of 18 months, and disbursed within a maximum of three years.
- 2.21 (b) **Corporate strengthening of NAFIN.** The cost of this component has been estimated on the basis of international experience with

the types of activity to be financed and a preliminary budget for the specific investments identified. The program stipulates that up to a maximum of US\$20 million may be required, to be disbursed within a period of three years. However, this estimate is subject to ongoing review given the dynamics of the project itself.

- 2.22 (c) **Multisector loan component.** NAFIN expects to increase its second-tier portfolio with the private sector during 1996 and 1997 by approximately US\$1.2 billion, based on estimated demand for credit. The figure is an estimate subject to change depending on developments in international capital markets (NAFIN principal source of funding), the performance of Mexico's economy, and the goals that may be set by the Mexican government under its macro-economic plan. The proposed program will provide approximately 30% of that amount, not including possible cofinancing from the Export-Import Bank of Japan.

**D. Costs and financing**

- 2.23 The program's total cost of US\$500 million will be financed with the following resources: (i) US\$250 million from the Bank, consisting of US\$100 million from the dollar window and US\$150 million from ordinary capital; and (ii) US\$250 million from NAFIN. All of the resources obtained through the Bank's dollar window will be applied to the multisector loan component of the program. NAFIN has requested that the entire loan be denominated in dollars, as soon as the new Bank policy in this respect is approved. In addition, NAFIN is negotiating possible cofinancing from the Export-Import Bank of Japan. The following table shows the allocation of resources by component.

**Cost of the program  
(in millions of US\$)**

	Component	Amount	Percentage
A	Modernization of financial institutions		
	IDB	50.0	
	NAFIN	50.0	
	Total	100.0	20.0
B	Corporate strengthening of NAFIN		
	IDB	20.0	4.0
C	Multisector credit		
	IDB	177.5	
	NAFIN	200.0	
	Total	377.5	75.5
	Supervision fee	2.5	0.5
	<b>TOTAL</b>	<b>500.0</b>	<b>100.0</b>

- 2.24 NAFIN will assign a large number of personnel to carry out the corporate strengthening component B. However, since the local counterpart resources allocated to components A and C of the program meet the minimum requirements set by the Bank, and taking into account the administrative costs involved in verifying counterpart expenditures under this component, it is proposed that component B be financed solely with resources from the loan.

### III. EXECUTION OF THE PROGRAM

#### A. General

- 3.1 The borrower and executing agency of the program is Nacional Financiera, S.N.C. (NAFIN). NAFIN is backed by the guarantee of the United Mexican States. Annex V contains an analysis of the organizational structure and financial status of this institution, and Annex VI examines its financial statements.
- 3.2 NAFIN explored with various international financial institutions the possibility of arranging exchange risk coverage for a basket of currencies versus the United States dollar. Due to the difficulties of securing medium-term coverage and the high transaction costs involved, it was decided that the traditional method used in loan 693/OC-ME under which the Ministry of Finance will assume the exchange risk.
- 3.3 Following is a summary of the most important features of program execution. The complete list of rules governing the financial institution modernization and multisector loan components are set out in the Operating Regulations (see Annexes I and III).

#### B. Modernization of financial institutions

- 3.4 Use of the resources provided under this component will be governed by the Operating Regulations (Annex I) and the loan contracts that NAFIN will sign with each borrowing institution. Prior to the first disbursement of the loan, the finance committee of the NAFIN board of directors must approve the final version of these documents, which were agreed upon with the Bank during the loan negotiations.
- 3.5 **Technical advisor.** In order to strengthen its capacity for analyzing financial institutions, NAFIN will hire a consulting firm or consultant with expertise in the management of financial institutions. This technical advisor will analyze the feasibility of the modernization projects and their contribution toward achieving the objectives of the component, and will confirm whether applications conform to the Operating Regulations. The credit office of NAFIN's finance division will submit applications, along with their risk analysis and the conclusions of the review by the technical advisor, to the loan committee. The consultant will be hired using resources from the corporate strengthening component and may be assigned additional duties besides those described above in order to help NAFIN control credit risks in general.
- 3.6 Prior to the first disbursement of the loan, NAFIN must hire the technical advisor, based on the terms of reference previously



agreed upon with the Bank. NAFIN has already submitted a draft which is currently under review by the Bank.

1. Use of resources

- 3.7 All modernization projects designed to meet the objective of improving productivity, efficiency, security and/or quality of service of any of the procedures followed in the operation and administration of an institution, and that have a significant impact on the institutions financial return, will be eligible under component A of the program.
- 3.8 Such modernization projects must produce a comprehensive change in one or more operations procedures or areas. The specific criteria are listed in the Operating Regulations (Annex I).
- 3.9 In all cases, purchases of goods and contracting of services must be from individuals or corporate entities that have no economic ties with the respective institution.

2. Eligibility of financial institutions

- 3.10 The eligibility criteria have been carefully designed to establish incentives appropriate for the current situation of Mexican banks. As noted above, a large portion of the increases in capital of the banks in 1995 has been in the form of convertible securities. These instruments are considered core capital in Mexico, whereas the internationally accepted standards of the Basle Committee classify them as supplementary capital. Mexican banks need to improve the quality of their capital in order to strengthen their situation. Accordingly, the eligibility criteria for this component establish incentives in addition to those instituted by the authorities to expedite the conversion of subordinated debt into equity. Since providing support for banks that already dominate the Mexican market because of their size would not be justified, the criteria exclude those institutions that hold 10% or more of the banking system's total capital.
- 3.11 Privately-owned banks will be eligible to participate in the modernization component, provided they meet the prudential requirements set by the CNBV and have a capitalization rate <sup>2/</sup> of at least 8%. In addition, the core capital, net of subordinated debt subject to mandatory conversion, must be at least equal to 50% of the capitalization ratio, unless the bank has agreed upon a timetable for conversion into equity with the CNBV that is acceptable to the technical advisor.

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<sup>2/</sup> Equity over assets weighted for risk in accordance with CNBV standards.

- 3.12 Nonbanking institutions must also be privately owned and must meet the following eligibility criteria: (i) their equity may not be less than 10% of total liabilities; (ii) they must observe the cap of 5% of the respective total portfolio per subborrower; and (iii) their portfolio in arrears may not exceed the average for the respective sector corresponding to the type of IFI, whichever is lower.

3. Exposure limits

- 3.13 The resources that banking institutions discount with NAFIN, including the resources of the loan, may not represent more than either (i) three times the equity in the case of an IFI rated by a rating agency or (ii) two times the equity in the case of no such rating.
- 3.14 The outstanding balance of nonbanking financial institutions may not exceed 50% of the total liabilities of the respective IFIs.

4. Terms and conditions for loans

- 3.15 Although the Bank's counterpart criteria do not require participation by the financial institutions, it was deemed advisable to ensure a sufficient level of cofinancing to protect the interests of the institution. This requirement for cofinancing also includes an incentive to increase the percentage of equity through the conversion of subordinated debt. Accordingly, the program will only finance up to the ratio of core capital to equity, not to exceed 70% of the total cost of each modernization project.
- 3.16 The maximum amount to be financed will be: (i) 5% of core capital in the case of banks; or (ii) 15% of core capital in the case of nonbanking institutions, not to exceed the equivalent of US\$30 million per financial group.
- 3.17 It was agreed that the same principles would govern both this component and the multisector loan component, and that the same interest rates would apply to foreign exchange. The rates NAFIN charges the IFIs will at least cover the average cost of NAFIN funding and its intermediation costs throughout program execution. The rates must also be positive in real terms and must vary according to the risk of each IFI and the terms of the loans.
- 3.18 The following method for setting the interest rate NAFIN charges the IFIs in foreign exchange will apply to components A and C uniformly: a base rate plus a credit risk margin.

- 3.19 **Base rate.** The following rates will be compared: (i) the average yield curve for Mexican paper with sovereign risk 3/ on the international markets in dollars, based on the most recent quotations ("Mexico rate"); and (ii) the sum of the average cost of NAFIN funding 4/ plus its intermediation costs 5/ (the "NAFIN cost"). If the Mexico rate is higher, it will be the base rate. If the NAFIN rate is higher, the base rate will be the Mexico rate plus the difference between the two rates on the point of the curve corresponding to the duration of the NAFIN cost. To simplify the system, the average rate will be calculated for one- to three-year terms, three- to five-year terms, and maturities of more than five years.
- 3.20 **Risk margin.** Each eligible IFI will be classified into one of three risk groups based on criteria established in the Operating Regulations. A minimum margin for each group will be set and added to the base rate 6/. The minimum risk margin that would be added to the group A (low risk) group will be equal to the difference between rate A, defined as the average most recent quotations for three- to five-year Eurobonds issued by BANAMEX and BANCOMER, minus 100 basis points, 7/ and the base rate. If the base rate should be higher than rate A, no margin will be added to the rate for group A.
- The minimum margin to be added to the base rate for groups B and C above and beyond the minimum rate applicable to group A will be set according to calculations by NAFIN with a view to ensuring an acceptable average return. Current calculations indicate a factor of 0.40% for group B and 1% for group C.
- 3.21 In addition, NAFIN is considering implementing an medium- and long-term auction system, following the program method to determine the minimum rate to be offered by the intermediaries. Based on the results of the auction, NAFIN will revise its current system for setting interest rates to be applied to all its discounting programs.

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- 3/ Included are NAFIN, BANCOMEXT, PEMEX, and Mexican government Eurobonds.
- 4/ Reckoned as the average weighted cost of the resources placed through freely available issues on the international capital markets, based only on the resources available for placement.
- 5/ Administration expenses (currently some 0.37%), plus a capitalization margin based on inflation.
- 6/ The average required in the NAFIN portfolio, and according to reserves and capitalization required by the authorities is an estimated 1.55%.
- 7/ This reflects the higher transaction costs and restrictions on the use of the program resources.

- 3.22 Disbursements in local currency under this component will be made at the NAFIN rate plus 2%. This rate is based on market movements (historic cost of NAFIN funding plus a marginal cost adjustment factor), and currently equals the average cost of bank borrowing plus 6%.

C. Corporate strengthening of NAFIN

- 3.23 This component will be carried out using the methods and organization described below. Prior to the first disbursement for this component, NAFIN must agree with the Bank on a plan of operations which has been duly approved by its executive committee, containing a description of the component activities, the terms of reference for the strategy expert, the methods to be used in implementing the component, and the timetable for its execution. An advance draft of this document is now available, and is summarized in Annex II. It is important to note that the activities themselves and the detailed budget must remain flexible in order to permit the adjustments dictated by the dynamic process of institutional change itself. Accordingly, execution of this component will require active participation by the Bank in the form of ongoing dialogue and close monitoring of activities, including twice-yearly administration missions.
- 3.24 It is also important to note that execution of this effort to transform the institution has the unconditional backing of NAFIN's highest authorities.
- 3.25 Execution of this component is expected to take no more than approximately three years, subject to reviews of its progress.

1. Implementation structure

- 3.26 The leader of the institutional strengthening project will be the Director General, who chairs the executive committee (EC), which is made up of the Deputy Directors of NAFIN. Prior to the first disbursement for this component of the program, NAFIN must take the necessary steps to implement the plan of operations. Although its specific structure has not yet been fully defined, the EC is expected to create a multidisciplinary group which will be called the project execution group (PEG), reporting directly to the EC. The PEG chair will be responsible for general coordination and overall execution of the project. The EC will assign five to eight members of NAFIN's professional staff to work full time on the PEG. These officials must be chosen for their analytic skills, independent judgement, creativity, adaptability to innovation, and leadership qualities. In addition, they must have at least five years' experience and be thoroughly familiar with the institution. The EC will select these officials carefully, identifying the individuals best suited for this task with complementary know-how.
- 3.27 The PEG will be a temporary body which will operate throughout the project execution period. It will be responsible for carrying out

all project activities, and will enjoy direct access to the Director General and the Executive Committee. The PEG will submit a proposed plan of execution to the EC, setting out personnel assignments for the activities, project budget, expected results, and timetable, including the assignment of additional staff to working groups set up to carry out the subprojects. Once this proposal has been approved and the agenda set, the members of the PEG will have the authority to create the working groups and assign professional staff to work on them full time, and will be responsible for full subproject execution. The PEG will report on a monthly basis to the EC, which will be responsible for making the executive decisions necessary to further the progress of the project.

## **2. Outside consultants**

- 3.28 Prior to the first disbursement for this component, NAFIN must hire a consultant according to the terms of reference previously agreed upon with the Bank. <sup>8/</sup> This strategy advisor will supervise overall execution of the component. The advisor must have extensive international experience with the processes of institutional change, preferably in banking institutions and will shape the organization and direct the overall execution of the component, establishing direct contact with members of the PEG and the EC, as well as with the Director General, in order to maximize efficiency and ensure early detection of any problems and implementation of the necessary measures to remedy them. Among other activities, the strategy expert will organize an initial two-day seminar with the participation of the Director General, the EC, and the PEG to review and become familiar with the planned process of change. The strategy expert will also serve as a source of information for the identification of consultants with expertise in specific topics. The strategy expert will work full-time for the first two months of the project, with followup visits each month thereafter.
- 3.29 Additional consultants will be hired on short-term contracts for the execution of activities relating to specific topics.

## **3. Phases of execution**

- 3.30 The execution of the component can be divided into three phases. The first will last for six to eight weeks and consists of the organizational process, including the hiring of the strategy expert, creation of the PEG and appointment of its members, the initial seminar, development of the proposed activities of the PEG, approval of these activities by the EC, and setup of the working groups.

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<sup>8/</sup> NAFIN has already submitted draft terms of reference, which are currently being reviewed by the Bank.

- 3.31 The second phase will consist of diagnostic studies and the design of solutions. In-depth analyses will be carried out to probe current weaknesses and develop proposed changes to remedy them. This phase, which will have a duration of six to eight months, will culminate in decisions by the EC and, where appropriate, the NAFIN board of directors concerning the specific reforms to be instituted, and approval of the detailed budgets and working groups that will implement them. It is understood that this will be a dynamic process in which proposals will have to be approved as they are generated. However, given the many interrelationships between the various topics, the decisions with the greatest impact will have to be taken simultaneously.
- 3.32 The third phase consists of implementation of the decisions taken at the institutional level. This phase will have a duration of 12-18 months, depending on the area. It will include the procurement of computer equipment and development of the necessary software.
- 3.33 Decisive diagnostic studies have already been conducted on several of the specific activities included in the program, and executive decisions have been made that will allow their implementation upon initiation of the program. The plan of operations will identify these activities so that NAFIN's urgent operating requirements can be met immediately, provided that in the opinion of the strategy expert, the need for the respective investment is not substantially dependent upon the results of other analytical studies which have yet to be carried out.

#### 4. Use of loan resources

- 3.34 The resources for this component will be used to finance the expenditures for component activities and must come from member countries of the Bank (see Annex II). International competitive bidding will be required for (i) the procurement of goods in amounts over US\$350,000; and (ii) the awarding of service contracts for amounts above US\$200,000 to consulting firms.

#### 5. Environment

- 3.35 Included among the activities under this component is NAFIN's intention to strengthen activities in environmental issues, with a view to developing proactive programs to mitigate the environmental pollution caused by NAFIN's borrowers, as well as taking other measures to be defined.

#### D. Multisector loan

- 3.36 This component will be subject to the Operating Regulations (Annex III) and either the general agreements NAFIN will sign with each banking intermediary or, where applicable, the loan contracts that NAFIN will sign with nonbanking intermediaries. Prior to the first disbursement of the loan, NAFIN must approve the final

version of these documents agreed upon with the Bank during the loan negotiations.

1. Eligibility of subborrowers

- 3.37 Enterprises in all sectors will be eligible to apply as subborrowers and receive program resources through eligible financial institutions, subject to the maximum amount established by NAFIN, currently NM\$65 million.
- 3.38 Except in the case of credit unions, parties related to the lending IFI will not be eligible to apply as subborrowers. NAFIN will establish the necessary procedures to ensure proper enforcement of this restriction.

2. Private credit rating agencies

- 3.39 Credit rating agencies duly registered in accordance with the regulations issued by the CNBV will take part in this component. The rating agencies will rate participating financial institutions according to their standards of evaluation. To this end, only agencies whose professional track record, principles of evaluation, and experience (including experience in assessing the management of institutions) satisfy generally accepted international standards will be eligible to participate. The ratings they give must be based on the commercial risk of the financial institutions, without taking into account current government support schemes.
- 3.40 Prior to the first disbursement of the loan, NAFIN must declare eligible at least two rating agencies, according to criteria previously agreement upon with the Bank. NAFIN is currently making the necessary consultations with a number of acceptable agencies.

3. Eligibility of IFIs

- 3.41 Privately owned banks, financial leasing companies, and factoring companies that meet the following requirements will be eligible to participate in the program: (i) they must be in full compliance with the prudential standards of the CNBV; (ii) they must have a capitalization rate <sup>9/</sup> of at least 8%; and (iii) they must be rated by a rating agency or meet NAFIN's eligibility criteria for the allocation of discount lines, which consist of basic parameters under an acceptable system of financial indicators that ensures the operating efficiency of the financial institutions. Credit unions must: (i) have a capital representing no less than 10% of their total liabilities; (ii) have a ceiling on the amount of a loan per borrower of no more than 5% of the loan portfolio; and (iii) have a

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<sup>9/</sup> Book capital, less subordinate securities subscribed by state-owned entities, over assets weighted for risk in accordance with CNBV standards.

portfolio in arrears no greater than the average recorded for banks or credit unions, whichever is lower.

4. Risk categories

- 3.42 Eligible financial institutions will be classified into three categories labeled A, B, and C, with category A representing the lowest risk, and category C the highest risk. Institutions which have not been rated by an eligible rating agency will be automatically classified in category C.
- 3.43 The total amount of resources disbursed to category C institutions may not exceed 15% of the program resources.

5. Exposure limits

- 3.44 The resources that banking institutions, financial leasing companies, and factoring companies may discount with NAFIN, including the proceeds of the loan, may not represent more than: (i) three times their equity in the case of an IFI rated by a rating agency; or (ii) two times their total liabilities in the case of IFIs not so rated.
- 3.45 In the case of credit unions, the total balance of the liabilities of each one may not exceed 50% of its total liabilities.

6. Use of resources

- 3.46 The resources of the program may be used to finance projects for the establishment, integration, expansion, or improvement of any sector, as well as for the development and modernization of technology or the reduction of adverse environmental effects. The environmental, legal, and financial feasibility of the projects must be established in the analysis conducted by the respective financial institution.
- 3.47 As indicated above, the proposed program will supplement the financial sector restructuring program and is part of the Bank's response to the macroeconomic crisis in Mexico. Due to the high nominal interest rates, many companies are currently finding it difficult to service their debt. The Mexican government is offering two facilities to allow restructuring of peso-denominated debt (see chapter I). However, these facilities do not include the possibility of rescheduling foreign-currency debt, which would contribute greatly to the recovery and spur economic and social growth, particularly for firms that have managed to increase their international sales as a result of the freeing of the exchange rate.
- 3.48 For this reason, the following exception to Bank policy is proposed. For a period of 12 months beginning on the date the loan is approved, and up to an amount which may not exceed US\$60 million, the loan proceeds may be used to support eligible projects for debt



restructuring provided that the project is viable and the company's cash flow has been adversely affected by the recent changes in macro-economic variables.

7. Restrictions on the use of resources

- 3.49 The use of resources is subject to the Bank's usual restrictions for this type of program, which are listed in detail in the Operating Regulations (Annex III).

8. Terms and conditions for subloans

- 3.50 Interest rates. The interest rates charged by NAFIN to the IFIs will be established as described in paragraphs 3.17 to 3.21 above.
- 3.51 Prior to the first disbursement for this component, NAFIN must adjust its portfolio management system to ensure compliance with the requirements of the program. The system currently lacks the capacity to manage multiple interest rates, a factor which is vital to this component. NAFIN has already begun to make the necessary adjustments, and is expected to have completed them shortly.
- 3.52 The interest rates on the subloans will be freely negotiated between eligible IFIs and subborrowers.

9. Environmental concerns

- 3.53 Under loan 693/OC-ME, NAFIN conducted a survey of 200 borrowing companies to assess compliance with their legal obligations and the credit regulations with respect to the environment. The conclusions of the sample are discussed in the environmental summary that was approved by the Environment Committee. The Committee's first recommendation was that a plan of action for environmental protection be prepared, which NAFIN must agree upon with the Bank prior to the first disbursement for the multisector loan component. The plan will set out a series of measures, coordinated with the Ministry of the Environment, Natural Resources, and Fisheries [Secretaría de Medio Ambiente, Recursos Naturales y Pesca] (SEMARNAP), designed to improve awareness of environmental legislation and to ensure that the loan component does not contribute to environmental pollution. Accordingly, the Operating Regulations require, in the case of activities that require environmental permits to be obtained and protective measures to be taken, that approval of subloans be subject to the obtaining of a certificate of compliance issued by SEMARNAP.

E. Inspection of the program

- 3.54 The Bank will establish such inspection procedures as it deems fit to ensure satisfactory execution of the program. The borrower will lend its full cooperation for this activity. The equivalent of US\$2.5 million will be deducted from the loan proceeds for this purpose.

F. Monitoring and evaluation

- 3.55 Owing to the complexity of the program, the Bank will monitor its progress at frequent intervals by scheduling twice-yearly administration missions to direct execution and correct any deficiencies detected in a timely manner. Three months after the first disbursement for the loan component, the Bank will conduct an evaluation of implementation of the plan of action for environmental protection and may suspend disbursements if the plan is not being implemented as agreed.

#### IV. FEASIBILITY AND RISKS

##### A. Feasibility

- 4.1 The economic plans of the Mexican government are designed to restore macroeconomic balance and lay the foundations for economic growth by encouraging a competitive, open economy that is fully integrated in the international market.
- 4.2 The restructuring financial sector program, cofinanced by the IDB and the World Bank, strengthens this macroeconomic approach by supporting specific measures designed to bolster the credit-worthiness of Mexico's financial institutions and promote their stability. The Mexican government is planning additional measures in the area of contractual savings which will further buttress the economy to ensure the sustainability of its economic growth in the medium term.
- 4.3 This program supports the efforts of the Mexican government to strengthen the competitiveness of the economy by offering financial resources to the country's business sector, financial intermediaries, and development banks. Moreover, this support has been designed under market conditions which are consistent with a sound structure of appropriate incentives so as to bring market discipline to bear and achieve higher levels of medium- to long-term savings. Thus, strict eligibility criteria will be applied to participating financial institutions, with the help of specialized private sector agencies, and the interest rates charged will be market rates. The financial viability of the participating institutions, including that of NAFIN as a second-tier institution, is an integral part of the program objectives in that two of the three components, the modernization of financial institutions and the corporate strengthening of NAFIN, are designed to reduce operating costs and improve rates of return.

##### B. Benefits

The program will benefit the Mexican economy by providing long-term financing to two sectors of vital importance to its recovery. The financial sector will be able to increase the competitiveness of its services by offering higher quality products at lower cost, and NAFIN will be able to focus its support in both sectors according to principles of transparency and efficiency. Private-sector companies will gain access to credit, enabling them to make the investments required for taking full advantage of free trade and the economic integration achieved by Mexico.

**C. Risks**

- 4.4 **Macroeconomic stability.** The program requires a stable macroeconomic environment which will allow for proper development of financial markets, including interest rates that are moderately positive in real terms. Mexico's current monetary and fiscal policies, together with the structural reforms under way or planned, constitute a solid basis for creating these conditions, and the Mexican government's commitment to these measures is unmistakable.
- 4.5 **Stability of the financial sector.** Under the financial sector restructuring program, the Government of Mexico has taken the steps necessary to place the financial sector on a sounder footing. The risk factors involved in that project, which has progressed satisfactorily to date, were fully analyzed in the respective loan document. Because its success is essential to that of the proposed program, the latter applies strict criteria for the selection of participating intermediaries, including the use of private credit rating agencies, further strengthened by the hiring of an expert in banking analysis under the component for modernization of financial institutions.
- 4.6 **Reduced demand on the part of intermediaries.** The market interest rates to be charged, along with the eligibility requirements mentioned earlier, reduce the attractiveness of the multisector loan component and the financial institution modernization components. In the initial phase, and until consolidation of the financial sector as such is achieved, there is the risk that the few institutions which meet these requirements will not be interested in working with the program. However, the term of the loans, the currency in which they are denominated, the fact they are available effectively without guarantee and the streamlining of administrative procedures are expected to help diminish this risk.
- 4.7 **Feasibility of bringing about substantive changes in NAFIN.** The administrative and policy changes that may be required to achieve the objectives of the component to provide corporate strengthening of NAFIN could encounter sufficient resistance - both inside and outside the institution - to hinder its execution. In which case, the component could end up financing marginal changes only, while having no impact on fundamental issues. This risk is negligible at present since the senior management of NAFIN is fully committed to the proposed program. In addition, the program includes frequent opportunities for review and monitoring of its progress.
- 4.8 **Lack of internal coordination in NAFIN.** Successful execution of the corporate strengthening component will require a high degree of coordination and organization. The program calls for creation of a project execution group reporting directly to the Executive Committee and dedicated full time to the coordination of activities, as well as

the hiring of a strategy advisor with extensive experience in this type of institutional change.

D. Impact on low-income groups

- 4.9 The recent macroeconomic crisis has had an adverse effect on low-income groups in Mexico by raising prices for imports, transportation, and, to a lesser extent, basic consumer goods. The program will help stabilize the economy and strengthen the country's service infrastructure. This will help reactivate the economy and spur private investment in Mexico. As a result, the program is expected to create new job opportunities, which will also benefit the low-income population.

**OPERATING REGULATIONS  
COMPONENT A**

**MODERNIZATION OF FINANCIAL INSTITUTIONS**

**ARTICLE 1. Purpose of the program**

The purpose of the program is to provide institutions with credit to finance modernization projects designed to lower their operating costs, expedite their reorganization, enhance their efficiency, performance, and portfolio quality, and upgrade the facilities they use to provide services to microenterprises and small and medium-sized businesses, and in general to improve their overall status and risk rating as financial intermediaries.

**ARTICLE 2. General terms and conditions**

These Regulations set forth the terms and conditions that are to govern the execution of the program, which will be financed in accordance with the contract for loan /OC-ME, entered into by Nacional Financiera, S.N.C. (NAFIN) as borrower and executing agency, and the Inter-American Development Bank (IDB).

**ARTICLE 3. Definitions**

The bolded terms below are to be defined as follows:

**"Capitalization ratio":** Equity (excluding subordinated debt subscribed by state-owned entities) over total risk-weighted assets, in accordance with CNBV standards.

**"CNBV":** National Banking and Securities Commission, or whatever institution may replace it.

**"Core capital":** The basic part of the net worth of a financial institution, as defined in Annex I of CNBV Circular 1186 dated 9/17/93.

**"Corporate strengthening program":** Program for the corporate strengthening of financial institutions referred to in the Loan Contract.

**"Credit application" or "application":** Form prepared by NAFIN to ensure that institutions apply for credit lines in accordance with standard procedures.

**"Credit committee":** The internal decision-making units of NAFIN, which are as follows: the board of directors, the steering committee of the board of directors, and the technical financial operation committee,

which, to the extent of their powers, authorize all loans granted by NAFIN.

**"Credit contract or contract":** Contract signed between NAFIN and an institution, setting forth the terms governing a line of credit.

**"Credit Department":** Department reporting to the Office of the Assistant Director for Financing of NAFIN. The purpose of this department, among other functions, is to review credit applications and to submit to the credit committee the opinions prepared by the technical advisor and the respective proposed resolutions.

**"Credit line" or "credit":** The credit which NAFIN makes available to IFIs using funds provided under the Loan Contract.

**"Financial Group":** Legal entity as defined in the "Law on Financial Groups," operating in accordance with the "General Rules for Incorporation and Operation of Financial Groups".

**"IDB":** Inter-American Development Bank.

**"Intermediary financial institutions (IFIs)":** Commercial banks, financial leasing companies, factoring firms, and privately owned credit unions, that apply for credit in accordance with the procedures set forth in these Regulations.

**"Loan Contract or loan":** Contract for loan /OC-ME, concluded between NAFIN and the IDB.

**"Loan proceeds":** Funds provided under the Loan Contract.

**"Modernization project" or "project":** Set of investments which will help achieve the program goals.

**"NAFIN":** Nacional Financiera, S.N.C.

**"Net worth":** Total equity of an institution, as defined in Annex I of CNBV Circular 1186 of 9/17/93 in the case of commercial banks, and in the respective circulars in the case of other financial institutions.

**"Program":** Financial institutions modernization component of the corporate strengthening program, designed to facilitate investments in projects for modernizing financial institutions.

**"Project execution period":** Duration of (i) services rendered by third parties, or (ii) the installation and startup of equipment procured in connection with a project.

**"Rating agencies":** Private, national or foreign firms that issue opinions on the credit standing of debt instruments issued by financial institutions.

**"Rules and regulations":** The rules issued by NAFIN on May 2, 1995, which set maximum limits for leverage and financing, among other things, for financial leasing companies, factoring firms, and credit unions.

**"Technical advisor":** Firm or expert hired by NAFIN to review credit applications and to issue opinions on the projects proposed in such applications.

**"Third party":** Individual or legal entity with no financial ties of an employment-related nature or any other connection with the financial institution or group, the members of its board of directors, its chief executive officer, the official in charge of the modernization program, the rating agencies, NAFIN, or the technical advisor.

#### **ARTICLE 4. Program resources**

The program resources will consist of the funds granted under the Loan Contract, the resources made available by NAFIN, and resources contributed by the respective institutions. The local counterpart contribution will be defined as the resources provided by NAFIN and the financial institutions to finance projects using their own resources or any other source of financing, subject to the terms and conditions established in these Regulations.

#### **ARTICLE 5. Use of resources associated with the modernization program**

All modernization projects that are designed to improve the productivity, efficiency, security, and/or service quality of any of the procedures used in the operation and management of an IFI and which would have a significant impact on the financial profitability of the institution will be eligible under the program.

Modernization projects will comprehensively reform one or more of the operating procedures or units, such as credit, credit risk control and management, collections, payment systems and cash management, personal banking services, corporate banking services, financial supervision, accounting supervision, treasury cash flow, money desk, exchange and special transactions (trading), distribution of information, distribution of communications, human resources and organizational development, training, strategic and financial planning, upgrading the facilities used to provide services for microenterprises and small and medium-sized businesses, development of new products, product marketing, general support services, development and maintenance of technology systems, management information systems, administration of assets and liabilities, operations in general, centralized processing units, and branch operations.



The program resources may be used to finance projects with these or similar characteristics. Specifically, the following types of expenditure are eligible:

- (i) procurement of technology resources or know-how for procedure design and implementation;
- (ii) consultants' fees for the provision of consulting services;
- (iii) procurement of computer hardware, communications equipment, and computer software for which no other source of funding is available;
- (iv) shipment of imported hardware and software;
- (v) investment in software customization;
- (vi) payments of royalties or licensing fees connected with use of the software;
- (vii) fees for suppliers of goods and services connected with the hardware and software procured;
- (viii) fees for training for the staff of the borrower institution in charge of implementing the project; or
- (ix) any other type of fees for services that make a direct contribution toward the implementation of a modernization project.

Without exception, goods must be procured from and contracts for services awarded to individuals or legal entities that qualify as third parties.

In cases where the projects submitted for financing were initiated prior to approval of the credit, any expenditures incurred less than 180 days prior to the date of the credit application will be eligible for retroactive financing in the amount of up to 20 percent of the total credit.

**ARTICLE 6. Restrictions on the use of modernization program resources**

Program resources may not be used by the IFIs for any of the following:

- a. payments of taxes or related assessments;
- b. payments in respect of any type of liability associated with financial operations;
- c. recoveries of principal or dividends;
- d. purchases of stocks, bonds, or other instruments or securities;

- e. administrative or personnel expenses of the institution not expressly covered in the preceding article; or
- f. expenses incurred more than 180 days prior to the date of the credit application.

**ARTICLE 7. Restrictions on the use of the loan proceeds**

In addition to the restrictions indicated in the preceding article, the loan proceeds may not be used to procure goods or services from countries that are not members of the IDB.

**ARTICLE 8. Eligibility of institutions**

Financial institutions meeting the following criteria will be eligible to participate in the program:

**A. Banks:**

- 1. The bank must comply with the prudential rules and regulations set by the CNBV.
- 2. Its net worth must be less than 10 percent of the total net capital of institutions making up the banking system.
- 3. Its capitalization ratio must be at least eight percent.
- 4. Its core capital, net of subordinated debt subject to mandatory conversion, must be equal to at least 50 percent of the capitalization ratio, unless it has agreed upon a timetable for conversion to equity with the CNBV that is acceptable to the technical advisor.
- 5. The bank's current portfolio with NAFIN may not exceed:  
(i) three times the equity of the bank if a rating has been obtained from a rating agency; or (ii) two times the equity of the bank if no such rating is available.

**B. Nonbanking institutions:**

- 1. The net worth of a nonbanking institution must be at least 10 percent of its total liabilities.
- 2. The maximum credit per subborrower may not exceed five percent of the IFI's total portfolio.
- 3. The portfolio in arrears may not exceed the average for banks or for the sector to which the type of IFI in question belongs, whichever is lower.

4. The volume of the IFI's portfolio with NAFIN may not exceed 50 percent of the total liabilities of the IFI in question.

**ARTICLE 9. Financial terms and conditions of credits**

**Currency:** In local currency or dollars of the United States of America, irrespective of the currency of the funds provided under the Loan Contract.

**Amount:** Financing may be granted for:

- a. up to five percent of the core capital in the case of commercial banks;
- b. up to 15 percent of the core capital in the case of nonbanking institutions;
- c. up to the percentage equivalent to the ratio of core capital to net worth, not to exceed 70 percent of the total cost of the modernization project; and
- d. a total amount of credit extended to IFIs not to exceed the equivalent of US\$30 million per financial group.

**Amortization:** Principal repayments will be made in equal quarterly installments during the amortization period. The amortization period will be determined in accordance with the characteristics of the project and the institution's cash flow, but will not exceed seven years from the first disbursement.

**Grace period:** The grace period for amortization of principal will be the project execution period, or a maximum of two years and six months. The grace period applies only to amortization of principal.

**Interest rates:** Interest rates will be based on market trends and will consist of a base rate, an IFI risk margin, and a term margin.

**Interest payments:** Interest will be payable quarterly in arrears for dollar-denominated credits and payable monthly in arrears for credits denominated in local currency; during the amortization period, these dates must coincide with the dates on which principal amortization payments are made.

**Disbursements:** The credit will be disbursed in accordance with the execution timetable submitted by the respective IFI in its credit application and solely on the basis of invoices paid by the IFI. Disbursements will be equal to the percentage of cofinancing set at the time the credit was granted. The IFI may submit a revised execution timetable at the end of each three-month period for the expenditures to be incurred over the next three-month period.

**Commitment fee:** NAFIN will charge a fee of 0.25 percent per annum on amounts committed but not disbursed (in accordance with the terms and conditions for the credit), and amounts spent but for which evidence has not been submitted in the form of an invoice paid on the date scheduled according to the execution timetable or a revised version thereof. The fee will not be charged if total arrears are less than 10 percent of the planned amount of the disbursement.

**Collections:** The credit will be repaid in accordance with established practices in discount operations. In the case of commercial banks, the system of automatic credit and debit of accounts which each institution maintains with the Bank of Mexico will be used, if available.

**ARTICLE 10. Credit application procedures**

**Outreach:** Program outreach will be the responsibility of NAFIN. NAFIN will prepare an information brochure explaining the objectives, eligibility criteria for projects and institutions, financing features, and credit application procedures. The brochure should also include an application form setting out all the information required for a credit to be approved, and must also include an annex containing these Regulations. NAFIN will make presentations to all IFIs through the Mexican Bankers' Association [Asociación de Banqueros de México, A.C.], the Mexican Association of Financial Leasing Companies [Asociación Mexicana de Arrendadoras Financieras, A.C.], and the Association of Financial Factoring Firms [Asociación de Empresas de Factoraje Financiero, A.C.], as appropriate.

**Documentation:** When submitting credit applications to NAFIN, institutions must enclose the following documents:

1. the timetable of execution, including programmed dates for disbursement and payment;
2. a description of the modernization project, including: (i) a letter from the secretary of the board of directors, certifying that the modernization project was approved by the board (in the case of commercial banks); or (ii) a copy of the minutes of the board of directors meeting showing proof that the modernization project was approved (in the case of nonbanking institutions); and
3. a detailed list of expenditures to be financed using the credit.

**Review and approval:** The technical advisor will assess the feasibility of the project and its contribution to the objectives of the program, and will confirm whether or not the credit application is in conformity with these Regulations.

If the advisor's opinion is favorable, the credit application submitted by an IFI will be forwarded by NAFIN to the appropriate committee. The

advisor's main findings must be included in the presentation of each case.

**Deadlines:** NAFIN will make a final decision on a credit application within 30 calendar days following the date on which the fully documented application is received. Once a decision has been reached by the credit committee, within 72 hours NAFIN will present a credit offer specifying the terms and conditions of the credit, which the institution will have 10 business days to sign and return to NAFIN. The credit contract and necessary credit instruments must be signed within 10 business days after the date on which the credit offer is accepted.

**ARTICLE 11. Credit contract**

The participation of the IFIs in the program will be governed by the credit contracts which NAFIN will enter into with each of them. These credit contracts will set forth the financial terms and the rights and obligations of both parties, in accordance with the terms and conditions set forth in these Regulations. The credit contract used must include a prior statement of nonobjection from the IDB and must establish the following terms and conditions, among other provisions:

- a. The IFI accepts responsibility for repayment of the credit to NAFIN, regardless of the success or failure of the modernization projects financed.
- b. The collection procedure must be agreed upon with NAFIN.
- c. The pertinent notes must be signed in favor of NAFIN.
- d. The funds may be used solely to pay for approved goods and services, in conformity with these Regulations.
- e. The IDB, NAFIN, and external auditing firms selected by NAFIN will have unrestricted access to records and other documents relating to the program, and will be allowed to verify the physical inventories of goods financed.
- f. Accounting information on the program will be maintained in such a way as to make it possible to identify: (i) funds originating from the loan and from the local counterpart contribution; (ii) past and future disbursements; (iii) past and future payments; (iv) vouchers documenting expenditures made using program resources; and (v) the sources of the goods and services financed.
- g. NAFIN will have the right: (i) to suspend disbursements if the IFI fails to comply with the terms of a credit contract; and (ii) to demand prepayment under the circumstances stipulated in these Regulations.

**ARTICLE 12. Supervision and control**

**Supervision visits:** NAFIN and/or the technical advisor will conduct such visits as are deemed necessary to confirm that the project is proceeding according to plan, and to verify that the credit resources and counterpart funds are being used properly. Both NAFIN and the IDB may conduct such inspection visits as are deemed necessary to monitor the project.

Risk evaluations by NAFIN, as well as opinions issued by technical advisors, must be carefully documented in the credit records. The IDB may review these documents at any time in order to verify that the credits have been granted in accordance with the provisions of these Regulations and the Loan Contract.

**When problems occur:** If NAFIN, the IDB, or the external auditing firms should detect any irregularities, breach of contract, or other circumstances that indicate that program resources are not being used properly, NAFIN will have the right to demand prepayment of the balance of the respective credit, either in whole or in part, depending upon the seriousness of the situation.

In addition, NAFIN may suspend disbursements if the financial position of the IFI, in NAFIN's judgement, has taken a serious turn for the worse.

The IFIs may discontinue their participation in the program. To do so, they must give NAFIN written notice at least two months prior to the next programmed disbursement if there are disbursements pending. The IFI may make prepayments at any time. Any prepayment will be applied first to interest and pending charges and secondly to principal. NAFIN may charge a fee for prepayment (in the case of fixed-rate credits) or when it has not been properly notified of the prepayment.

**ARTICLE 13. Use of recoveries**

Recoveries of principal will be added back to the program's available funds, provided that their reuse does not prevent NAFIN from making the payments required under the Loan Contract.

**SUMMARY OF THE PLAN OF OPERATIONS**  
**COMPONENT B**  
**CONSOLIDATION OF FINANCIAL INSTITUTIONS**

**I. PURPOSE**

- 1.1 The purpose of the plan is to set out all the activities needed to achieve the corporate strengthening and modernization of NAFIN.
- 1.2 The ultimate goal is to increase the operating efficiency of NAFIN through an in-depth and far-reaching process of operational, financial, and administrative change.

**II. DESCRIPTION OF THE PLAN**

- 2.1 The plan consists of four major areas of activities that are interconnected:
  - a. strategy development;
  - b. redesign of procedures;
  - c. risk management; and
  - d. organization and human resources.

**III. METHODOLOGY**

- 3.1 The following methodology will be used for each area of activity:
  - a. preparation of a diagnostic study;
  - b. identification of the necessary reforms and other measures;
  - c. preparation of a plan for implementation of the activities;
  - d. preparation of the respective manuals and regulations;
  - e. development and implementation of the necessary data processing systems; and
  - f. evaluation of the implementation of the plan of activities.
- 3.2 The above-described methodology will be executed as follows:
  - a. An executing group will be set up for the plan, chaired by NAFIN's Deputy Director for Corporate Affairs and reporting directly to the NAFIN Executive Committee.
  - b. An external advisor will be hired to act as strategy advisor for the executing group throughout execution of the plan. The

advisor will have the following duties: (i) direct organization and general execution of the plan; (ii) oversee proper execution of activities carried out under the plan; (iii) detect, at an early stage, any problems in the execution of the plan; (iv) suggest alternative solutions to any problems encountered; and (v) provide information to help identify consultants specializing in specific areas.

- c. External consultants will be hired and NAFIN staff assigned to carry out the activities programmed.

#### **IV. DESCRIPTION OF SPECIFIC ACTIVITIES**

##### **A. Strategy development**

- 4.1 In order to redirect NAFIN's focus in the coming years to provide support for the economic development of Mexico in its capacity as development bank, the following activities will be carried out:
  - a. The institutional mission of NAFIN will be revised.
  - b. Its market niche will be identified.
  - c. The strategy plan of NAFIN for the period from 1996 to 2000 will be drawn up.
  - d. The activities and products that will help NAFIN achieve its mission and meet the objectives of the strategy plan will be determined.

##### **B. Redesign of procedures**

- 4.2 In accordance with the objectives, activities, and products selected for NAFIN, current procedures will be thoroughly redesigned and new procedures developed, as appropriate, for the following activities:
  - a. procedures for financing: in order to achieve greater efficiency and control of activities for credit, risk capital investment, and granting of guarantees;
  - b. procedures for obtaining financial resources: in order to reorganize and simplify activities for domestic borrowing, external borrowing, liquid asset management, and investment banking operations;
  - c. procedures for business development: in order to strengthen NAFIN's activities to develop the business capacity of



microenterprises and small- and medium-sized businesses, especially in industry; and

- d. procedures for environmental protection: in order to develop activities for monitoring and quality control of the measures NAFIN borrowers must take to protect the environment.

**C. Risk management**

- 4.3 The new activities and products selected by NAFIN must be supported by more solid risk management, which will be achieved through the following activities:

- a. implementation of a risk analysis methodology, in order to institute new technology for management of financial assets and liabilities so as to achieve greater control over institutional risk; and
- b. establishment of a risk management system, in order to adjust the various information systems for risk management.

**D. Organization and human resources**

- 4.4 In order to ensure consistency between the activities in each area and the staffing and material resources necessary, the following activities will be carried out:

- a. design of the organizational structure and review of decision-making authority;
- b. preparation of manuals on organization, functions, and procedures;
- c. preparation of a training plan; and
- d. review of personnel policies.

**V. DURATION**

- 5.1 The plan will be executed over a three-year period.

**VI. RESOURCES FOR EXECUTION OF THE PLAN**

- 6.1 The following table summarizes the activities, expected results, and resources required for execution of the plan.

RESOURCES REQUIRED FOR EXECUTION OF THE PLAN				
AREAS OF ACTIVITY	ACTIVITIES	RESULTS	SUPPORT SYSTEMS	COST (US\$M)
Strategy development	- Review of NAFIN mission - Identification of market niche	- NAFIN mission - Market niche of NAFIN identified	- Projects (SIMPI) - Statistics on impact - Data on fulfillment of strategy goals	5.71
	- Preparation of strategy plan	- Strategy plan for 1996-2000		
	- Identification of NAFIN activities and products	- List of activities - List of products		
Redesign of procedures	- Design of procedures for financing	- Credit and guarantee procedures - Risk capital investment procedures	- Discounting and portfolio monitoring	7.5
	- Design of procedures for obtaining financial resources	- Procedures for domestic borrowing - Procedures for external borrowing - Procedures for liquid resource management - Procedures for investment banking operations	- Collection control - Financial operators - Business development (PRODEM)	
	- Design of business development procedures	- Procedures for development of business capacity		
	- Design of environmental protection procedures	- Establishment of Environment Unit - Procedures and manuals for monitoring environmental protection activities		
Risk Management	- Preparation of risk analysis methodology	- Risk analysis methodology	- Risk management - Bank control - Performance monitoring of IFI network	3.37
	- Design of risk management system	- Risk management system		
Organization and human resources	- Design of NAFIN's organizational structure	- New organizational structure of NAFIN	- Performance indicators - Personnel data	3.42
	- Definition of functions and design of procedures	- Manuals on organization, functions, and procedures		
	- Preparation of training plan	- Training plan		
	- Review of personnel policies	- Personnel Management manual - Salary scale - Staff performance evaluation manual		

OBJECTIVES	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<b>1. Strategy development</b> <b>1.1 Review of NAFIN's mission:</b> <ul style="list-style-type: none"> <li>- Clearly establish the direction and objectives of NAFIN as a development bank</li> </ul>	<ul style="list-style-type: none"> <li>- Assurance in the role to be played by NAFIN in supporting the economic recovery of the country</li> </ul>	<ul style="list-style-type: none"> <li>- Economic indicators of Banco de México</li> </ul>	<ul style="list-style-type: none"> <li>- A stable macroeconomic and financial environment is necessary</li> <li>- There is political stability</li> <li>- A contribution will be made to the economic recovery of the country</li> </ul>
<b>1.2 Identification of the market niche of NAFIN:</b> <ul style="list-style-type: none"> <li>- Define the segments, sectors, and states in which NAFIN should focus its attention</li> </ul>	<ul style="list-style-type: none"> <li>- Increase in the support provided to the segments, sectors, and regions assigned priority</li> </ul>	<ul style="list-style-type: none"> <li>- Periodic reports on sector and regional economic activity</li> <li>- Periodic reports on NAFIN's lending activity</li> </ul>	<ul style="list-style-type: none"> <li>- There is political stability</li> <li>- The government sets national priorities</li> </ul>
<b>1.3 Preparation of a strategy plan:</b> <ul style="list-style-type: none"> <li>- A document that will help all the departments of NAFIN focus their activities on achieving the goals established</li> </ul>	<ul style="list-style-type: none"> <li>- Development of the strategy plan for 1998-2000</li> <li>- Achievement of specific goals and objectives by each department</li> </ul>	<ul style="list-style-type: none"> <li>- Annual report to the board of directors</li> <li>- Semiannual activity reports</li> </ul>	<ul style="list-style-type: none"> <li>- Long-term focus</li> <li>- Fulfillment of the National Development Plan and sector plans</li> <li>- Commitment on the part of NAFIN departments to achieve the goals and objectives</li> </ul>
<b>1.4 Identification of NAFIN activities and products:</b> <ul style="list-style-type: none"> <li>- Determine the appropriate activities and products of NAFIN as a development bank</li> </ul>	<ul style="list-style-type: none"> <li>- Proper rate policy</li> <li>- Increase in competitiveness of products and services</li> <li>- Cost reduction</li> <li>- Greater demand for products and services</li> </ul>	<ul style="list-style-type: none"> <li>- Periodic reports on product and service performance</li> <li>- Accounting reports</li> <li>- Opinion surveys</li> </ul>	<ul style="list-style-type: none"> <li>- NAFIN supplements the products and services provided by commercial banks</li> <li>- There is an impact on the efficiency and productivity of commercial banks</li> </ul>
<b>2. Redesign of procedures</b> <b>2.1 Design of procedures for financing:</b> <ul style="list-style-type: none"> <li>- To achieve greater efficiency in the operating procedures for credit, risk capital, and granting of guarantees</li> </ul>	<ul style="list-style-type: none"> <li>- Streamlining of procedures</li> <li>- Cost reduction</li> <li>- Optimal use of human and material resources</li> <li>- Increase in returns</li> </ul>	<ul style="list-style-type: none"> <li>- Accounting reports</li> <li>- Periodic progress report on financial plan</li> <li>- Opinion surveys</li> </ul>	<ul style="list-style-type: none"> <li>- Costs of IFIs do not change</li> <li>- Economic recovery is stimulated</li> <li>- Demand for resources increases</li> </ul>
<b>2.2 Design of procedures for obtaining financial resources:</b> <ul style="list-style-type: none"> <li>- To achieve greater efficiency in the operating procedures for borrowing</li> </ul>	<ul style="list-style-type: none"> <li>- Streamlining of procedures</li> <li>- Improved control</li> <li>- Cost reduction</li> <li>- Risk reduction</li> <li>- Increased efficiency</li> </ul>	<ul style="list-style-type: none"> <li>- Periodic Treasury and Investment Banking reports</li> </ul>	<ul style="list-style-type: none"> <li>- Macroeconomic and financial stability</li> <li>- Borrowing conditions improve</li> <li>- Increase in demand for resources</li> </ul>
<b>2.3 Design of business development procedures</b> <ul style="list-style-type: none"> <li>- To strengthen NAFIN's activities designed to develop business management capacity</li> </ul>	<ul style="list-style-type: none"> <li>- Greater efficiency in management of enterprises</li> <li>- Increased sales and returns</li> <li>- Improved financial structure</li> </ul>	<ul style="list-style-type: none"> <li>- Financial statements of enterprises</li> <li>- Followup visits</li> <li>- Targeted surveys</li> </ul>	<ul style="list-style-type: none"> <li>- Entrepreneurs are interested in improving their managerial capacity</li> <li>- Resources are available for training expenses</li> </ul>
<b>2.4 Design of environmental protection procedures</b> <ul style="list-style-type: none"> <li>- To monitor activities of subborrowers designed to protect the environment</li> </ul>	<ul style="list-style-type: none"> <li>- Decrease in adverse environmental impact</li> <li>- Improvement in quality of the environment</li> </ul>	<ul style="list-style-type: none"> <li>- Periodic progress reports on projects supported by NAFIN</li> <li>- Report by environmental impact rating agencies</li> </ul>	<ul style="list-style-type: none"> <li>- Compliance with international standards</li> <li>- Support from enterprises to verify pollution levels</li> </ul>

OBJECTIVES	INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
<b>3. Risk management</b> <b>3.1 Preparation of risk analysis methodology</b> - To incorporate new technology for better institutional risk control	- Decrease in probability of losses - Increase in returns - Timely recovery of portfolio	- Periodic reports on investment portfolio behavior and on IFI portfolio ratings - Accounting reports - Periodic internal auditing reports	- Strengthening of IFIs - Stability of the target sector for credit and investment - Selection of best available technology - Capitalize on experience of similar banks
<b>3.2 Design of risk management system</b> - To improve control of exposure levels	- Decrease of potential risk - Reduction of losses - Deterioration of assets is avoided - Decrease in finance charges	- Period internal auditing reports - Accounting reports - Periodic report on portfolio in arrears	- Operation with IFIs on selective basis - Flexible system allowing adjustment to future needs - Improvement in capitalization ratio - Sound financial structure promoted
<b>4. Organization and human resources</b> <b>4.1 Design of NAFIN's organisational structure</b> - To adjust NAFIN's organizational structure to its new activities and objectives	- Streamlining of hierarchy - Increased efficiency - Cost reduction - Assignment of decision-making authority - Streamlining of organizational structure	- Period reports from Human Resources Department - Periodic internal auditing reports - Periodic reports from Evaluation Department	- Commitment to the restructuring on the part of senior management - Staff with most experience and greatest capacity will be maintained
<b>4.2 Definition of functions and preparation of manuals</b> - To clearly set out the activities to be conducted, the responsibilities assigned to each department, and decision-making authority	- Elimination of errors - Elimination of duplication of efforts - Greater efficiency in implementation of activities	- Periodic report by internal auditing department - Opinion surveys	- Improvement in NAFIN's service image
<b>4.3 Preparation of a training plan</b> - To promote staff development and improvement	- Increased knowledge and skills for performance of duties	- Periodic evaluation of staff trained - Periodic evaluation of training programs	- Staff is interested in developing a career in NAFIN - NAFIN is strengthened
<b>4.4 Review of personnel policies</b> - To stimulate staff productivity	- Greater assumption of responsibilities - Greater efficiency on the job - Reduction of time needed for performance of duties	- Periodic evaluation of staff performance	- Staff increases productivity

**OPERATING REGULATIONS  
COMPONENT C**

**MULTISECTOR CREDIT**

**ARTICLE 1. Purpose of the program**

The purpose of the program is to promote the development and growth of microenterprises and small and medium-sized businesses in the private sector by providing medium-term and long-term financing for their investments.

**ARTICLE 2. General terms and conditions**

These Regulations set forth the terms and conditions that are to govern execution of the program, the financing for which will be provided in accordance with the contract for loan [ ]/OC-ME entered into by Nacional Financiera, SNC (NAFIN), as borrower and executing agency, and the Inter-American Development Bank (IDB).

**ARTICLE 3. Definitions**

The bolded terms below are to be defined as follows:

"CNEBV": National Banking and Securities Commission, or whatever institution may replace it.

"Connected parties": Persons as defined in Sections I through VII of Article 73 of the Law on Credit Institutions.

"Core capital": The basic part of the net worth of a financial institution, as defined in Annex I of CNEBV Circular 1186 of 9/17/93.

"Credit risk rating": The results of the analysis performed by eligible rating agencies, expressed as a category A, B, or C in accordance with the methodology agreed upon by NAFIN and the IDB.

"Credit regulations" or "Regulations": The Regulations set forth in this document.

"Credit line": The financing facility which NAFIN makes available to eligible IFIs, using program resources.

"Credit": Financing provided by NAFIN to eligible financial institutions, using program resources.

"Financial Group": Legal entity incorporated in accordance with the "Law on Financial Groups", operating in accordance with the "General Rules

for Incorporation and Operation of Financial Groups" and which is the owner of one or more financial institutions.

"IDB": Inter-American Development Bank.

"Intermediary financial institutions" or "IFIs": Commercial banks, financial leasing companies, factoring firms, and credit unions, legally incorporated in Mexico in accordance with the Law on Credit Institutions or the General Law on Credit Organizations and Auxiliary Credit Activities, respectively, of which a majority of the capital is held by individuals or legal entities in the private sector.

"Loan contract": The contract for loan \_\_\_\_\_/OC-ME, entered into by NAFIN and the IDB.

"Loan": Financing provided in accordance with the loan contract.

"NAFIN": Nacional Financiera, S.N.C.

"Net worth": Total equity of an institution, as defined in Annex I of CNEV Circular 1186 of 9/17/93 in the case of commercial banks, and in the respective circulars in the case of other financial institutions.

"Program": Multisector credit component of the corporate strengthening program, executed in accordance with these Regulations.

"Project": Set of activities financed by means of subloans.

"Rating agencies": Private, national or international firms that issue opinions on the credit standing of debt instruments issued by financial institutions.

"Rules and regulations": The set of guidelines and requirements set by NAFIN, with which IFIs must comply.

"SEMARNAP": Ministry of the Environment, Natural Resources, and Fisheries [Secretaría de Medio Ambiente, Recursos Naturales y Pesca].

"Strengthening program": Program for the corporate strengthening of financial institutions, financed by the loan.

"Subborrower": Individual or privately owned legal entity, legally incorporated in Mexico, granted program resources on a subloan basis, or which is a lessee of a capital good financed using program resources pursuant to a financial leasing contract.

"Subloan": Financing provided by eligible IFIs to subborrowers using program resources, including capital goods financed by means of financial leasing contracts.

**ARTICLE 4. Program resources**

The program resources will consist of the funds granted under the loan contract, the resources made available by NAFIN, and resources contracted by the respective IFIs, in accordance with the rules set forth in these Regulations, provided they do not originate from other IDB financing operations.

**ARTICLE 5. Eligibility of subborrowers**

Private sector firms will be eligible to obtain financing as subborrowers using program resources through eligible financial institutions, up to a maximum amount set by NAFIN, currently MexN\$65 million.

With the exception of credit unions, parties connected with a given IFI will not be eligible as subborrowers.

**ARTICLE 6. Use of program resources**

Program resources may be used to finance projects for the establishment, integration, expansion, or enhancement of industrial, commercial, or service-related activities, technological development and modernization, and the mitigation of adverse environmental impact. The projects financed must be feasible from the environmental, legal, and financial standpoints, in accordance with the evaluation performed by the respective IFI.

For a period of 12 months after the date on which the loan is approved, and provided the amount in question does not exceed the equivalent of US\$60 million, eligible projects may also involve restructuring the debt of viable eligible firms whose cash flow has been adversely affected by recent trends in macroeconomic variables.

IFIs may obtain program resources from NAFIN in the form of credit to pay for the services of rating agencies.

**ARTICLE 7. Restrictions on the use of program resources**

Program resources may not be used by subborrowers to finance:

- a. projects using technologies harmful to the environment;
- b. the manufacturing, sales, or export of weapons or other goods used in warfare;
- c. the settlement of debt, with the exceptions mentioned in the preceding article;
- d. reimbursements of expenses incurred, principal recoveries, or dividends;

- e. overheads or administrative expenses of subborrowers that are not associated with an investment project;
- f. purchase of shares or equity holdings in enterprises;
- g. the leasing and/or purchase of real estate, except that required for project execution purposes, in which case the local counterpart resources must be used; or
- h. taxes and other related assessments, excluding import tariffs and charges.

**ARTICLE 8. Restrictions on the use of loan proceeds**

The loan proceeds may not be used to finance the procurement of goods or services from countries that are not members of the IDB.

**ARTICLE 9. Eligibility of IFIs**

IFIs meeting the following criteria will be eligible to participate in the program:

**A. Banks, financial leasing companies, and factoring firms:**

- 1. The IFI must comply with the prudential rules and regulations set by the CNBV.
- 2. Its capitalization index must be at least eight percent.
- 3. The IFI's current portfolio with NAFIN may not exceed: (i) three times the net worth of the IFI if a rating has been obtained from a rating agency; or (ii) two times the net worth of the IFI if no such rating is available.
- 4. The IFI must have a credit risk rating (categories A or B) or fulfill the eligibility criteria for obtaining discount facilities (category C).

**B. Credit unions:**

- 1. The credit union's net worth must be at least 10 percent its total liabilities.
- 2. The maximum credit per subborrower may not exceed five percent of total portfolio.
- 3. The portfolio in arrears may not exceed the average for banks or the sector to which the type of intermediary institution in question belongs, whichever is lower.



**ARTICLE 10. Rating agencies**

Rating agencies will assign credit ratings in accordance with their evaluation standards to the participating IFIs that so request. The only eligible rating agencies will be those whose professional track record, evaluation principles, and experience meet internationally accepted standards, including with respect to the evaluation of IFI management. The ratings must consider the commercial risk of the IFIs, without taking into account any government assistance programs that may be in effect.

**ARTICLE 11. Risk ratings**

Eligible IFIs will be classified into one of three categories: A, B, or C, category A indicating the least risk and category C the highest risk. IFIs that have not been rated by an eligible rating agency will be automatically classified as category C.

The total amount of resources disbursed to category C IFIs may not exceed 15 percent of the program resources.

**ARTICLE 12. Obligations of financial institutions**

The IFIs will participate in the program in accordance with general agreements that will set forth general principles to govern the discounting and extension of credit in the case of banks, and, in the case of nonbanks, on the basis of credit contracts which NAFIN is currently signing with each IFI. These agreements will stipulate the requirements and obligations which the IFIs must fulfill with respect to NAFIN, including the following:

- a. Financial information on the program must be maintained and made available to NAFIN or the IDB on request, in such a way as to identify: (i) funds from the program and from local counterpart contributions, if applicable; (ii) the financial terms of the subloans; (iii) the status of the subloan portfolio; (iv) the origin of the goods and services financed; (v) additional information on subborrowers and any other information which NAFIN may require in order to monitor the program.
- b. Program auditors must be allowed access to all the information required for the above purpose and ex post evaluation of the operation.
- c. Annual financial statements audited by a firm of public accountants must be submitted, as must any other information reasonably requested by NAFIN or the IDB in order to monitor the financial performance of an IFI.
- d. In the case of activities requiring a certificate of environmental compliance issued by SEMARNAP in accordance with the rating given by

NAFIN to the IFIs, each subborrower must provide such a certificate prior to the first disbursement of the respective subloan.

- e. The IFIs will be responsible for any other applicable obligations set forth in these Regulations.

**ARTICLE 13. Credit lines**

In addition to the provisions of other articles in these Regulations, the agreement on the terms and conditions will stipulate the amount of the credit line which NAFIN will grant to each eligible IFI. The amount will be revised every six months in the case of nonbanking institutions and every 12 months in the case of banks, to reflect any changes in eligibility criteria, and may be amended by NAFIN whenever it deems it appropriate.

The fact that a credit line has been extended does not constitute a commitment by NAFIN to guarantee availability of resources. Requests for discounting will be processed to the extent that NAFIN's available resources permit. However, an IFI may explicitly stipulate the amount of funding that it will require, in which case NAFIN will charge a commitment fee.

**ARTICLE 14. Formalization of subloans**

The document formalizing a subloan must include:

- a. a commitment by the subborrower to the effect that goods and services financed through the subloan are to be used exclusively for execution of the respective project;
- b. the right of NAFIN, the IDB, and the respective IFI to examine the assets and goods, locations, and activities of each project;
- c. the obligation on the part of the subborrower to provide any information requested by NAFIN in connection with a project and its financial status; and
- d. the right of the IFI to suspend disbursements and/or to demand prepayment of a subloan if the subborrower fails to comply with the terms of these Regulations.

**ARTICLE 15. Terms and conditions of credits and subloans**

**a. Denomination**

Credits and subloans will be denominated in dollars of the United States of America, provided the enterprise in question generates net foreign exchange or quotes its goods at international prices.

b. Terms

The amortization and grace periods for subloans will be freely negotiated by the IFIs and subborrowers, as will the terms applicable to credits. However, the minimum period of time for the first due date may not be less than one year, and the maximum period for the final due date may not exceed 15 years. NAFIN may shorten the maximum period in order to ensure that portfolio maturities are consistent with loan maturities.

c. Interest rates applicable to credits

Interest rates will be based on market trends and will consist of a base rate, an IFI risk margin, and a term margin.

d. Interest rates applicable to subloans

Interest rates on subloans will be freely negotiated by the IFIs and subborrowers.

e. Fees

NAFIN will charge each IFI a commitment fee of 0.75 percent per annum on amounts reserved at the specific request of a subborrower but not disbursed.

In the case of fixed-rate credits, NAFIN will charge a prepayment fee in the amount of ... percent on amounts paid by an IFI prior to the originally agreed-upon maturity.

f. Disbursements and documentation

The program will use the system of automatic discounting, rapid discounting, and optional discounting, in accordance with the various levels of eligibility prescribed in NAFIN regulations and in accordance with the operating mechanisms for the discounting of credits.

**ARTICLE 16. The environment**

NAFIN will conduct periodic environmental assessments of the operation by analyzing a sample that is statistically significant and representative of the various types of subborrower firms. On the basis of the results thus obtained, NAFIN will make any appropriate adjustments at yearly intervals.

**ARTICLE 17. Supervision**

Subloans granted using resources obtained from this program will be closely monitored by NAFIN to verify that IFIs and subborrowers are complying with these Regulations.

Supervision will be exercised in accordance with applicable NAFIN rules and regulations and on the basis of samples of projects financed. The IFIs will be required to take all the necessary steps to cooperate with such supervision.

**ARTICLE 18. Penalties**

NAFIN may suspend disbursements and/or demand prepayment of a subloan if an IFI fails to comply with the terms of these Regulations.

**ARTICLE 19. Amendments to the Regulations**

NAFIN may propose amendments to these Regulations to make them more closely reflect such new circumstances as may arise during program execution. Amendments to these Regulations will take effect once the IDB has issued a statement of nonobjection.

For the purposes of this program, such amendments as NAFIN may make to the rules and regulations referred to in the Regulations will take effect once a statement of nonobjection has been received from the IDB.

PROPOSED RESOLUTION

MEXICO. LOAN \_\_\_\_/OC-ME TO NACIONAL FINANCIERA, S.N.C. (NAFIN)  
CORPORATE STRENGTHENING OF FINANCIAL INSTITUTIONS PROGRAM

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 Estados Unidos Mexicanos, as Guarantor, for the purpose of granting it a financing to cooperate in the execution of a Corporate Strengthening of Financial Institutions Program. Such financing will be for the amount of up to US\$250,000,000, or its equivalent in other currencies, except that of Mexico, which are part of the Ordinary Capital resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" of the Executive Summary of the Loan Proposal. Up to US\$100,000,000 of the proceeds of the loan shall be financed under the modalities indicated in Document FN-483-3, "Proposal for the Establishment of a U.S. Dollar Window", approved by the Board of Executive Directors on May 11, 1994.