

# The Banking Sector Rescue in Mexico

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**T**HE DEVALUATION OF THE MEXICAN PESO IN DECEMBER 1994 PROVOKED A PROFOUND ECONOMIC DOWNTURN AND REVEALED A FRAGILE BANKING SECTOR. ALTHOUGH MEXICO HAD ALREADY LIBERALIZED MANY PARTS OF THE ECONOMY AND PRIVATIZED STATE-RUN BANKS, MANY BANKS STILL HAD LAX MANAGEMENT, AND ALL BANKS OPERATED WITHIN A WEAK ACCOUNTING AND SUPERVISORY ENVIRONMENT. FEARFUL THAT THE FINANCIAL SYSTEM WOULD COLLAPSE UNDER A RISING LEVEL OF PAST DUE LOANS, THE MEXICAN GOVERNMENT MOUNTED A RESCUE OF THE BANKING SECTOR THAT INCLUDED INTERVENING IN THE DAILY OPERATIONS OF SOME PROBLEM BANKS WHILE ESTABLISHING A SERIES OF CAPITALIZATION AND RESTRUCTURING PROGRAMS AVAILABLE TO ALL BANKS.

The banking sector's problems were not quickly surmountable. Immediate government intervention helped shore up the system and began improving bank balance sheets, but past due loans remained at high levels and credit provision remained low. The continued poor performance of some banks compelled authorities to expand their systemic restructuring efforts through new interventions and the forced sale of some banks. Resolution of the bank rescue was further complicated by the fact that Mexico was also undergoing political liberalization. The governing Institutional Revolutionary Party (PRI) lost its long-time control of Congress in 1997, forcing it to seek the approval of opposition parties for new legislation.

These bank rescue programs carried huge financial costs. By early 1998, the price tag for the bank rescue efforts, which took four years to complete, had risen to \$55 billion, equal to around 15 percent of 1997 gross domestic product (GDP).<sup>1</sup>

This article examines Mexico's bank rescue efforts (1995–98) with a particular focus on the role of the deposit insurance fund, the Bank Fund for the Protection of Savings (FOBAPROA) and shows how the rescue was successful in stabilizing the banking sector but failed to revitalize it as the nation's financial intermediary. In terms of evaluating the bank restructuring efforts, this article uses the definition provided by Dziobek and Pazarbasioglu (1997). They define the goal of restructuring efforts as twofold: "to restore the financial viability of the banking system (restore solvency and sustainable profitability); and to restore the system's intermediation capacity and an appropriate level of banking services relative to aggregate economic activity" (1997, 7). The article also attempts to place the overall rescue effort within a larger context by looking at its economic and political consequences.

The article first provides a short background discussion of important developments in the Mexican

banking sector in recent years and then describes the peso crisis and its consequences for domestic banks. The next section describes the different programs instituted by the Mexican government to prevent a systemwide collapse of the banking sector. This discussion is followed by an analysis of the impact of the banking sector rescue on Mexico's democratizing political system. The last section attempts to evaluate the bank rescue in Mexico by looking at bank performance indicators and by comparing the Mexican case with similar experiences in other countries.

The Mexican Congress commissioned an independent audit of the governmental bank rescue as part of the compromise legislation that brought the bank bailout to a formal close in December 1998. The audit, known as the Mackey Report, is both an evaluation of government efforts as well as the first publicly available institutional history of the bank rescue. The findings of the Mackey Report are cited throughout.

### Background Developments

Facing an incipient debt crisis, Mexican President José López Portillo nationalized the banks in 1982 in an attempt to assert the government's ability to control the direction of the financial system. Although policy there had favored domestic over foreign capital in the banking sector since the 1940s, many politicians at the time of nationalism now feared that private financial interests were becoming too powerful. The nationalization decree brought fifty-eight banks under the umbrella of the state and enshrined the concept of state-owned banks in the Mexican constitution. Only two banks were spared nationalization: a branch of the U.S.-based Citibank (the only foreign bank operating in Mexico at the time) and the union-owned Banco Obrero (Welch and Gruben 1993).

This policy direction was short-lived, however, as the next administration began to liberalize Mexican financial markets shortly after the banks had been nationalized. Not surprisingly, nationalization of the banks was not well received by domestic or international capital markets, and leaders were faced with the challenge of revitalizing the economy after the debt crisis. According to Maxfield (1997), the next generation of Mexican presidents understood "that sustained economic recovery from the nation's fiscal and balance-of-payments crisis would require reestablishing Mexico's investment and creditworthiness" (95–96).

Over the course of the next four-year period, policy mechanisms were put in place that paved the way for liberalization of the banking sector. Exchange controls

were removed, many nonbanking components of the banks such as insurance companies and brokerage houses were sold back to the private sector, and the provision of credit by state-owned development banks was curtailed (Maxfield 1997).

Nevertheless, the banks remained under government control for a decade. During this period, government ownership was complicated by the fact that many institutions were not healthy when they were nationalized, and the poor performance of the Mexican economy during the 1980s never permitted any real improvement. Low oil prices, high debt service payments, rising inflation, and financial repression by political authorities kept the banks from becoming effective financial intermediaries. By 1988 when Carlos Salinas de Gortari took office as president, the government was poised to get out of the banking business. Salinas, a U.S.-trained technocrat and an ardent supporter of economic liberalization, was eager to follow the same liberalizing policies set in motion by President Miguel de la Madrid. Almost immediately, Salinas began to lay the legal framework for returning the banks to private hands and also worked to open up the financial sector to foreign participation (Gruben and McComb 1993; Maxfield 1997).

Mexico privatized the remaining eighteen banks in 1991 and 1992, and the actual process took less than a year and a half as a sale was held approximately every three weeks. The banks brought in an average of more than three times their book value and nearly fifteen times the previous year's earnings, for a total of more than \$12 billion ("Mexico" 1993; Gruben and McComb 1993). At the time, the privatization process was considered a success for the government in its efforts to reorder the Mexican economy and was hailed as being efficient, transparent, and lucrative ("Mexico" 1993). Over time, however, the manner in which the banks were privatized has undergone considerable scrutiny, often being blamed for setting the stage for subsequent problems in the sector. The Mackey Report cited the "price maximization" focus of privatization as an "underlying cause of the banking crisis" (1999, 179).

**Immediate government intervention helped shore up the system and began improving bank balance sheets, but past due loans remained at high levels, and credit provision remained low.**

1. Using government data from June 30, 1998, Mackey estimated the cost to be nearly \$64 billion (1999). Peso figures are calculated in dollar terms using the exchange rate on December 31, 1998 (U.S.\$1:9.9 Mexican new pesos).

Analysts have argued that the high prices paid for the banks probably meant that the new owners had expectations of operating in an environment of restrained competition, which would allow them to recoup their large investments (Gruben and McComb 1993). The study by Rojas (1997) of Mexico's postprivatization banking sector reached similar conclusions. Rather than the increase in competition that would normally be expected to take place among the newly privatized banks, there was only a small increase in competition in the credit market compared with the period when banks were owned by the government. Competition for deposits, on the other hand, fell sharply over the same period. Rojas concludes that these data "suggest a tendency toward tacit collusion, which would allow Mexican banks to increase profits at the expense of a smaller surplus of banking customers and of an oligopolistic distortion in the financial intermediation process" (1997, 71).

Even though competition among banks did not heat up the banking sector as would be expected in the period after privatization, credit was being offered on a broader basis. Domestic commercial bank lending to the private sector grew at an annual rate of 25 percent between late 1988 and late 1994. Mortgage loans increased 47 percent per year, direct store credit for consumer durable goods ballooned by an annual rate of 67 percent, and credit card liabilities grew at a yearly rate of more than 30 percent (Gil-Diaz 1998). "[B]anks actually lent so much that they passed the point that marginal cost exceeded marginal revenue. . . . [T]here was much evidence to suggest banks began to expand consumer credit despite limited information on the creditworthiness of the borrowers" (Gruben and McComb 1993, 25). Banks also overlooked some regulations and "did not devote enough attention to minimizing the problems of asymmetric information that were inherent in the market" (Gavito and others 1998, 97).

There were other indications that potential problems were developing in the sector. In a February 1993 survey on Mexico, the *Economist* alerted readers that the potential problems facing the financial sector included an expansive growth rate in credit allocation, problems associated with high interest rates and currency risk, and rising past due loans. The article also noted that one analyst had forecast a banking crisis within eighteen months (*Economist* 1993).

Why then were these problems not mitigated or resolved in a timelier manner? Much of the explanation seems to lie in the quality and extent of the regulatory apparatus. While Mexican authorities had designated parts of its financial apparatus to overseeing the recently privatized banks, hindsight shows that the agencies were unprepared and resources were insufficient for the magnitude of the problems. Different interpreta-

tions of core regulatory requirements in Mexico, compared with international standards, provided another reason that potential problems were undetected or poorly understood. The Mackey Report faults the definition of capital used by banking authorities in determining capital adequacy, asserting that it "may significantly overstate the quality and quantity of the capital of Mexican banks" (1999, 129).

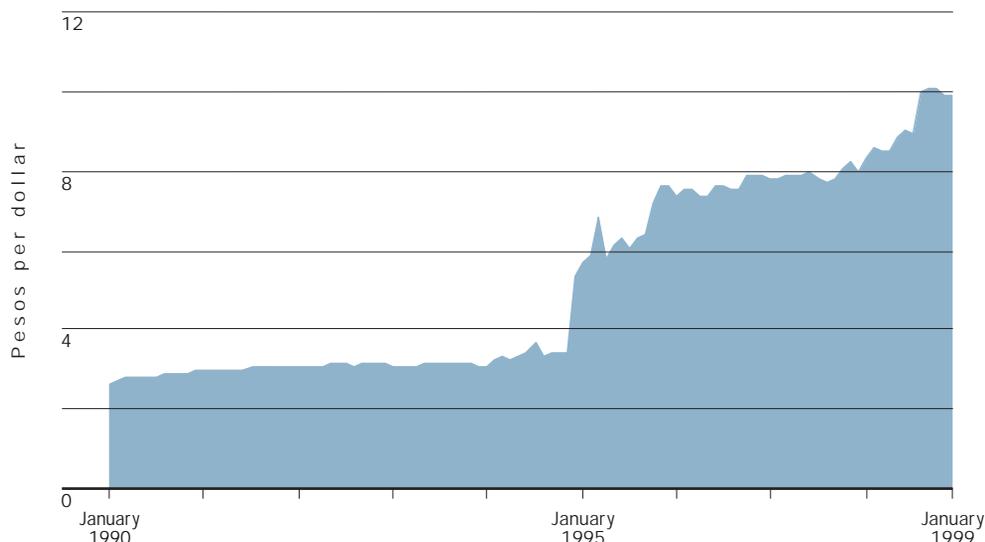
### Banks and the December 1994 Peso Crisis

Although competition in the sector was probably greater than the new bank owners expected, Mexico's newly privatized banks did have the luxury of operating in an environment of foreign exchange stability. Since 1991, Mexican monetary policy had maintained a managed exchange rate that was set on a slow depreciation schedule. Chart 1 demonstrates this period of currency stability in the first part of the decade and its abrupt end in 1994. This stability began to erode in March 1994 when the peso first came under pressure, and monetary authorities intervened to prop up the exchange rate as it reached the upper limit of the currency band. These interventions hedged against a more rapid decline in the currency's value, but they were unsuccessful in deterring further pressure. Managing the foreign exchange rate also meant costly declines in international reserves, which fell by almost 80 percent in 1994, dropping sharply from \$29 billion in February to only \$6 billion in December.

The exchange rate pressures in March followed the assassination of PRI presidential candidate Luis Donaldo Colosio earlier that month. The peso continuously depreciated over the course of 1994, and in December the government allowed the peso to float because it was no longer able to prop up the exchange rate. The value of the currency fell by more than half in the three-month period between December 1994 and March 1995.

While the direct impact of the devaluation on bank balance sheets was minimal because Mexican regulations limit banks' foreign currency exposure, the indirect consequences were considerable. A study by the Organisation for Economic Cooperation and Development highlighted three important impacts: the drop in economic activity, rising interest rates, and the immediate demand for dollars (1995). Economic activity plummeted in 1995; real (inflation-adjusted) GDP growth dropped to -6.2 percent from a positive 4.4 percent growth rate in 1994. The official unemployment rate doubled to 7.6 percent in the first eight months of the year. The fall in economic activity was devastating for the banks as the value of depositors' peso holdings was slashed in dollar terms and many borrowers lost their jobs, leaving them unable to repay their loans.

The hike in interest rates further impinged on borrowers' ability to meet their obligations. Although the



Source: Haver Analytics

prime lending rate was almost 17 percent at the end of 1994, it rose to 58 percent by the middle of 1995 and did not drop below 20 percent again until the second quarter of 1997. Along with the economic decline, the high interest rates caused a huge increase in past due loans and made borrowing prohibitive, reducing banks' ability to earn interest income. The other main impact was rising demand for dollars. As foreign lenders were generally unwilling to roll over dollar-denominated debts, Mexican borrowers had an acute need for dollars to repay their loans. The Banco de México, the country's central bank, had to temporarily make dollars available to commercial institutions so that they and their clients could repay foreign obligations. The devaluation also brought about a sharp rise in the peso value of dollar-linked debts.

### Rising Past Due Loans

The previous sections show that even though the effects of the peso devaluation dealt a crippling blow to the banking sector, much of the deterioration in the banking sector after the devaluation had its origin in developments that had occurred before. Thus, rather than being a catalyst, the devaluation was more of a final, crippling blow to many institutions in the Mexican banking sector.

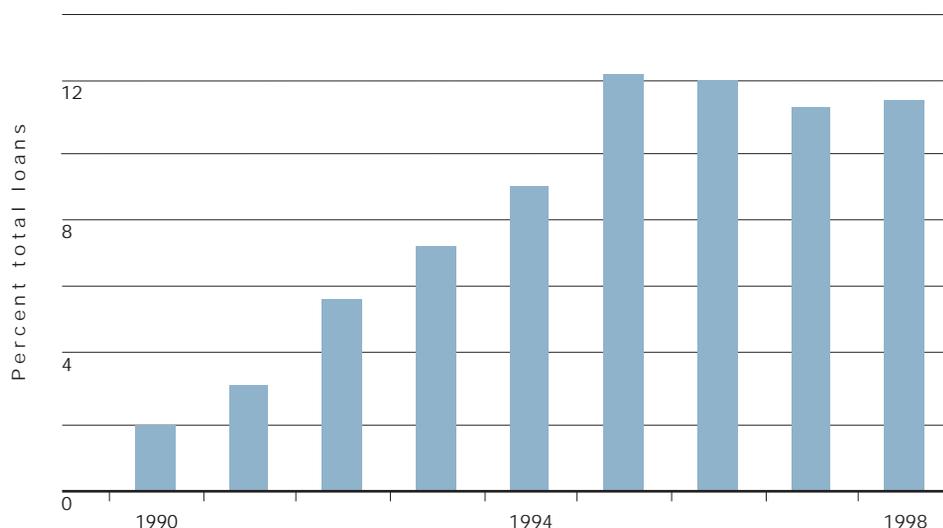
Chart 2, which shows the incidence of past due loans in the Mexican banking sector, reveals that there

were clear signs of strain before foreign exchange pressures appeared. Nonperforming loans were already high in 1993 when they constituted 7.3 percent of all loans, before rising to 9 percent by the end of 1994.<sup>2</sup> Economic growth did slow considerably from 5.1 percent in 1990 to 2.0 percent in 1993, but the decline was gradual and the Mexican economy was not considered to be experiencing a crisis. In 1994 the economy picked up again with 4.4 percent real GDP growth, but past due loans increased nonetheless.

This pattern strongly suggests that the practice of lending in order to increase market share had extended credit too broadly. After the devaluation, the inability of many clients to repay loans meant that banks did not have sufficient capital to cover losses. This situation left many banks insolvent. The Mackey Report asserts that the entire banking system was undercapitalized at the time of the peso crisis (1999). By the end of 1995, the first full year after the peso crisis, past due loans had jumped even further to 12.3 percent and real GDP growth had dropped sharply.

These data suggest a relative disjunction between problems in the banking sector and the situation in the real economy, showing that past due loans were already high before the peso crisis, when growth was positive although declining. The deep problems with past due loans were even more visible in the 1996–98 period when economic growth picked up again but past due

2. Subsequent revisions to loan-classification guidelines strongly suggest that nonperforming loans were substantially underestimated during this period. See the section on "Preventing Systemic Risk" for a discussion of the new reporting methodology.



Source: Mexican National Banking and Securities Commission

loans continued at high levels: growth resumed to 5.1 percent, 6.7 percent, and 4.8 percent respectively. Even so, past due loans remained above 11 percent from 1996 through 1998.<sup>3</sup>

Less stringent regulatory standards also played an important role in the banking sector's problems. Gruben and McComb (1993) outline several factors that may have contributed to the sector's fragility when the peso crisis occurred. These include the lack of a strong credit culture capable of effectively identifying and rejecting risky borrowers, problems associated with universal banking, and loose banking regulations for past due loans. Mexican banking regulations may also have contributed to a weak banking environment in that they "do not impose upon shareholders the consequences of their banks' behavior as fully as do those of the United States" (1993, 26).

The absence of a credit culture with strong checks and balances may be largely due to the fact that prior to the 1990s banks were either owned by the government, in which case they facilitated national developmental needs, or were held in private hands but operated in a weakly competitive environment. This culture did little to encourage the use of sound credit history as lending criteria.

The universal banking structure, which allows institutions to operate a range of financial services in addition to banking, may have contributed to the sector's problems because it sometimes makes it difficult to discern the extent of self-lending among the different parts of an organization. Only in 1995 were financial groups required to present consolidated financial reports in

order to make it easier to see linkages and money flows among related entities. Although some regulations existed, bank supervision was weak and ineffective before the Mexican National Banking and Securities Commission (CNBV) was established in May 1995 by fusing two pre-existing agencies. While these omissions may have been regulatory failures, weak supervision and regulation may be a consequence of state control of banks during the period when financial groups and conglomerates were taking shape. The state had little incentive to supervise itself and obviously was not concerned with the notion of self-lending.

The Mackey Report highlights weaknesses in supervision and regulation as an important factor in causing the sector's problems: "The weak supervisory environment in which both the new and privatized banks found themselves, coupled with the implicit guarantee given by the government that all liabilities, including deposit liabilities, would be met, gave the banks the opportunity, and possibly the incentive, for excessive risk taking and removed the incentive to put in place proper management structures. The regulatory authorities have agreed that, in hindsight, the privatization process should have been conducted in a more prudent manner" (1999, 96).

### Preventing Systemic Risk

The December 1994 devaluation pressed Mexican banking authorities into new roles. Very shortly after the foreign exchange crisis, the government began to implement a series of recapitalization and debtor rescue programs to shore up the fragile banking sector. Despite this early action, the absence of an

established regulatory oversight agency made it virtually impossible for authorities to fully discern the breadth of the crisis. In fact, the magnitude and implications of problems only appeared to increase upon deeper investigation, leading authorities to adopt an incrementalist approach by launching new support programs and improved regulatory measures as new problems arose. This section describes the most salient of these efforts.<sup>4</sup>

Government officials have stated that they were fully aware of the dangers presented by a meltdown in the banking sector. One participant in setting up the rescue later wrote that “the authorities had to act promptly to provide liquidity and maintain the integrity of the banking system; otherwise, deterioration of the system’s financial situation (or some of its segments) could have spread quickly to the business sector” (Gavito and others 1998, 98). A government document clearly describes the imperative for action: “The decision was made with the objective of preventing the grave consequences that the breakdown of the banking system would have had for all Mexicans” (Fondo Bancario 1998b, 2).

The Mexican banking system was unaccustomed to high levels of nonperforming loans. A World Bank study estimated that past due loans as a percentage of total loans were very low during the 1980s—never rising above 2.9 percent (Morris and others 1990).<sup>5</sup> Although the study also asserts that this figure probably underestimates past due loans during this period, past due loan levels above 10 percent after the peso crisis would certainly have been considered shockingly high. Nevertheless, as will be seen later, the jump in the share of past due loans to 12.3 percent between 1994 and 1995 may not have fully demonstrated the extent of the sector’s problems.

Responding to this environment, the Mexican government established a series of specialized stabilization and restructuring programs. Two principal programs were designed to help banks increase the asset side of the balance sheet in the face of rising past due loans. The Temporary Capitalization Program (PROCAPTE) was targeted to help banks increase their capital-to-assets ratio above 8 percent. Some banks already met this requirement but others did not. PROCAPTE allowed banks needing additional capital to issue five-year convertible bonds, which were purchased by FOBAPROA. Participating banks agreed to surrender their institution to banking authorities if they were unable to convert their debt into equity capital. The

program had strong incentives for banks to increase their capital to 8 percent because they were being charged higher interbank interest rates and were prohibited from issuing other subordinated debt until they exited the program.

Thus, PROCAPTE became a short-term program with strong incentives for participating institutions to act expeditiously to improve their capital ratios. Nevertheless, the program did not fully function as intended. “The market considered participation as a sign of weakness or as a prelude to intervention. . . . Because of the negative public perception [of PROCAPTE], banks attempted to avoid participation by increasing their capital on their own. However, many banks were unable to raise capital during this period. As a result, additional measures were required following PROCAPTE” (Mackey 1999, 191).

The second program was the Loan Purchase and Recapitalization Plan, which exchanged delinquent loans held by banks for government-issued bonds. The program is often referred to as FOBAPROA, after Fondo Bancario de Protección al Ahorro, the deposit insurance agency that administered it (see the box). The basic purpose of the program was to clean up bank balance sheets and improve asset quality at virtually no immediate cost to the government. The bonds issued to the banks were ten-year, zero-coupon bonds. Interest payments, based on domestic treasury rates, were payable at maturity. As a condition of this program, bank shareholders injected one peso of new capital into the bank for every two pesos of bad loans transferred to the FOBAPROA trust. Banks were also required to set aside reserves valued at around 25 percent of the total debt transferred, but they could not profit from the transaction because the bonds were not tradable.

The Mackey Report concluded that the Loan Purchase and Recapitalization Program had mixed results. The scope of the program was not sufficient for the system’s capitalization needs, necessitating the inclusion

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3. *The return to growth in the Mexican economy is unusual in comparative terms. In a review of banking crises in more than 200 countries, Caprio (1997) found that countries that have a banking crisis tend to experience a growth slowdown in the years following insolvency.*

4. *Some material in this section was adapted from McQuerry and Espinosa (1998).*

5. *The World Bank study covers only the 1980–87 period. Some of the bank indicators are from World Bank staff estimates.*

FOBAPROA was created in 1990 as part of the Credit Institutions Law governing the legal framework for Mexico's new universal banking structure. Its funding comes from fees levied on commercial banks as well as monies from the central bank. The central bank also administers funds under the control of FOBAPROA. The entity is still governed by a committee of representatives from the Finance Ministry, the Bank of Mexico, and the CNBV. As a deposit guarantee agency, FOBAPROA differs from its U.S. counterpart, the Federal Deposit Insurance Corporation (FDIC), in that deposits are insured to 100 percent of their value, regardless of ownership or size of the account. The FDIC guarantees only \$100,000 per

depositor in an individual institution. Although Mexican law does not guarantee full deposit insurance, 100 percent coverage of deposits had been an implicit and established practice of the Mexican government (Mackey 1999).

The original purpose of FOBAPROA was for it to act preventively, addressing potential problems in commercial banks. FOBAPROA's mandate was broadened in 1996 beyond deposit insurance responsibilities to make it a bank rescue agency (Mackey 1999). Later these responsibilities were expanded further to include government intervention of individual banks as well as the resale of assets, much as the Resolution Trust Corporation (RTC) did during the U.S. savings and loans debacle.

of additional resources. Also, some modifications had to be made because banks were unable to meet some of the program's reporting requirements. Mackey also concluded that the supervision of the program was "adequate" but that the results were uneven. "For five of the twelve banks that participated in this program the level of additional capitalization was sufficient, while the remaining seven banks have continued to require additional reserves and capital, with the net result being that the effectiveness of the program was limited" (1999, 195).

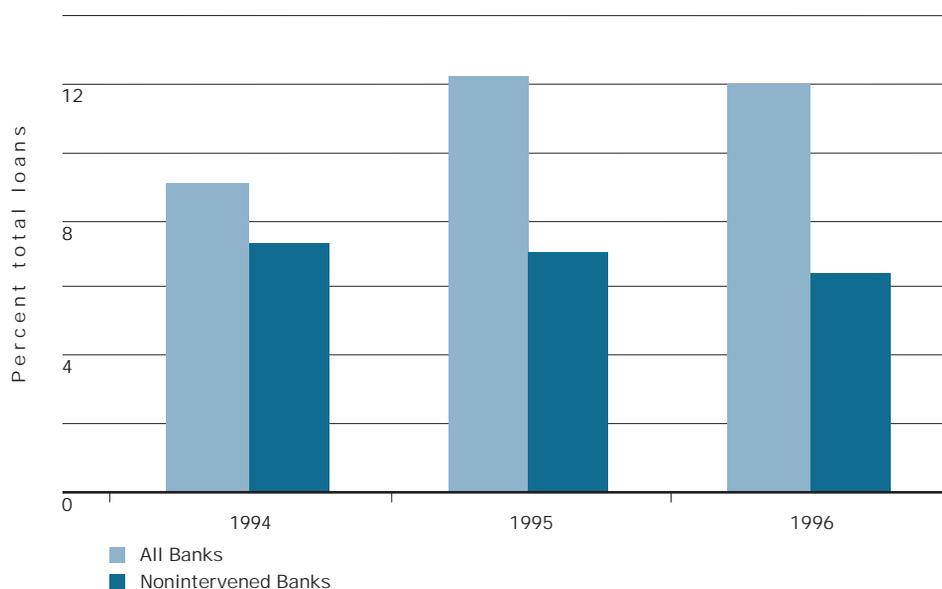
These limitations were reflected in the fact that past due loans continued to increase even as bad loans were taken off bank balance sheets. Chart 3 shows past due loans in the two-tiered format used by CNBV banking authorities through the end of 1997. The first category, system totals, represented the share of past due loans in the entire banking system. The category of nonintervened banks reported them only in those institutions in which the government had not intervened and not taken over day-to-day operations. The data in Chart 3 shows an increasing concentration of bad loans in the banks that had been intervened, providing additional impetus for continuation of the bank rescue. Although CNBV data did not provide a breakdown for past due loans in the intervened banks, the figure should be similar to the difference between past due loans for the entire banking system and that of the non-intervened banks. Initially, in 1994, the difference between the two categories was only 1.7 percentage points. Calculating this figure shows that roughly 19 percent of all delinquent loans was held by the intervened banks. By 1995 and 1996, however, the difference between the two categories had grown to 5.2 and 5.6

percentage points, roughly equivalent to 42 and 46 percent of all past due loans.

In January 1997, the CNBV changed its reporting methodology as it required banks to adopt new accounting practices. The new system, which reported past due loans only on a system-total basis, was another effort by Mexican authorities to enhance the performance and respectability of the sector. In requiring that domestic banks use a variant of the generally accepted accounting principles (GAAP), the globally recognized accounting standard, banking authorities imposed a much greater degree of disclosure on banks, made their balance sheets more directly comparable with banks in other countries, and improved reporting of nonperforming loans.

The new rules highlight how nonperforming loans went underreported in the old system. Under the new measures, known as Mexican GAAP, the value of a past due loan is reported as the total unpaid balance of the loan. Under the old accounting system, only missed payments were entered as past due and the outstanding balance could still accrue interest. Also, under Mexican GAAP, the outstanding balance is considered past due after a set number of payments (varying by type of loan) is missed. In this way, the new rules greatly expanded the scope of the past due loan category.

A factor tending to reduce delinquency rates in past due loan portfolios was the series of debtor relief programs offered by the government that focus on the specific needs of borrowers, in contrast to the bank rescue programs that sought to support the needs of the banking institutions. These programs included protection for borrowers against interest rates rising above a certain level depending on the type of loan as well as



Source: Mexican National Banking and Securities Commission

restructuring loans so that borrowers would pay larger interest and principal payments later, when the economy was assumed to have recovered. Other programs specifically targeted mortgage holders, agricultural borrowers, and small and medium-sized business. These programs were successful in preventing even larger increases in banks' past due portfolios even though they may not have been the most effective channel to benefit the debtors themselves (Mackey 1999).

### Mexico's New Debt Politics

Just as the devaluation had spilled over into a fragile banking sector, Mexico's political system was also affected by the tensions spawned by the banking sector rescue. While costs of the bank rescue mounted, uncertainty also grew over their financing, and much anticipation and speculation preceded the government's March 1998 announcement of a plan to assign these costs. However, rather than any sense of collective relief, a political uproar resulted when the Zedillo administration proposed that the costs of bank restructuring be incorporated as national debt. The controversy was all the more noteworthy because, for the first time in modern Mexican history, the political opposition mounted an effective legislative rebellion against the ruling PRI. This section reviews the government's proposal, details the costs associated with the FOBAPROA program, and attempts to explain how the proposal became such a contentious political issue. These details not only provide further insight into the

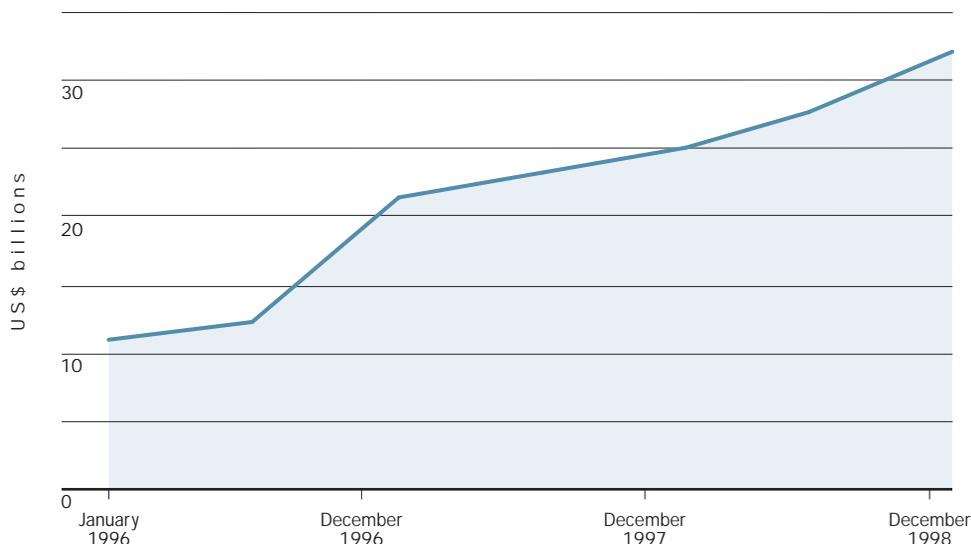
Mexican experience with banking sector restructuring but also provide perspective for countries facing similar dilemmas.

The financial sector reform measures sent to the Mexican Congress by the Zedillo administration aimed to strengthen the soundness and supervision of the banking system as well as to finalize the governmental rescue of the banking sector by formally transferring assets in the FOBAPROA fund to public debt of the federal government. The package also sought to consolidate supervision and regulation responsibilities by granting autonomy to the CNBV and moving it from the jurisdiction of the finance ministry to the Bank of Mexico. Another key measure intended to strengthen the banking sector sought to eliminate most restrictions on foreign investment in the banking system, allowing the country's largest banks to form partnerships with foreign banks.

Finally, the package sought to formally dissolve FOBAPROA and create two new institutions to carry out its primary functions. An entity called the Asset Recovery Commission (COREBI) would resell assets acquired by FOBAPROA, and the Deposit Guarantee Fund (FOGADE) would replace FOBAPROA as the nation's deposit guarantee agency and reduce the amount covered by governmental guarantee (Fondo Bancario 1998c; 1998d).

While the Zedillo administration package contained a wide-ranging set of reform measures, the single point about granting the president the authority to

## CHART 4 Funds Transferred to FOBAPROA



Source: Bank of Mexico, "Financiamiento Canalizado por la Banca Comercial al Sector no Bancario"; compiled from data available online at [http://www.banxico.org.mx/public\\_html/fmi/finbc/fbmenu.html](http://www.banxico.org.mx/public_html/fmi/finbc/fbmenu.html)

assume liabilities held by FOBAPROA as public debt was by far the most controversial. Granting this authority required changing the General Law of Public Debt to give the executive office the right to grant guarantees, which can be assumed as public debt. Many Mexicans objected to this proposal given that per capita income had fallen by more than 20 percent in Mexico in the three years after the peso crisis. In addition, the class of debtors who had attempted to make payments on their loans, largely by keeping current with the enlarged interest expense, felt punished because their debts were not included in the Zedillo administration's proposal to forgive unrecoverable loans and absorb them as national debt. In general, borrowers with current loans had not been transferred to FOBAPROA because they were not considered delinquent.

What made this proposal controversial enough to deadlock the Congress for nearly nine months? Two primary reasons can be identified, one economic and the other political. First, the sheer cost of the banking sector rescue made this issue a thorny political question. By asking for a change in the General Law of Public Debt, President Zedillo was effectively asking for the transfer of \$55 billion in private debt to the stock of public debt. This proposal raised complicated legal questions. In some ways, the proposal is misleading because debts held by FOBAPROA were effectively already public debt because they were in public hands. The government bank rescue was predicated on the notion of transferring troublesome loans from bank balance sheets to government custody, which carried an

implicit guarantee of payment and was considered a contingent government liability. Opponents of the measure point out that the president did not have the authority to assume public debt in Mexico. Also, the government had not explicitly stated an intention to absorb these loans as public debt.

Political factors also made the proposals highly controversial. The political-legislative climate was in transition from a long period of PRI dominance to a multiparty environment. These changes brought an increase in contestation, as well as a greater expectation of transparency to Mexican politics. Before entering a discussion of the delicate political questions surrounding the resolution of FOBAPROA liabilities, the next section contains a breakdown of the bank rescue costs.

**Composition of FOBAPROA Debts.** Chart 4 traces the growth in the value of FOBAPROA's portfolio from the beginning of 1996 through year-end 1998. During this period, the face value of assets transferred into the fund grew from \$11 billion to \$32 billion. The price tag commonly attached to FOBAPROA is, however, much more than the amount of loans shown here. Depending on the foreign exchange rate used to estimate the costs, the total cost of the bank rescue ranged between \$55 billion and \$65 billion at the end of 1998.

Chart 5 outlines the four main cost components of the banking sector rescue as of February 1998, based on figures derived from documents presented to the Mexican Congress by the Zedillo administration. The largest part of the rescue was the net cost of FOBAPROA bonds, estimated at nearly \$34 billion. This figure is cal-

culated from the difference between the fund's liabilities (\$55.8 billion) and estimated value of its assets (\$22.1). Among its assets, FOBAPROA holds a mix of shares of intervened banks, cash received for banks sold, and fixed assets like real estate, all of which have differing expected recovery values (García-Cantera, Burbridge, and Juárez 1998).

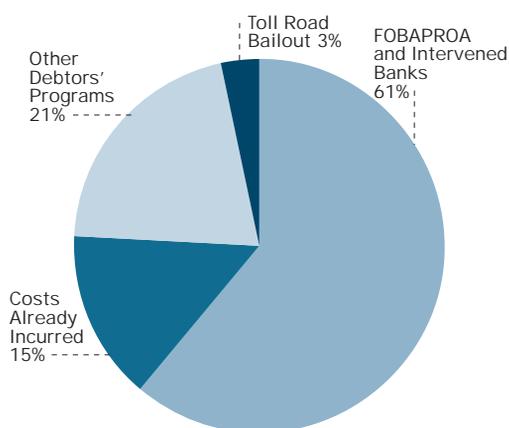
The other components were costs incurred in carrying out the debtor rescue programs (\$11 billion) mentioned in the section on preventing systemic risk, costs already realized (\$8 billion), and the governmental rescue of the toll roads (almost \$2 billion). The Zedillo administration proposal asked Congress to transfer the entire cost of the bank rescue to public debt, not just the loans transferred to FOBAPROA.

The government hoped to reduce the program's final cost by selling some of the assets under the control of FOBAPROA in a secondary market. The government had set up an institution similar to the Resolution Trust Corporation called the Asset Valuation and Sales (VVA) agency. By selling the loan-servicing rights and the confiscated collateral to domestic and foreign investors, both the government and the banks would be relieved of the burden of debt collection as well as some portion of the debt. In the case of the banks, they would not have the potential liability of a write-off if the loans were fully unrecoverable. The government would also benefit from supporting the creation of a secondary market for the resale of assets, which had not previously existed. While the effort ultimately had only short-term success, establishment of the VVA signaled the government's intention to apply a market logic to this aspect of the bank bailout.

The VVA's first auction, containing some of the higher-quality loans in the portfolio, recouped an impressive 49 percent of face value. This amount was significantly above the government estimate of an average recovery of 30 percent of face value. However, other auctions were postponed for lack of bidders, and in August 1997, shortly after the program became fully operational, the government quietly folded the asset resale organization into FOBAPROA after the VVA director unexpectedly resigned ("False Start?" 1997; Brothers 1997).

How does the cost of Mexico's bank rescue compare with efforts of other countries? By any standard, the \$55 billion price tag attached to Mexico's bailout of the banks is considerable. However, even at 15 percent of GDP, Mexico's rescue is not among the costliest in Latin America. The fiscal costs of the 1980–82 rescue in Argentina totaled 55 percent of GDP, Chile's 1981–83 crisis represented 41 percent of GDP, and Uruguay's 1981–84 problems totaled 31 percent of GDP (Caprio and Klingebiel 1996, cited in Stiglitz 1998). Similarly, in terms of the absolute value of bad loans, Mexico's \$32 billion is not among the highest in the region. Argentina

CHART 5  
Breakdown of Banking Sector Rescue  
Costs as of February 1998



Source: García-Cantera, Burbridge, and Ard (1998)

amassed \$42.5 billion in bad loans; Colombia, \$40 billion; and Venezuela, \$57.2 billion (Rojas-Suárez and Weisbrod 1996).

**Political Questions Surrounding FOBAPROA.** The fact that the banking rescue took place at a particularly delicate juncture in Mexican history was the second reason the Zedillo administration's proposal to nationalize the banking rescue costs became so controversial. Mexico was undergoing democratization in its political system at the same time that it liberalized the economy. This process exposed the country to a myriad of new pressures. When elections in 1997 ended the dominance of the PRI in the lower house of Congress, the Mexican legislature also became subject to competition after having been effectively ruled by a single party since 1929.

The PRI held a majority in all elected political offices prior to the 1997 elections and exercised a virtual monopoly in domestic political outcomes. After the elections, the governing PRI still held 39 percent of votes in the Chamber of Deputies but lost its majority and was forced to seek at least minimal cooperation from one of the opposition parties in order to pass legislation. The National Action Party (PAN), often referred to as the party of business, now held 28 percent of the seats, and the left-leaning Party of the Democratic Revolution (PRD), a party started in 1988 by disgruntled PRI members, garnered 26 percent. This plurality of parties and votes forced the Mexican Congress to function more as a deliberative body rather than a sanctum for ratifying PRI proposals.

The far-reaching implications of the financial reform proposals immediately generated the opposition's ire and spawned a complicated political debate.

The crux of the congressional debate centered on the legality of the Zedillo administration's issuance of FOBAPROA bonds backed by government guarantees. Opposition parties contended that, because in Mexico only Congress can authorize the assumption of public debt, the government did not actually buy debts from the banks. Instead, the opposition argued, the debts were guaranteed by the government and placed into contingency. Thus, when the banks and the government traded loans for FOBAPROA notes, the transactions were carried out in the form of individual private contracts.

The government, on the other hand, argued that the very real possibility of a crisis in the banking sector created a set of circumstances that demanded that it act quickly and decisively. Banking authorities contended that the Zedillo administration acted legally when it transferred loans to the auspices of FOBAPROA (the government), and the March debt-nationalization proposal ratified only those acts already carried out by the government. "Legally, the guarantee [for the bank loans] granted by the Federal Government is based on the General Law of Public Debt and, without a doubt, justified by the clear effects and consequences which permitted the preservation of economic and political stability in the country in these difficult times" (Fondo Bancario 1998b, 2). A government document asserted that by transforming these loans into public debt, they could be repaid "in the best terms possible with the lowest interest rates" and that not recognizing these debts "implies denying reality and putting off the solution to this problem onto future generations of Mexicans" (Mexican National Banking 1998b, 3).

While some in the opposition acknowledged that the government had little choice but to intervene as it did, they could not support any attempt to transform such a large sum of bank liabilities into public debt. They argued that nationalization of this debt would only increase the burden on poor Mexicans while seeming to provide debt relief to Mexicans wealthy enough to obtain bank credit. The move would also appear to absolve rich bankers from the consequences of making bad lending decisions.

Some opposition legislators also alleged that FOBAPROA's bank rescue activities favored PRI supporters and that officials who devised the bank rescue were parties to corruption. The PRD released documents alleging that some wealthy bankers who made sizable campaign contributions to the PRI's 1994 presidential election bid later had large sums of bad debt transferred to FOBAPROA. Although the government denies any such activity, these accusations resonated well with Mexicans who believe that the PRI is a corrupt institution (Smith 1998).<sup>6</sup>

By all accounts, the political implications of the government's banking sector rescue were intense. The

debate over how to finalize FOBAPROA held up the 1999 budget for nearly nine months, but a compromise solution was reached at the eleventh hour. The new legislation did not formally nationalize the costs of the banking sector rescue as requested by the Zedillo administration but included an agreement that the annual costs would be paid for by the government in each year's budget. Legislators agreed to disband FOBAPROA but declined to formally separate out its asset resale responsibilities from the new deposit insurance agency. Assets under the custody of FOBAPROA will be transferred to the new Bank Savings Protection Institute (IPAB). The bonds issued by FOBAPROA will be replaced by new ones that are tradable on the open market. The banks will hold the bonds, and the Mexican government will continue to provide the promissory guarantee. The government still hopes to recover part of the rescue's cost by selling the loans and collateral on the secondary market.

Legislators did not approve the Zedillo administration's proposal to grant autonomy to the CNBV. The final legislation did contain a provision to carry out an audit of several aspects of the bank rescue, including the loans under FOBAPROA's custody. Any loans in the FOBAPROA portfolio determined to have been illegally obtained would be wholly returned to the issuing banks. Three new debtor-assistance programs were also approved alongside provisions to gradually do away with existing limits on bank ownership by foreigners in Mexico.

### Evaluating Mexico's Bank Rescue

The political controversy over the proposal to assume the costs of the banking sector rescue as national debt was clearly unintended. Similarly, this section, which attempts to gauge the impact of the bank rescue on banks themselves, shows that the bank rescue did not have the expected result of reinvigorating the banking sector. However, when compared with bank rescues in other countries, the Mexican experience shared many of the characteristics found in more successful efforts. Two types of standards are evaluated. First, the discussion examines some performance measures of Mexican banks to assess the impact of the governmental rescue on the banks' operational effectiveness. Then the Mexican banking rescue is compared with the results from a study of best practices from other countries' experiences with systemic bank restructuring.

**Performance.** One measure of the aggregate success or failure of government programs is to look at a set of common performance indicators, such as capital adequacy, profitability, and liquidity. Asset quality, another commonly used performance indicator often measured by past due loans, has already been reviewed above.<sup>7</sup> These data are shown in the table.

Probably the single most important traditional indicator for bank soundness is capitalization, measured

TABLE 1 Performance Indicators of Mexican Banking System

	1993	1994	1995	1996	1997	1998
Net Capital/Risk-weighted Assets	9.93	9.72	10.79	13.06	17.22	13.33
Return-on-Average Assets	1.66	0.49	0.31	-0.64	0.43	0.03
Loans/Deposits	110.36	116.46	130.08	119.08	101.66	103.11

Source: García-Cantera, Burbridge, and Ard (1999). All figures are end of period.

here by net capital over risk-weighted assets. A bank's capitalization level is extremely important because it measures how prepared the institution is for unexpected developments, like the peso crisis, when borrowers are unable to make payments or bank assets decline in value. According to the official data presented here, the average Mexican bank has been well above the commonly accepted Basle Accord standard of an 8 percent ratio of capital to risk-weighted assets. These data show only a slight fall at the end of 1994. The ratio improved by a full percentage point in 1995, and it climbed even further over the next two years before dropping off in 1998. Indeed, these data suggest that Mexican banks have been well capitalized (if not overcapitalized) all along and beg the question of why banks needed government support.

Both the PROCAPTE and FOBAPROA programs were primarily designed to help banks boost their capitalization levels. As discussed above, the type and composition of capital allowed by banking authorities in Mexico has received sharp criticism (Mackey 1999). Another analysis of bank capital valuation in Mexico asserts that the ratios are overvalued because they do not fully account for the high degree of potential losses from bad loans. The ratio would be much lower if properly adjusted for risk (Thorne 1998).

Bank profitability, the second indicator, is often measured by return on assets. This ratio shows how well

bank assets are being used to generate earnings, which in turn can be used to fund administrative operations as well as generate revenue for shareholders. Whereas a solid return on assets in the United States would be 1 percent, the average Mexican bank was attaining much more than this amount in 1993. Average profits fell abruptly with the peso crisis, and they were negative in 1996. While profitability improved after the sharp decline in 1996, banks have not yet been able to return to solid profitability despite the removal of a massive amount of bad loans from the system. Bubl and Skelton (1998) observe that the loans for bond swaps did not fully clean up balance sheets, thereby preventing banks from returning to lending and earning profits from this traditional source of income.

Liquidity is another important performance indicator. Bank liquidity, here measured by the ratio of loans to deposits, is a demonstration of how quickly a bank could convert its assets to cash. The more deposits a bank has, the more liquid it is unless the bank has tied up those deposits in longer-term instruments like loans and securities. In general, a lower ratio means a bank is more liquid (that is, has more short-term assets on hand), but large banks might be comfortable with a higher ratio because these institutions generally have access to other sources of cash or borrowing. Although the data oscillate a good bit over the six-year period

6. *The strict bank secrecy laws in Mexico inhibited a more thorough examination of the debts transferred to FOBAPROA and allegations of corruption. Although the Zedillo administration furnished some documents to Congress for its internal investigation, it refused to comment on the content of documents that were released to the public, citing that all information was protected by the secrecy statutes. The Mackey Report concluded that about \$7.3 billion of the loans transferred to FOBAPROA did not meet the criteria established for inclusion in the Loan Purchase and Recapitalization Program and that just over \$600,000 of those loans was of illegal origin (1999).*

7. *Figures presented here are system aggregates and represent the performance of the average bank. Performance indicators should be interpreted with a high degree of caution. System standards are always more meaningful when compared with a peer group, but in Latin America, comparison is not easily achieved because countries use different accounting standards and exhibit varying degrees of regulatory compliance. Similarly, comparisons with the United States should also be made with caution. In addition to accounting differences, U.S.-based banks operate in very different regulatory and macroeconomic environments. A comprehensive analysis of the Mexican banking sector would examine a larger range of performance indicators than presented here, including risk-weighted measures such as bank spreads, loan growth, and interbank debt ratios. See Rojas-Suárez (1998) for a discussion of why these measures may be more appropriate measures of risk in emerging market economies.*

shown, they demonstrate the banks' poor liquidity. Thus, despite FOBAPROA's efforts to remove bad loans from the system, the average bank in Mexico has considerably more loans than deposits, making the system vulnerable to potential shocks or bank runs.

Bank performance measures tell us about operational effectiveness. Data on the allocation of credit by the banking system are also used to measure the banks' capacity as a financial intermediary. Chart 6, which traces the provision of credit by the banking system from late 1995 through the end of 1998, shows that total financing steadily increased throughout the period, growing from around \$81 billion to \$115 billion in

Despite authorities' prompt moves to implement restructuring programs, none was successful in substantially improving preexisting problems, such as high levels of delinquent loans and insufficient capitalization.

November 1995 to year-end 1998. Financing to the private sector, however, actually fell over this same period. On a year-over-year basis, the contraction in credit to the private sector began to ease only in late 1997. As Chart 4 shows, the government's issuance of FOBAPROA bonds grew steadily during this period. If these bonds are separated out, the amount of credit being supplied to the private

sector is much less. Subtracting the FOBAPROA bonds provides a more accurate snapshot of the banks' performance as financial intermediaries because the FOBAPROA bonds are guarantees on past, possibly unrecoverable credit issued, not new credit. Indeed, the Mexican government gradually took over loans equaling a quarter of the value of total loans outstanding in the banking system through its issuance of FOBAPROA bonds. On a year-over-year basis, credit to the private sector minus FOBAPROA notes did not begin to increase until three years after the devaluation in early 1998, only to have that figure fall again at the end of the year.

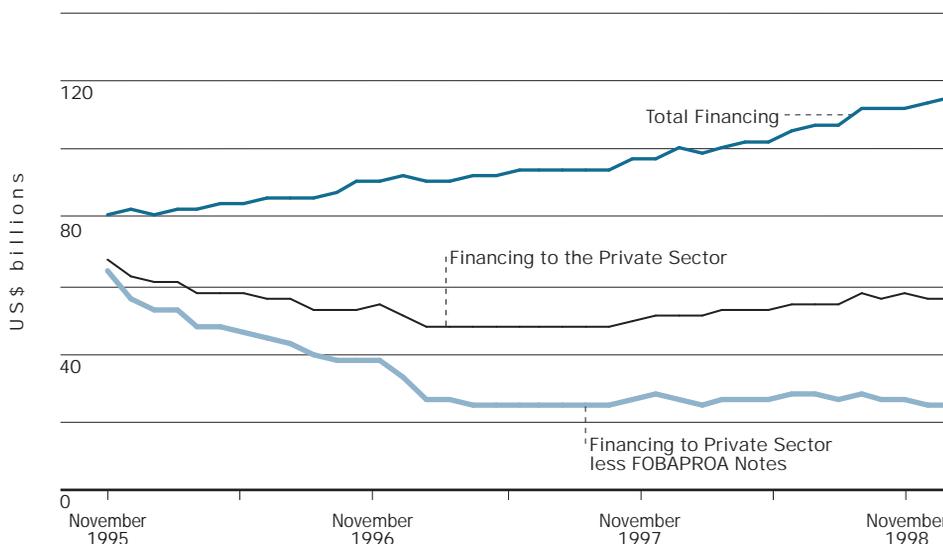
Another of the difficulties for the Mexican banking system in returning to the business of making loans is the concentration of bad-loan portfolios among the nation's three largest banks. At year-end 1998, Banamex, Bancomer, and Serfin, which together controlled 55 percent of assets in the banking system, held 48 percent of the FOBAPROA bonds issued by the government. While these bonds represent loans transferred off the three banks' books, the banks must still make provision against 25 percent of the potential losses. Furthermore, two of these banks continue to have past due loan ratios above the system average (Mexican National Banking 1998a).

**Best Practices.** This article also compares bank restructuring efforts in Mexico to those of other countries as a final measure of the rescue's effectiveness. The twenty-four-country study of responses to systemic banking crises by Dziobek and Pazarbasioglu (1997) provides the baseline for evaluation. The authors examined a range of indicators (performance and intermediation indicators and mix of policy instruments) in the selection of countries and then drew out a series of best practices from the more successful cases. The list of successful policies is more representative of the range of successful policies than an exhaustive checklist. The study did not directly evaluate Mexico because it did not formally include countries in which bank restructuring began after 1994.

The Mexican experience compares favorably with the best practices of nations attaining substantial progress in their bank restructuring efforts. Indeed, all but three of the fourteen policies identified as successful by Dziobek and Pazarbasioglu were present to some extent in the Mexican case. The Mexican bank rescue would rank highest in its efforts toward development of a *comprehensive approach* to a range of shortcomings (accounting, legal, regulatory, supervision), imposition of *operational restructuring techniques* on banks, use of ongoing *monitoring* of bank operations, government *financial support* of insolvent banks, *removal of non-performing loans* from bank balance sheets, use of *loan workouts* to help recover some costs, and the return of *positive economic growth*. The presence of these policies in Mexico promoted the government's efforts to restructure and rehabilitate the banks even if the results were uneven.

The Mexican example also exhibited other best practices, but these were present to a lesser degree or, in some cases, tended to have a negative effect on the outcome of bank rescue efforts. These areas were *prompt action* by authorities within a year of crisis, designation of a *lead agency* to coordinate efforts, central bank disposition to provide *short-term credit*, and the existence of *loss-sharing* between banks and the public. As this article has shown, Mexican authorities did act quickly to design a restructuring strategy after the peso crisis, but they were not successful in initially recognizing the severity of the sector's problems, and these actions had to be followed by additional efforts to improve system soundness. In Mexico's case, because of its weak regulatory environment, authorities were poorly prepared for a rapid response. Similarly, despite authorities' prompt moves to implement restructuring programs, none was successful in substantially improving preexisting problems, such as high levels of delinquent loans and insufficient capitalization.

In Mexico, the FOBAPROA agency was clearly designated as the lead restructuring agency in the country's



Source: Bank of Mexico, "Financiamiento Canalizado por la Banca Comercial al Sector no Bancario"; compiled from data available online at <[http://www.banxico.org.mx/public\\_html/fmi/finbc/fbmenu.html](http://www.banxico.org.mx/public_html/fmi/finbc/fbmenu.html)>

bank rescue. This duty made FOBAPROA both the deposit insurance agency as well as the restructuring authority. Although responsibility for bank regulation and supervision was still separated out and held by the CNBV, Mexico's regulatory environment was confused by making the deposit insurance agency responsible for issuing billions in government bonds and for asset removal and resale after the VVA was dissolved. Furthermore, the fact that FOBAPROA did not release its records or data on the rescue to the public raises questions about the government's commitment to transparency.

The central bank did provide short-term liquidity to the banks by making dollars available during the initial foreign currency crunch. This much-needed effort produced positive results. Moreover, the dollar-liquidity program did not produce fiscal costs because these loans were repaid with interest. However, when the bank support programs began to extend funds or guarantees to the banks for periods of five years (PRO-CAPTE) and ten years (FOBAPROA), the government began to incur both real and potential liabilities. Ultimately, these programs translated into massive fiscal costs for Mexican taxpayers, in turn injecting divisive tensions into the national political debate.

Finally, the question of loss-sharing between the banks and the public complicated resolution of the bank rescue. The Loan Purchase and Recapitalization Program stipulated that banks would be liable for 25 percent of any losses on loans transferred to FOBAPROA. During the congressional debate, the conservative PAN sought to reject this loss-sharing formula and impose 100 percent of the losses back on the banks

("Mexico's PAN . . ." 1998). This proposal would have avoided any nationalization of bad bank debts. Although the PAN initiative was unsuccessful, the loss-sharing equation became a delicate political question and a principal impediment to passing the final legislation.

Three of the best practices recognized in Dziobek and Pazarbasioglu were largely missing in the Mexican case. As previously discussed, Mexico clearly lacked an appropriate design of the privatization of *state-owned banks*. Much evidence suggests that the manner in which Mexico's banks were sold set the stage for future problems in the sector. The incremental nature of the bank rescue programs is also indicative of the failure to provide an adequate *diagnosis* of system problems and development of strategies for each problem. The inclusion of additional debtor relief initiatives in the final bank rescue legislation is further testament to this shortcoming. Finally, the bank restructuring in Mexico also lacked the presence of *firm exit policies*. Indeed, the practice of banking authorities toward shutting down insolvent banks was the exact opposite of an exit policy. The Mackey Report noted that the policy in Mexico was "that no banks would fail and that bank operations would be 'regularized' rather than liquidated" (1999, 179).

### Conclusion

The governmental rescue of the banking sector in Mexico was successful in attaining its primary goal of preventing a systemic breakdown of the banking and financial system in that country. At the same time, efforts by the Mexican government to recapitalize and refurbish

domestic banks have failed to improve the sector's financial viability or its financial intermediation capacity. In particular, the transfer of more than \$30 billion in bad loan portfolios off bank balance sheets had little effect in addressing fundamental problems in the banking sector. Past due loans remained very high, and bank capitalization levels were still considered inadequate after four years of bank rescue programs and billions in expense. The review of performance indicators showed that the average bank requires additional enhancement before the sector's recovery will be complete, and Mexico's use of many best-practice policies in the banking sector rescue did not correlate with a revitalization of the sector.

The Mexican experience also suggests that country-specific factors can profoundly affect the success of government policies. The outcome of the bailout was deeply shaped by the process of political democratization under way there. The polemical debate surfacing out of the legislative battle over allocating the costs of the bank rescue demonstrates the need to pay more attention to political matters, even when the problems appear economic or technical in nature. The ultimate resolution to the bank rescue may have been more easily reached had the Mexican government presented the bank rescue to the public in a more transparent manner and proposed legislation more acceptable to a multiparty Congress.

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