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The Corporate Governance of the Mexican Banking System. A Historical Perspective: 1940-2000

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Abstract

This paper elaborates on the historical transformations of the corporate governance of the Mexican banking system from the thirties to the consequences of NAFTA in this industry. The paper describes the configuration of the banking system after its collapse during the Mexican revolution; it explains how commercial banks emerged linked to business groups, the consolidation of specialized financial intermediaries into multi-banks, and the formation of a corporate network of interlocking directorates among banks. The bank nationalization of 1982 changed the ownership, control and management of banks. The paper also explains the changes after the re-privatization process, its inherent change in ownership and control and the impact of the 1995 crisis. The paper describes the process of crisis resolution, bailout and the consequent internationalization of banks, and concludes with the recent transformations in regulation of corporate governance of bank.

Resumen

Este documento analiza las transformaciones históricas del gobierno corporativo de la banca mexicana desde los años treinta hasta los cambios recientes después del TLCAN. El documento describe la configuración del sistema bancario después de su colapso durante la revolución mexicana; se explica cómo la industria bancaria surgió vinculada al interior de grupos empresariales, se esboza cómo se consolidaron los distintos intermediarios financieros hasta llegar a la formación de la banca múltiple y cómo se formó una red de interconexiones entre los consejos de administración de los bancos. La nacionalización bancaria de 1982 cambió esta estructura de propiedad, control y administración de los bancos. Este documento también explica los cambios después del proceso de reprivatización de la banca, los cambios inherentes en propiedad y control y el impacto que tuvo la crisis de 1995. El documento describe el proceso de resolución de la crisis, rescate y la consecuente internacionalización de esta industria. Se concluye con las transformaciones recientes en la regulación del gobierno corporativo de los bancos.

Introduction

The banking sector has undergone dramatic changes in Mexico since the NAFTA was signed, particularly as far as corporate governance of banks is concerned. Although the Mexican banking sector has experienced many changes during the last thirty years, the most significant have taken place over the last decade. In the last thirty years, the Mexican banking industry has gone from being a local industry, protected and established by specialized intermediaries, to a state industry, to finally become an industry made up of financial groups controlled by major international banks. This was not a smooth process, on the contrary, it was complex, it produced costs to the Mexican economy, and the action of the state has always been a relevant factor for explaining it. This paper aims to show how the corporate governance of banks followed its own adaptive evolution, and how events such as nationalization in 1982 and the crisis in 1995 changed the direction of this evolution irreversibly and triggered unexpected consequences.

Corporate governance is the relationship between a company's ownership, control and management structures. The organizational arrangements that derive from these structures define the facility to establish commitments, the possibility of obtaining privileged information and other means of creating incentives to conduct business transactions. Therefore, corporate governance structures have an effect on business performance. The history of the Mexican banking sector tells how corporate governance has not only transformed due to the evolution of the sector, but also to the action of the state and external shocks.

This article departs from the early construction of the Mexican banking system. Between 1940 and 1982, the Mexican commercial banking system underwent a unique process of sustained growth. This article explains that the Mexican banking sector achieved a high growth rate during this period and at the same time it was a sound system as far as profitability and risk are concerned. To a great extent, this was thanks to the organizational arrangements that originated from its corporate governance structure. This article looks at two arrangements: the first is the practice of insider lending and the second is the use of a network that boards of directors used to communicate. In an economy in which property rights are uncertain and information is scarce, these practices helped banks to protect themselves from opportunistic actions and to establish commitments and create discipline. Nevertheless, as the banking system then was very concentrated and had very few competitive options, these practices restricted access of credit to the economy.

In general terms, the practice of relational banking comprises the establishing of long-tem commitments between a banking intermediary and a borrower with diverse financial needs. This practice's most well-known variant arises when intermediaries and borrowing companies have ownership linkages: banks are established to meet the financial needs of holding business groups by insider lending. This article highlights a number of examples of the relationship that banks had with their holding groups. As most banks were established within business groups, this was a common practice. It would seem that insider lending allowed banks to rectify asymmetric information problems and establish commitments with borrowers, although this restricted funding of companies that did not have close links with banks.

The emergence of banks in financial groups was associated with a process of consolidation of financial intermediaries, as commercial banks also were establishing business relationships with other intermediaries, mainly in order to overcome the regulatory restrictions imposed on their activities. This meant that commercial banks were not only linked to non-financial companies, but also to other intermediarys, such as with financieras (non-bank banks). This led intermediaries to establishing financial groups and, after 1975, they consolidated as bancos múltiples (multi-banks or full-service banks).

An interesting phenomenon that occurred in the Mexican banking system between 1940 and 1982 was the setting up of a network of interlocking directorates between the boards of directors of banks. This article explains why the network developed, how it led to banks transferring information between one another, and how the network allowed banks to set up a cross-monitoring mechanism, as various board members could represent differing interests.

The corporate governance structure of the Mexican banking system changed when the banks were nationalized in 1982, therefore the aforementioned methods disappeared and, in turn, the manner in which banks did business was altered. One of the consequences of nationalization was that it had an adverse effect on credit market activity and incentive mechanisms within the banking system itself. Nevertheless, this meant that another group of intermediaries, casas de bolsa (brokerage firms), expanded. When the banking sector was re-privatized in 1990, brokerage firms became the new owners of the banking system through the creation of financial groups. This paper explains how the re-privatization was carried out by the government and the behavior of the newly re-privatized banks.

The behavior of the banking system after 1990 is partly explained by the strategies implemented by the new controlling groups, although several factors came together that resulted in the one of the sector's most serious crises ever.

This article explains the re-privatization process up to the crisis in 1995. A combination of poor corporate strategy, insufficient and inappropriate regulation, and a severe macroeconomic crisis, led to a critical time that was unprecedented in the history of the banking system. This article explains the crisis and its resolution, a process that generated major changes in the ownership and control of banks. This article also outlines the mergers and acquisitions process employed in the banking sector after the crisis during this time, in particular, how foreign banks absorbed Mexican banks. This article explains how after the 1995 crisis, the Mexican banking system has undergone critical changes in its regulation and supervision.

The internationalization of the Mexican banking system is part of a global process that has been of particular relevance in Latin America. International banking in this part of the world has expanded considerably in recent years, however, expansion in Mexico was accelerated by the crisis and was made possible thanks to the NAFTA. Mexico's financial sector is now that with the greatest presence of foreign companies, a rather unusual feature for economies that are similar to the Mexican economy.

This article is organized as follows: the next section explains growth and gradual consolidation of the banking system to 1982. Section two explains the consolidation of the financial system at the interior of business groups and the practice of relationship lending, inherent to this process. Section three explains the working of the network of interlocking directorates among banks. Section four explains the nationalization of Mexican banks and its consequences. Section five describes the process of re-privatization of banks, the 1995 crisis and its resolution. Section six describes the internationalization of Mexican banks after the crisis. Last section is an epilogue to the future of this story.

1. The Construction of the Mexican Banking System: 1940-1982

1.1 Growth and gradual consolidation

A number of notable events took place in the Mexican banking system between 1940 and 1982, including sustained growth and the gradual consolidation of financial intermediaries. This helps us to understand corporate governance of the banking system to the extent that commercial banks formed operational and ownership links with other financial intermediaries, which eventually led first to the creation of financial groups in 1970 and then to the multi-banks system in 1975, the current form in which banks operate. This section explains how financial intermediaries consolidated themselves in a growth context.

Credit given by the financial system between 1940 and 1982 as proportion of the GDP underwent unprecedented sustained growth. Although the Mexican Revolution brought about the collapse of the country´s financial system at the beginning of the twentieth century,[1] it came out of hibernation during the

[1] Anaya, L., 2002.

thirties and the number of intermediaries, the number of transactions and penetration of financing in the economy began to increase.

The credit/GDP ratio increased throughout this period, particularly from the fifties up to the seventies, reaching a historical maximum of more than 36% in the seventies. The greatest increase with regard to the GDP was on the part of non-banking intermediaries, mainly *financieras* (non-bank banks that were linked to commercial banks), and government development banks. Although the private commercial banking sector had been the economy's major intermediary and that which had undergone sustained growth, in comparison with the GDP, it retained its proportionally minor participation in growth. On the other hand, when comparing this scale with other economies that were similar to the Mexican economy, such as those of Argentina and Brazil, penetration of the financial system was relatively modest.

An important aspect throughout this entire period is that the Mexican banking system was highly profitable and the past-due portfolio level was low. High profitability meant that most banks could expand, as many reinvested their profits as capital. High profitability and the low level of past-due portfolio were applicable to industry as a whole, as the individual performance of each bank was variable. Very few banks went bankrupt between 1940 and 1980 and risk problems were dealt with reasonably successfully.

One question that should be asked is how the banks could maintain high profitability and low risk levels in a context such as that of Mexico at that time. In the first place, insider or related lending was common practice, which could lead to moral hazard when granting loans. Prudential regulation was scant and had little effect on banks' actions. In addition, the legal framework was unfavorable, for example, bankruptcy legislation had a number of shortcomings.

To a certain extent, the ability of the banks to maintain a low level of past-due portfolio was associated with the information that they had available regarding their main borrowers, and their ability to carry out effective monitoring. The Mexican banking system managed to fulfill this particular aspect, thanks to methods established under its corporate governance structure, as explained further on in this paper.

During this period, the Mexican financial system went through a gradual process of consolidation. Commercial banks established linkages with other intermediaries, mainly *financieras*, (the second most important type of intermediary) and with other specialized intermediaries, such as mortgage intermediaries, and these bonds were related to both ownership and business operations. This was mainly because the specialization of intermediaries laid down in banking Law passed in 1941, restricted banks' operations, which led them to establishing operational relationships with other intermediaries, so as to provide financing at longer terms or to conduct investment banking business, by way of an example. Although legislation laid down the specialization of intermediaries, it did not impose major restrictions on ownership links. To the second degree, the development of business groups led to the creation of financial units that generally comprised banks and other intermediaries that supported the group's credit and financial services needs. This was another relevant factor that went a long way towards the association between banks and other intermediaries being created.[2]

By the mid-1960s, commercial banks and their associated firms formed *conglomerados financieros* (financial conglomerates, as they were called by analysts of the day). These groups were the financial units of larger business groups or conglomerates that emerged and consolidated during this period. Although conglomeration dated from the period of the financial system's reconstruction in the 1930s, formal operations became visible in the 1960s.

In December of 1970, the banking law was amended to recognize the legal existence of *grupos financieros*, financial groups or conglomerates.[3] The law expressed some reservations about the formation of these groups because it implied, according to policy-makers, the establishment of a potential oligopolistic financial system as well as the concentration of wealth and risk. But the system had already arranged itself in that way.

These links took on such importance by the seventies that the government authorized the merger of specialist intermediaries. In 1974, an amendment to the banking law modified many of its articles to open regulatory avenues for creating *bancos múltiples* or multi-banks. The government's rationale concerning the formation of multi-banks was "[…] to promote a financial system composed of more solid entities (meaning, essentially, larger)".[4] However, many analysts perceived this move as a step toward eliminating small banks by forcing them to merge with larger financial groups. The amendment continued government policy, dating back from the late 1960s, of stimulating the transformation of banks into larger and larger units. Even *Banco de México* made funds available to banks to acquire smaller entities. But the concept of multi-banks had more to do with the organizational scope of intermediaries than with bank size. Thus, there is open question concerning what would have occurred if the government had instead supported small bank transformation into *bancos múltiples*.

The model of *banca múltiple* was legally constituted in 1974 and 1975, and in 1976 the regulation for the establishment of multi-banks was published by the Secretaría de Hacienda.[5] The law permitted the formation of multi-banks by merging the different entities of a financial group, with the exception of commercial banks that were established in a different geographic location.

2 *Ibid.*
3 Ley General de Instituciones de Crédito, Art. 99-bis, Reform of December, 1970.
4 The Articles modified were: 2, 19, 26, 29, 30, 31 45, 94-bis, and 138-bis, Ley General de Instituciones de Crédito.
5 Reglamento para Operación y Establecimiento de Bancos Múltiples, March 16, 1976.

This restriction became irrelevant, however, because once multi-banks were formed, they began taking over smaller commercial banks in different geographic locations.

2. Ties and Relational Lending

Up until 1982, the majority of Mexican banks was either owned by Mexican business groups or had ownership links with these groups, so this meant that many loans were made under the premise of what is known as insider lending or related lending.[6] Close relationships with borrowers helped to resolve the problems regarding asymmetric information in a situation in which rights of ownership were uncertain. Therefore, the practice of insider lending gave the banks great advantages with regard to the information that they had. In addition, the association established between banks and business groups assigned a wide range of financial services, for example, opening lines of credit, issuing bonds or refinancing or renewing contracts. The close relationship between banks and borrowers, however, meant that the implicit problems regarding adverse selection, monitoring, making payments and establishing new contracts, could be dealt with.[7]

Some literature gives us the notion that insider lending is a perverse practice in the banking sector.[8] Nevertheless, in a financial system at its early stages in which banks emerge with ownership linkages with non-financial firms, and an environment of uncertain property rights, banks had the incentive to make loans to related firms. Needless to say that most of the banks established between 1940 and 1970 were in fact established to respond to the need of business groups to have their own intermediaries in the absence of a properly developed credit market. The type of economic result that emerged from this depended on the incentive mechanisms used in the lender-borrower relationship.[9] Performance of the banking sector throughout this period shows that very few banks experienced financial problems that arose from the contractual opportunism derived from insider lending practices.

On the other hand, despite the fact that the *financieras* could have constituted a financing alternative, they actually complemented commercial banking transactions. As mentioned in the previous section, most *financieras* became part of business groups' financial units and thereby complemented the transactions that the banks carried out with the companies of the group of

[6] Del Ángel, G., 2002. Early works that document these relationships are for instance Basave *et al.*, 1994, and Hamilton, N., 1982, among others. For porfirian Mexico see Marichal, C. and M. Cerruti, 1997; Haber, S., 1989.
[7] Del Ángel, G., 2002.
[8] See La Porta, R., F. López and G. Zamarripa, 2002.
[9] See Lamoreaux, N., 1994, for early New England; Aoki, M., and H. Patrick, 1994, for the Japanese main bank system; and Maurer, N. and T. Sharma, 2001, for Porifirian Mexico.

which they were a part. This also worked for transactions conducted with companies not part of the group with which banks were related, and this was very important for those transactions that banks were unable to conduct due to legal and regulatory restrictions.[10] This evolution towards the consolidation of intermediaries on account of the relationship between banks and financial institutions, reinforced the banks' dominant position in the private financial system.

In this panorama, ownership of banks was reserved for Mexicans, and foreign investment was in the Mexican financial system was not allowed (with one or two exceptions that only involved a small proportion of foreign investment), until the NAFTA was signed. The only foreign banks operating in Mexico at the time was Citibank.

Virtually all commercial banks were controlled by one business group or another, either wholly, or with a majority holding. There were also many cases in which banks were controlled by several business groups that operated on a regional basis, although one group or another always held corporate control. The authorities, particularly the *Banco de México*, looked kindly upon the conjunction of several business groups in one single bank, as this provided a means of checks-and-balances among the different interests participating in the bank. Following are several examples of the relationship of banks with holding groups.

Mexico's two largest banks, Banco Nacional de México and Banco de Comercio, were not controlled by any specific group, but rather by a convergence of interests of major capitalists. Banco Nacional de México, established in 1884, dominated the banking sector and one of its most important characteristics is that although it was not associated with any group in particular, its board of directors included several prominent capitalists, for example, Pablo Diez, a directorate of Cervecería Modelo, and Graciano Guichard, financier and directorate of the San Rafael paper factory.[11]

The corporate structure of this bank was more developed than that of other companies at the time. The Legorreta family controlled administration of the bank, even though they were minority shareholders, and this was a way of keeping corporate control of the banks apart from its ownership or, in other words, from the private interests of businessmen involved as shareholders. This structure maintained a balance between various interests. Although this does not mean that the bank did not practice insider lending, as there were transactions of this type, it does mean that there were disciplinary procedures in place to carry out insider lending transactions without affecting the bank's financial situation.

The Banco de Comercio is another interesting example. It was the country's second largest bank and the main competitor of Banco Nacional

[10] Del Ángel, G., 2002.
[11] *Ibid.*

Mexicano. In its beginning Banco de Comercio was not linked to any specific business group; it was rather a convergence of interests of several groups. It was established in 1932 by Salvador Ugarte and Raul Bailleres, Eustaquio Dominguez, Ernesto Amezcua (an association of interests named grupo Buda, after their initials), Liberto Sederos, and others. They had a close relationship with various financial intermediaries, such as *financiera* Crédito Minero y Mercantíl and Banco General de Capitalización and two major insurance companies: La Nacional and La Comercial, and others. Its expansion strategy consisted of a creative mechanism of corporate governance. Banco de Comercio associated itself with small local banks and establishing links with local businessmen throughout the country and thereby it was able to establish a network of regional affiliates under the head office in Mexico City. This meant that it could have information from local potential borrowers, as well as carry out transactions with the regional groups that controlled the affiliates, while maintaining monitoring procedures and disciplinary procedures through the head office in Mexico City.

In 1955, Banco de Comercio suffered a hostile takeover headed by Manuel Espinosa Yglesias and William Jenkins, and corporate control and management of Banco de Comercio and its affiliates was centralized under the figure of Manuel Espinosa. Nevertheless, the new owners kept many business groups and interests involved in the bank.[12]

The examples of Banco Nacional de México and Banco de Comercio are atypical, as most banks maintained a close relationship with their proprietary groups. Banco de Londres y México, the oldest Mexican private bank founded in 1864, always competed for a place among the four largest entities. Originally, Banco de Londres y México was a case in which a family business group, the Garza-Sada family, maintained control but not as the only player. In 1934, the bank suffered a crisis from problems carried since the Revolution, what forced its owners to reduce its capital and implement a reorganization process. Subsequently, Manuel Gómez Morín headed a group of entrepreneurs who took over the bank. This association united several Mexican and foreign interests. The most outstanding were the two of the largest *financiera* firms, Compañía General de Aceptaciones and Sociedad Financiera Mexicana. The former ended up assuming ownership and control of the bank. It was a rare case in which a *financiera* gained the dominant position over a commercial bank inside of a business group.[13]

The Banco Comercial Mexicano was a case of a bank constituted for the operations of a single business group that remained in its hands. The Vallina family, a group of large paper manufacturers from Chihuahua, established the bank in 1934. Their interests included Celulosa de Chihuahua, Bosques de Chihuahua, Plywood Ponderosa, and Viscosa de Chihuahua. Eloy Vallina,

[12] *Ibid.*
[13] Cfr. Hamilton, N., 1982; Morera, C., 1998; Del Ángel, G., 2002.

founder and CEO, was trained as a financier. Vallina also served as the Vice-CEO of Banco Mercantil de Chihuahua, which was owned by his brother, Rafael Vallina. Banco Comercial Mexicano became the main financial entity of the group and initiated many ventures such as Chihuahua Cement in 1941. The group also made joint ventures with the Carlos Trouyet group; examples included the establishment of Celulosa de Chihuahua and the unsuccessful purchase of Teléfonos de México.[14]

Banco Mexicano was another large entity initially established to fulfill the needs of a particular business group. A group associated with Abelardo Rodríguez, a former President of Mexico, and other members of his administration established this bank in 1932. The management team of the bank included several financiers previously associated with Banco de México, such as Federico Lachica. In the beginning, the bank practically served the exclusive entrepreneurial interests of Abelardo Rodriguez. In 1941, it helped to open of one of the largest *financieras*, Sociedad Mexicana de Crédito Industrial, in which several banks (including government banks) served as investors.

An example of a bank with close relationships with different business groups is Banco del País. This bank was founded in April 1942 with links to two business groups, both of them partnerships constituted with families of entrepreneurs. One was Grupo Corpomex of Rogerio Azcárraga, which included firms that manufactured licensed products of Kelvinator, Motorola and Videovox; it also included radio stations, a recording company named Orfeón, and a distributor of dairy products. The Azcárraga Group was also financially supported by the financieras Crédito Financiero de México and Financiera Minera. The other group involved in the Banco del País was formed by a family of entrepreneurs with diversified interests that also obtained support for their businesses from two financieras, Sociedad financiera Mercantíl, and Crédito Americano de México. The financial group of Banco del País, like other financial groups, participated in ventures with North American banks to import machinery from the U.S.

Other groups mainly sought support from financieras instead of banks. One particular case is Crédito Minero y Mercantil, a financiera established in 1934 by Raul Bailleres. Although he was associated with Grupo Buda, through Banco de Comercio, he made Crédito Minero y Mercantil the financial center of his own business group for a certain time. Credito Minero was involved in mining, so he bought the company Metalúrgica Mexicana Peñoles. He was also an intermediary authorized by the government to conduct international transactions with precious metals. Bailleres's group controlled the El Palacio de Hierro department stores, the Moctezuma brewery, insurance companies and was directorate of the Modelo brewery.[15]

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14 *Ibid.*

15 *Ibid.*

These links led to banks having a high number of shares in the assets of related companies (and unrelated companies). Bank legislation attempted to regulate these links, with a partial success most of the times. But regulators had to adapt the law to the current practices. A law reform of 1962 reduced the restrictions of the percentage of stock of a single firm a bank can hold, to not exceed more than 30% of the equity of the firm. This represented a relaxation with respect to the 20% imposed by the Law of 1932.[16] The reform was more restrictive in other instances. It stipulated that investments in stock of financial firms could not exceed 50% of paid-in equity plus reserves, nor could they exceed the difference between the minimum equity and paid-in equity of the bank. Stock investments of a single financial firm were not to exceed 15% of the paid-in equity.[17] At the same time, the reform relaxed restrictions to *financieras*, which could not hold more than 25% of the equity of an industrial or commercial firm. However, in case of new enterprises banks could hold up to 50% of the firm with authorization of Banco de México. The total amount of stock of different firms that a *financiera* could hold could not be superior to 50% of its equity.[18]

However, a credit collection slowdown during the mid-1960s, emerging cases of opportunism, and the increasing concentration of related risks were serious concerns of authorities. The 1970 Law arrangement (*exposición de motivos*) to reform the banking law established that the *Secretaría de Hacienda* was allowed to regulate the maximum amounts that a bank could lend to individuals or groups of individuals (and firms) who possessed ownership linkages with the bank. The authorities considered that these loans represented higher risks. The same reform contained pleas to invest to members of the Board, commissaries and directorates with greater legal responsibilities, in addition to provide information to the public and monitor the state of the bank. Legal penalization of individuals involved in fraudulent and high-risk behavior in banks was to be increased. The *Comisión Nacional Bancaria* was able to apply legal penalties to banking executives, board members and directorates when considered their activities were to jeopardize the intermediary with a high-risk position.[19] It is not clear whether the prudential regulators were able to succeed in the implementation of that change.

Another legal reform on March 8th, 1977 focused on regulating the concentration that financial firms had in their operations with firms or individuals. First, the reform set the maximum amount of liabilities that banks and other intermediaries could hold from a single individual, entity, or group of individuals. The main goal was to ensure the "diversification of the sources

16 Ley General de Instituciones de Crédito, Art. 41, sub-section, VIII, Reform of 1962.
17 Ley General de Instituciones de Crédito, Art. 46-ch, Reform of Dec-29, 1962.
18 Ley General de Instituciones de Crédito, Art. 28, Reform of Dec-29, 1962.
19 Ley General de Instituciones de Crédito, Art. 91-bis, Reform of Dec-29, 1962.

of bank funds". For intermediaries whose liabilities were less than 1 billion pesos, the limit was 3% of total liabilities, for those with liabilities greater than 1 billion it was 2%. For the inter-bank liabilities and liabilities in favor other intermediaries the limit was 10%.[20] Financing granted to a single individual should not exceed 10% of net equity. For corporations, the limit was 25% or 500 millions of pesos was established. Cross-financing between financial firms could be 100% of net equity, but should not exceed 500 million pesos. The regulation also attempted to control loans to individuals who had previous ownership linkages with the bank.[21] In many was, this seemed a relaxation of the 1932 law, but under the current conditions it was not, because banks had already exceeded those limits.

This story presents a process in which disparate clusters of linked firms, loosely regulated, evolve into more consolidated arrangements. The fashion in which business groups formed and linked to financial firms during the first half of the twentieth century determined the business development and corporate culture of Mexico. This genesis of business groups and conglomerates can be understood as initial conditions that help to explain further patterns of evolution. Nevertheless, there must exist feedback mechanisms that have maintained some path-dependent outcomes. To be more specific, in the case of Mexico many incentives behind the formation of business groups persisted throughout the period, but there were also contextual events that reinforced the outcomes. For example, the lack of well-developed credit markets, a need for risk diversification, and transaction costs pushing towards vertical and horizontal integration might exist at the beginning of the process. Business groups were an organizational form that permitted the solution of those problems and contributed to the development of new capabilities. However, in the institutional and economic environment of the 1950s and 60s these capabilities motivated business groups to maintain their closed structures. Some of these include complementarities among their firms, but also the privileged access to capital that outsiders did not have.

3. A Network of Interlocking Directorates[22]

A network of interlocking directorates between the boards of the banking industry was formed between 1940 and 1982. Many bank directorates sat on the board of other banks. This was a particularity of corporate governance of the private commercial banking system and the financial system of the time. Sitting on a number of boards gave directors access to the privileged

[20] Ley General de Instituciones de Crédito, General Rule Regarding the Maximum Amount of direct or Contingent Liabilities that a Credit Institution may have in the name of the same Person, Organization or Group of Persons. March 8th, 1977.
[21] *Ibid.*
[22] Most of this section is based on Del Ángel, G., 2003.

information of other banks and this enabled them to prevent risks in their loan portfolio. In other words, the problem concerning lack of information was solved by a private organizational solution. This network also meant that directors who belonged to other business groups coincided with the board of a certain bank, which meant that a certain balance between differing interests could be achieved.

At that time, asymmetric information posed a grave problem for the Mexican economy, as it does now. The main information problems that banks faced were mainly those regarding overdrafts and failure to pay off loans. Failure to pay also affected the economy, as transactions cost for contract enforcement increased, and it created problems for businesses and made commercial credit more risky. In order to solve these problems, banks needed greater access to information, and better legislation, in order to deal with adverse selection problems and fraud. However, the problem of lack of public information remained unresolved throughout the entire period.

As far as business groups were concerned, banks were able to deal with insufficient access to information by establishing relational banking practices, such as those mentioned in the previous section. There were some borrowers, however, who did not have such close links with banks, therefore it was necessary to use other means of information. As I have already mentioned, at that time, the Mexican banking sector found itself in a situation in which information was scarce and control of information was uncertain, making financial transactions difficult to carry out. Therefore, private means of obtaining information, such as the network of boards of directors, became a way of solving the shortcomings of the institutional body.

In a broader sense commercial banks were a particular example of the corporate networks established during the twentieth century, as their influence reached far beyond the financial sector. The network established within the banking system was in fact part of a much larger network that extended throughout the rest of the financial system, as well as industry and business. This is demonstrated by the fact that bank directors or board members also sat on the board of steel companies, cement companies, manufacturers or tourism companies that, in turn, were associated with other firms. As already mentioned, several of these companies also set up business groups and conglomerates, which brought them even closer to the commercial banking system. We should also bear in mind that those responsible for making the most important decisions in *financieras*, belonged to the network of commercial banks.

There are a number of factors that explain why banks set up networks through their boards of directors, the most relevant being the presence of professional financiers, the need to diversify funding, and corporate relationships between banks. From the thirties onwards, there was very little specialized human capital in the financial sector and the group of professional financiers was considered as valuable and highly quoted human capital for a growing financial sector. Many of these financiers were invited to join the board of directors of a number of banks, due to their expert knowledge.

Many businessmen, however, invested in more than one bank to diversify and expand their business, which means to say that by being shareholders of several banks, they were able to diversify their sources of funding, as they were board members of banks and could now become part of the sphere of business activity in which banks were involved. This was well favored and, in many cases, highly recommended by the financial authorities, particularly by the Banco de México. It is not clear as to whether this was an explicit official policy, but the authorities were aware that these types of conflicts of interests would prevent any problems concerning opportunism arising in cases of insider lending.

Finally, banks set up associations as a form of strategic alliance and in subsidiary relationships. These corporate relationships meant that the directors of a bank could sit on the board of banks with which it had some sort of relationship. Figure 1 (see below) shows the connection between banks over the network and, in particular, that the biggest banks did not necessarily have most connections and that some banks had no connections at all.

Literature on Mexican business in the twentieth century has discussed at great length the networks set up by the various boards of directors, although the actual structure of the network and its economic implications have not been studied in depth. Del Ángel (2002, 2003) shows that those banks that had the most connections within the network tended to have a lower level of past-due portfolio, in proportion to the overall portfolio. The network could be used to transfer information between banks, a process that helped to prevent risks.[23]

Transfer of information was not the only function of the network. The fact that directors of various banks could sit on the same board of another bank meant that conflicting interests could converge in the same corporate space. These interests could be conflicting, as the board members involved could well belong to different business groups, and this led to a cross-monitoring procedure between directors being established. The cross-monitoring process meant that decisions taken by a board of directors did not affect the bank's financial soundness, as opportunistic actions that could influence directors to favor a particular business group could be monitored by directors who were part of another group. This was a way of establishing an organizational disciplinary system that helped to maintain the financial stability of the banking system. Since there were no systems for market discipline, or effective regulatory disciplinary systems, the cross-monitoring that took place over the network between board members established a certain discipline

[23] Del Ángel, G., 2002 and 2003.

using a private organizational system. Del Ángel (2003) provides two types of evidence to prove this: the first is econometric, this being the inverse relationship between the number of connections and the level of past-due portfolio in proportion to the overall portfolio; the second is historic, showing that many of the cases of opportunism that occurred during this period, cases in which directors abused the practice of insider lending, involved boards that had not established a cross-monitoring system.[24]

The network produced an organizational configuration of ownership and corporate linkages that had a substantive effect on economic performance. This effect derived from the melding of common interests through interlocking directorates and from creating a network that permitted transmission of information and sustain a mechanism of cross-monitoring across the banking industry.

4. The Bank Nationalization of 1982 and its implications[25]

On September 1, 1982, President José López Portillo announced the nationalization of the Mexican banking system during his last state of the union address. Ownership, control and administration of the banking system were transferred to the state. Due to its effect on the economy, nationalization of the banking system was one of the most relevant events in recent Mexican economic history. The bank nationalization followed the debt crisis that was unleashed in August the same year, which was not only catastrophic for Mexico, but for all of Latin America.

The main argument for nationalizing the banking sector was that the government should control the exchange rate in light of the debt crisis and check the drain of capital, for which the government blamed bankers. In addition, some groups within the government thought that the state should be more actively involved in the economy, proof of which was the aim to set up exchange rate controls. The aim was to control the banking system, that at the time, was considered by the supporters of the nationalization as an industry monopolized by private interests. In addition, the mutual tolerance that existed between government and the private sector had been lost those years, although their relationship had not reached breaking point. In this sense, the causes for nationalization of the banking sector were, to a large extent, political, although it was argumented that the government aimed to have an instrument for controlling macro-finance.

Nationalization of the banking sector considerably changed the relationship between the state and the private sector and had unexpected

[24] Del Ángel, G., 2003.
[25] Most of this section is based on Del Ángel, G., C. Bazdresch and F. Suárez, eds., 2005.

consequences in the political arena,[26] as it dealt a major blow to the configuration of the property rights of the private sector. Although the Constitution considered private banking as a public service that could be given in concession to private agents, the rights of ownership of the banking sector had been respected *de facto* for a long time. As far as the relationship between the state and business was concerned, nationalization broke a tacit agreement of mutual tolerance that had been in place since the years of *Cardenismo*.

As nationalization of the banking sector altered the structure of corporate governance in the banking sector, it also altered its behavior and performance. It also had a major effect on the rest of the financial sector. First, although the nationalized banks were still able to make a profit, this was due to the fact that much of their loans were used to finance the public sector, and deposited in the Banco de México, both of which received substantial remuneration.[27] The law established that part of the funds secured by banks were set aside for the banking reserve requirement, selective credit, government securities and credit for the public sector, on account of which banks received high returns. Nevertheless, there was a very small part left over for funding private projects and between 1981 and 1988, private sector credit plummeted and the number of bank borrowers decreased by more than 50%.[28]

Second, although one of the arguments for nationalization was that the banking sector indulged in oligopolic practices, the actual results of nationalization were in fact contrary to its original purpose, because the merger of banks, as part of the so-called *rationalization* of the banking sector, produced a more concentrated industry. This process of consolidation through mergers, made a lot of sense for the government, because as the banks were part of the public sector, many turned out to be redundant, although this led to a sector with less banks and a higher industrial concentration.

Third, several relevant sequels of nationalization only came to light after re-privatization. For example, the consolidation of financial intermediaries from the multi-bank system to an universal banking system failed, as securities markets were operated by brokerage firms. Another of the serious consequences was that as a large part of funds were set aside for financing the public deficit, much experience was lost in credit risk management,[29] which also led to reducing the experience of regulators. Corporate incentives within banks were lost, as the aim of bank top executives was no longer necessarily to have a career in the banking sector, but rather to climb the

26 See Elizondo, C., 2001 and 2005; Bazdresch, C., 2005; and Abedrop, C., 2005.
27 Suárez, F., 2005; Marcos, J., 2005.
28 Marcos, J., 2005.
29 *Ibid.*

political ladder. This was a crucial factor, because although the attempt was made to choose competent people to fill the role of bank directors, internal incentives had changed. Handling of credit had more to do with political relationships with the government than with maximizing the value of the bank's assets. Furthermore, the Federal Executive was responsible for appointing directors of banks, therefore, on some occasions, this responsibility fell upon politicians who carried much more weight than any bank official or regulator who supervised the performance of banks. This affected the capacity to implement regulation, as the effectiveness of the actions of the *Comisión Nacional Bancaria*, which previously had little regulatory and supervisory ability, were restricted even further.[30]

In the face of this situation, a banking sector that was not an effective source of credit for the private sector, Mexico's major companies had to increase their level of financing on the securities market. In this sense, it was the bank nationalization that brought about the first major boom in the history of the Mexican securities market. Although the most important reforms were made to the Mexican securities market in 1977 and 1978, it was in the eighties when the market boosted. Therefore, the development of the so-called *banca paralela*, the brokerage firms, was encouraged by the government. The political intention of the government during the administration of Miguel de la Madrid was to compensate the private sector after the events of 1982, without going back on nationalization. Among other things, this implied to grant to brokerages a monopoly of the CETES (government bonds).[31]

The government passed legal reforms, created new financial instruments and established confidence in investors, which meant that stock market transactions increased. There is no doubt that this particular period has been the most important with regard to passing legal reforms to boost the securities market. Although the initial boom was only short lived, as the stock market suffered a setback in the 1987 crack, brokerages still played a very important part in the financial sector.[32] With the creation of financial groups, the expansion of brokerages allowed them to become the most important acquirers of the commercial banking sector, once the re-privation process of banks had got underway.

Paradoxically, state ownership and control of banks facilitated the process of financial reform and the opening up of the banking sector, this constituting the preparing for re-privatization. To a certain extent, financial reform and the opening up of the banking sector was made easier, because there were no groups with private interests with which to negotiate, and it was relatively

30 *Ibid.*
31 Suárez, F., 2005.
32 Minushkin, S., 2005.

easy to organize the various financial sectors of the state into a homogenous group.

One of the aspects of the financial reform was that the law was amended in 1989 to authorize the formation of *grupos financieros* (financial groups) under a controlling firm. This law came into effect on July 19, 1990. At the outset, these groups could include any type of authorized intermediary, except banks. With privatization of the banking sector, these groups would also include banks.

This reform came about due to several shortcomings in the previous law. The problem with the 1970 law that regulated financial groups was that the various intermediaries of a financial group were regulated by different laws, and this discrepancy distorted the groups' legal functioning. The 1990 law attempted to establish a common regulation criterion and emphasized the setting up of controlling firms that would control the shares of the group's intermediaries.[33] The controlling firms would have the majority vote at shareholders' meetings and on the board of all the companies that were part of the group, therefore it would have to own shares, with the right to vote, that represented at least 51% of paid-in capital. No individual could acquire control on his or her own account of more than 5% of the paid-in capital of the controlling firm, although the *Secretaría de Hacienda* could authorize an individual holding of up to 10% of paid-in capital.[34] This law also authorized linkages between various intermediaries, although without the intervention of a controlling firm, in other words, groups of related financial intermediaries, such as many of those that existed prior to 1982. This paved the way for re-privatization.

5. A dream turned into a nightmare: the re-privatization of Mexican banks

5.1 The privatization

In 1989 there was a further change to corporate governance in the Mexican banking sector: re-privatization of the commercial banks, a process launched by a presidential decree of December 1989. Although this was part of a comprehensive policy of privatization and divestiture of government entities, in the case of banks the state had to amend the Mexican Constitution. This process of divestiture was initiated during the administration of Miguel de la Madrid, with the first wave of financial reforms, and concluded under the presidency of Carlos Salinas. Selling the banking sector to the private sector not only constituted the crowning of the financial reform, but also of the divestiture and privatization process. Privatization of the banking sector and

33 Borja, F., 1991.
34 *Ibid.*

its resulting increase in credit during the following years were some of the most emblematic hallmarks of the ephemeral economic boom during the presidency of Carlos Salinas.

It could be said that at the process of sale of the banks there were discretional criteria in place. For example, there was no clear argument as to why the previous owners of the banks were not authorized to offer themselves as bidders to repurchase the banks that they used to own. One of the main criticisms made after the process had concluded, was that the banks were sold to the highest bidders, without taking into account either their reputation or their ability to manage a bank. According to many specialists, this was one of the problems that brought about the crisis in 1995.[35] Another retrospective criticism was that the process involved political interests and in this sense, neither is it clear why privatization did not include judicious regulation that was even remotely in line with the Basle Accord, measures that were only implemented once the crisis had passed.[36]

The groups of investors authorized to bid for a bank received a prospect that included studies, analyses and a package of financial and technical information relevant of the institution being auctioned. Table 1 shows the sequence of the disincorporation process, the price of the winning bid for the capital stock, and the name of the winning group. The *Comité de Desincorporación* (divestiture committee) received 133 applications to bid from 44 groups, both from financial groups and from individuals.

[35] Haber, S, 2004; Kessler, T., 1999.
[36] *Ibid.*

Table 1. Process of Bank Privatization

Bank	Date of Auction	Group of banks No.	Price of Sale/Equito (book value)	Acquirers: Brokerage or Private individuals (representing a group of investors)
Multibanco MM	6/7/91	1	2.66	Probursa, represented by José Madariaga
Banpaís	6/14/91	1	3.02	Mexival, represented by Angel Rodríguez
Cremi	6/21/91	1	3.40	Private: Raymundo Flores
Confía	8/2/91	2	3.73	Abaco, represented by Jorge Lankenau
Oriente	8/9/91	2	4.00	Private: Marcelo and Ricardo Margain Berlanga
Bancrecer	8/16/91	2	2.53	Private: Roberto Alcantara Rojas, Carlos Mendoza Guadarrama and Ruben Goldberg
Banamex	8/23/91	2	2.62	Accival, represented by Roberto Hernández
Bancomer	10/25/91	3	2.99	Vamsa, represented por Garza Lagüera
BCH	11/8/91	3	2.67	Private: Carlos Cabal Peniche, Carlos Bracho González and Ricardo Armas Arroyo
Serfín	1/24/92	4	2.69	Operadora de Bolsa, represented by Sada y Lunken
Comermex	2/7/92	4	3.73	Inverlat, represented by Agustín Legorreta
Somex	3/1/92	4	4.15	Invermexico, represented by Carlos Gómez and Manuel Somoza
Atlántico	3/2792	5	5.30	Private: Alonso de Garay Gutiérrez and Jorge Rojas Mota Velasco
Promex	4/3/92	5	4.23	Finamex, represented by Eduardo Carrillo
Banoro	4/10/92	5	3.95	Estrategia Bursátil, represented by Rodolfo Esquer
Banorte	6/12/92	6	4.25	Private: Roberto González Barrera, Juan Antonio Gonzalez Moreno and Federico Graf Campos
Internacional	6/26/92	6	2.95	Prime, represented por Antonio del Valle
Bancen	7/3/92	6	4.65	Multivalores, represented por Hugo Villa

Sources: Murillo, J. A., 2005; and Ortiz, G., 1994.

The average price of banks was 3.068 times their book value. The government received 37,856.36 million pesos for the sale, less 1,382.5 million pesos for the adjustments made under the eight sale audits, an amount equivalent at the time to twelve billion dollars.[37]

[37] Murillo, J. A., 2005.

5.2 The Tequila Crisis

One particular event that specialists have analyzed in depth is the crisis that commenced in 1994 and that lasted throughout 1995, a crisis that led the Mexican banking system to a catastrophe that had not been seen since the 1910 revolution. Although the macro-economic crisis of 1994 was the catalyst for what followed, the prevailing conditions in the banking sector were the most important factor that determined the fate of the banks. The causes of the crisis have been explained by a solid production of literature.[38] This paper refers to that literature, but it focuses in Murillo (2005), Hernández and Ávalos (2005), and Secretaría de Hacienda (1998) to describe then events in the process of the crisis and crisis resolution.

A number of political events during 1994, together with a general financial imbalance, provoked a strong run on capital that put much pressure on the value of the peso. The general imbalance that authors attribute to causing the crisis may be divided into three specific aspects: first of all, Mexico had experienced an appreciation in its real exchange rate, together with a continuous deterioration in its balance of payments. However, unlike previous crises, Mexico was not suffering from high public deficit and inflation. Secondly, the short-term public debt during 1994 increased substantially, relative to the level of reserves, which made it the debt vulnerable to negative capital flows. In this situation, the high number of short-term liabilities encouraged speculative behavior of foreign debt holders, as they realized that there was a high probability of default of their loans. The increase in the proportion of the short-term national debt in dollars (*Tesobonos*) served as a notice to the Banco de México that it could not efficiently increase interest rates to protect the value of the currency, as the debt had to be converted to dollars to slow down the accelerated drain of capital. This shortcoming was mainly brought about due to the high amount of leverage of many large private corporations and the exaggerated growth of credit during a period of real appreciation of the peso. [39]

The fragility of the Mexican banking system towards the end of 1994 was a third and a crucial factor in these events. One of the most important factors was probably that the banks' portfolio was increasing without an appropriate strategy to manage the risks to which they were exposed. The banks adopted

[38] There is a vast amount of contributions that help to elucidate this problem, for instance: for explanations regarding the bank crisis, conditions of the banking sector and bank regulation see Haber, S., 2004; Hernández, F. and M. Avalos, 2005; Gruben and R. P. McComb, 2003; Gruben, W., 2002; Girón, A., 2004; Hernández, F., and O. López, 2001; Foncerrada, L., 2003; Rojas Suárez, L. and S. Weisbrod, 1997; Goodhart, C. *et al*, 1998; Del Villar, R., D. Backal and J. Treviño, 1997. For explanations of the macroeconomic conditions that lead to the crisis see Gil, F. and A. Carstens, 1996 and 1997; Hernández, F. *et al*., 2001. For an explanation of the political economy of those events see Kessler, T., 1999. The government's explanation of the crisis and bank bailout can be found: Secretaría de Hacienda, 1998. A textbook explanation of the macroeconomic events can be found in Lustig, N., 2002.

[39] Hernández, F., and M. Avalos, 2005 and Hernández, F. *et al*., 2001.

a risky behavior without having much experience in credit risk management. A problem that went back to when the banking system was state controlled. The banks were also well behind in their information systems and their ability to process information. Many of the systems used for the expanding business were not only obsolete, but also incompatible. The inherent shortcomings of the Mexican legal system also aggravated the risks to which banks were exposed.

When the government privatized the banks, it did not establish an adequate prudential regulation to go with this process. Therefore, banks had no regulatory restrictions with regard to expansion of credit, and the unlimited deposit insurance scheme, through the bank deposit insurance institution, Fobaproa (Bank Savings Protection Fund), encouraged this behavior. Many authors have pointed out that this deposit insurance scheme encouraged moral hazard on the part of the banks.[40] Apparently, the government did not change the regulations to protect those who had paid a high price for the banks. Neither did the banks have any incentive to self-regulation, as acquiring groups entered into ferocious competition with the aim of winning greater segments of the market, and of creating ever more business, thus the banks fell for a "balance trap".[41] I should point out that many of the "new bankers" that purchased banks had experience in the brokerage business, but not in commercial banking. Many banks were run under the same criteria as those for brokerage companies.[42]

There were also cases of bankers committing fraud in their banks and some authors believe that this was a consequence of insider lending practices[43]. Nevertheless, most fraudulent activities have been identified and not all were related to insider lending or related lending, but rather to a broader range of corporate malfeasance.

In 1994, the perception of political instability in Mexico and the financial imbalance of the macro-economy brought pressure to bear on the peso. In view of the accelerated drain of capital caused by an increase of the perception of credit risk in Mexico, and of the increased probability of the Banco de México devaluating the peso, the government eventually had to devaluate the peso in 1994. A consequence of this financial panic was that the government asked the international community to provide support so that it could meet its short-term obligations.[44] At the same time, the monetary authorities drastically increased interest rates, reaching over 100% towards the end of March 1995.[45] Under the conditions at the time, the banks found it

[40] Haber, S., 2004; Gruben, W., 2002; Rojas Suárez, L. and S. Weisbrod, 1996; Goodhart, C. *et al.*
[41] Gruben, W., and R. P. McComb, 2003; Gruben, W., 2002; Foncerrada, L., 2003.
[42] For an example, see Del Ángel, G. and A. Gómez Galvarriato, 2005.
[43] La Porta, R., *et al.*, 2002.
[44] See Rubin, R., 2004, for an interesting explanation of how the American authorities perceived the problem.
[45] Hernández, F., and M. Avalos, 2005 and Hernández, F. *et al.*, 2001; Murillo, J.A., 2005; Gil, F. and A. Carstens, 1996; Secretaría de Hacienda, 1998.

very difficult to weather the crisis, in particular the astronomic rise in interest rates.

The Mexican banking sector was wallowing in its deepest crisis ever. The high level of past due loan portfolio caused by high interest rates, the contracting of the supply of funds available for loans, the reduction in financial mediation and the slow-down of the economy meant that the government had to step in.[46]

5.3 Bailing out the banking system

The two main reasons for bailing out the banking system were to prevent the loss of the public savings within the system and to prevent the system of payment from collapsing, both events of which would have had a high economic and political cost. To do this the government used the bank deposit insurance institution, Fobaproa. This fund later changed its name to the Bank Savings Protection Institute (IPAB, acronym in Spanish) and operated under a new system that made it more independent from the government and that afforded it more facilities to recover assets. The Banco de México set up a credit window in dollars for Mexican banks in conjunction with this program, in order to relieve the liquidity pressures caused by short-term foreign currency obligations.

The government instigated a portfolio purchase program in the face of the drastic deterioration in bank loan collection, under which it undertook to purchase two pesos of past-due portfolio for each additional peso that shareholders contributed to the capitalization of their banks. These credits were acquired through Fobaproa promissory notes, backed by the Federal Government, which banks could not negotiate and that produced yield that could be capitalized every three months at a market rate. Under this program, the banks were still responsible for collecting the credits sold to Fobaproa, and they also undertook to share the losses from the non-collectable portfolio. The value at which Fobaproa bought the portfolio was calculated on the basis of the audits made at the time of acquisition.[47] When capitalization programs were insufficient, the Fobaproa stepped in and rescued the institutions.

All these measures went hand-in-hand with regulatory changes, in particular a dramatic change in prudential regulation, which meant that the banking system had to rigorously observe the Basle Accords. New accounting criteria were put in place,[48] along with improved risk management and corporate governance practices. The legislative framework was also reformed with the promulgation of the Bankruptcy Law and the Guarantees Law, both

[46] *Ibid.*
[47] *Ibid.*
[48] See Del Ángel, G., S. Haber and A. Musacchio, 2005.

of which are discussed at the end of this article. A high price was paid for not taking these measures earlier.

Between 1994 and 2001, the National Banking and Securities Commission (CNBV, initials in Spanish) ordered fifteen credit institutions to be placed in *managerial* intervention; all other receiverships were *administrative*. In the former case, a manger-receiver was appointed and the authorities replaced the board of directors; in the latter case, the authorities appointed a receiver to supervise the actions of the bank's board of directors. The interventions ordered by the CNBV show that the banks with the severest problems had been put into receivership just one year from when the crisis had set in, thus ensuring that the their credit risks would not get any worse.[49]

Those banks that had low capitalization and whose transactions did not transgress the law were not put into intervention, but were bailed out by Fobaproa, who sought investors to help contribute to their recovery. These banks were bailed out and then merged, as follows: Mercantil Probursa, was bought out by BBV; Banoro, bought out by Bancrecer; Promex, bought out by Bancomer, and Atlántico, bought out by Bital. A different procedure was used in the case of Banco Inverlat. Fobaproa took over control of the bank in July 1996 and appointed the Bank of Nova Scotia as administrator, granting it a purchase option that it eventually exercised in March 2001. Even the largest banks of the Mexican banking sector, Bancomer and Banamex, needed additional investment to be able to compete in the new scenario, even though their capitalization was at an appropriate level. Bancomer merged with BBVA, Banamex with Citibank and Bital was bought by the English group HSBC.

Both, Banco Mexicano and Banca Serfín were bailed out and the latter was put into administrative receivership, which meant that Grupo Santander could merge with them, with the first at the beginning of 1997 and with the second at the beginning of 2000 (the merger of Santander Mexicano with Serfin was not fully completed until 2005). Table 2 shows the mergers and buy-outs of banks after the crisis. What the table also shows is that the banks were bought out by international banks, which would prove to be the most significant events in recent Mexican economic history.

[49] Murillo, J.A., 2005.

Table 2. Mergers and Buy-outs. 1994-2002

Process initiated	Merged bank	Merging bank: local (L) or international (I)	Merging bank and process
Feb/95	Union	L	Intervened in March 1994 and merged with Bancomer in February 1995
May/95	Probursa	I	BBV signs a letter of intent to acquire 70% of the shares of Banco Mercantil Probursa in May 1995. The merger took place in June 1996
Mar/96	Oriente	I	Put into receivership in January 1995. Bought out by BBV
Mar/96	Cremi	I	Put into receivership in March 1995. Bought out by BBV
Oct/96	Mexicano	I	Santander Investment signed a letter of intent in October 1996 to purchase the majority of the shares of Grupo Financiero Inverméxico, which controlled Banco Mexicano, along with other banks. The merger was completed in 1997
Jan/97	Obrero	L	Obrero was put into receivership in February 1995 and merged with Banca Afirme in January 1997
Jan/97	Banoro	L	Merged with Bancrecer
Feb/97	Centro	L	Put into receivership in March 1995, merged with Banco Mercantíl del Norte in February 1997
Mar/97	Confía	I	Put into receivership in March 1997, bought out by Citibank in March 1998
Mar/97	Banpais	L	Put into receivership in January 1995, merged with Banco Mercantíl del Norte in March 1997
Apr/97	Alianza	I	Merged with GE Capital in April 1997
Dec/97	Atlántico	L	Grupo Financiero Bital signed a letter or intent for the merger of Banco del Atlántico with Bital in December 1997. FOBPROA took control of the bank in March 1998 and handed over its administration to Bital
Jan/98	Sureste	L	Put into receivership in February 1996 and merged with Bital in January 1998
May/98	Promex	L	Bancomer declared its intent to buy the shares of Promex in May 1998. The merger took place in 2000
Dec/99	Serfin	I	The IPAB decided to capitalize Banca Serfin, thereby acquiring the majority of its shares in June 1999. The call to the public bid was published in the *Diario Oficial* in December 1999. Grupo Financiero Santander Mexicano was awarded the bid in May 2000. The group kept Serfin as a seprate entity and the merger was completed in 2005
Aug/00	Bancomer	I	Merged with Grupo Financiero BBV-Probursa in August 2000. The merger was agreed between the banks without the FOBAPROA being involved.
Mar/01	Inverlat	I	Fobaproa names the Bank of Nova Scotia as administrator in July 1996. The merger took place in March 2001
Aug/01	Banamex	I	Merged with Citibank in August 2001. The merger was agreed between the banks without the FOBAPROA being involved
Sep/01	Bancrecer	L	Bought out by Banorte in September 2001. Banorte was the only bank that submitted a bid for the tender put out by the IPAB
Nov/02	Bital	I	Bought out by the English bank HSBC in November 2002. The merger was agreed between the parties without the FOBAPROA being involved

Sources: Murillo, J.A., 2005, with information from Banco de México, CNBV, and Asociación de Banqueros de México; and Girón, A., 2002, with information from CNBV and journalistic sources.

6. Towards a Better Equilibrium? Mexican banks go global

The need to inject capital into banks after the crisis speeded up the decision to change the terms of the NAFTA in order to allow foreigners to invest in the banking sector. This has been the most relevant change in corporate governance in the Mexican banking sector in recent years. I should point out that although internationalization of ownership and control of the Mexican banking sector was accentuated by the crisis, this process was also due in part to a global phenomenon. Internationalization of banking around the world has been one of the most important recent events in the sector. Latina America is one of the regions in which foreign companies have been most heavily involved. By way of an example, Spain's largest banks invested over ten billion dollars in the region between 1995 and 1999.[50]

Table 3 shows the penetration of foreign banks in the national banking system of several Latin American countries. Among which Mexico is one of the countries with the highest level of foreign interest.

Table 3. Participation of the group of banks controlled by foreign companies in the overall balance of the Latin American banking system

	Assets (%)						Equity (%)		
	Loan portfolio			Total assets			Total		
	1994	1998	2001	1994	1998	2001	1994	1998	2001
Bolivia	6	39	34	6	41	35	50	61	40
Brazil	5	6	26	7	17	28	7	20	29
Chile	15	25	45	15	33	57	N. A.	37	53
Colombia	6	26	23	6	28	23	36	36	25
Costa Rica	0	12	26	0	8	19	1	11	18
Mexico	1	14	68	1	17	73	3	38	73
Peru	6	40	58	6	39	59	10	41	61
Venezuela	1	39	43	1	42	43	2	40	43

Source: García, J.A., 2003.

The general view is that international banks and other financial services providers will continue expanding in Latin America, mainly through mergers and buy-outs. This will probably increase competition and lead to regulatory harmonization between countries.[51] Nevertheless, there is still some debate as to whether the involvement of foreign banks has increased the level of competition.[52]

50 Calderón, A. and R. Casilda, 1999.
51 García, J.A., 2003.
52 See Haber, S. and A. Musacchio, 2005; Dueñas, E., 2003; Del Ángel, G. and A. Gómez Galvarriato, 2005.

As previously mentioned, foreign competition in the Mexican banking sector was barred for seventy years. For many years, the only foreign bank with an interest in the Mexican financial system was Citibank. Of the foreign banks that established themselves in the era of Porfirio Diaz, Citibank was the only one that remained after the others withdrew in 1934. Henceforth, this was the only institution authorized to operate as a foreign bank. Although other foreign banks had representative offices, they were not authorized to conduct commercial banking transactions. Then there were only three banks that were authorized to have foreign partners. When the banks were nationalized in 1982, Citibank was one of the two banks that escaped nationalization. Nevertheless, for a long time it had a mnor market share, to the extent that after re-privatization, its assets amounted to just 0.5% of the total of the banking sector.

It is likely that the most important change that occurred in the direction of foreign involvement in the banking sector was the amendment made to the *Ley de Inversión Extranjera* (Foreign Investment Law) in 1989. This amendment opened up most of the economy to direct investment, and portfolio investment, with the creation of new instruments. This amendment also authorized the repatriation of profits and capital, and allowed foreign investment in the portfolio of Mexican firms.[53]

During the nineties, the Mexican financial system was opened to the participation of international banks, in a three-stage process. This not only included banks, but also the financial groups to which they belonged. Most bank buy-outs were agreed as the buy-out of an entire financial group.

The first stage of this process began with the signing of the North American Free Trade Agreement (NAFTA), which established the gradual opening up of industry, however, during the first few years, the limit of involvement was very low, in addition to which the right was reserved to slow down foreign interest in the banking sector. The transition period began in January 1994 and would end in December 1999. The NAFTA established that the maximum interest that any individual bank could have would be 1.5%. Overall participation of foreign banks was initially to be restricted to less than 8%, to increase gradually to reach a ceiling of 15% by the end of the transition period. The NAFTA also established that the amount of capital that a foreign bank could contribute to a Mexican credit institution would be equivalent to 30%.[54]

Four foreign banks commenced operations in Mexico during the first period of the opening up of the sector: GE Capital in April 1994, followed by Santander, J.P. Morgan and Chase Manhattan in November the same year. Several other credit institutions established themselves in the years to follow, 1995 being the most prolific year in which thirteen new foreign affiliates were

53 Minushkin, S., 2005.
54 Murillo, J.A., 2005.

authorized to commence operations. Five other foreign institutions later joined the market, most of which conducted few transactions that were geared to corporate banking. Over the course of time, most of these institutions managed to find their market niche, although four were unsuccessful and had to cease operations.[55]

A consequence of the banking crisis was that the limit of foreign participation that Mexico had established when it signed the NAFTA was extended in February 1995, thus bringing about the second stage of the opening up of the banking sector. The main changes comprised raising the market participation ceiling of affiliates of foreign banks that acquired a Mexican bank, from 1.5 a 6% on an individual basis, and from 8 to 25% on an overall basis, and increasing the limit of foreign investment in Mexican banks from 30 to 49%. In addition, making these limits more flexible allowed injections of capital to banks that faced problems of solvency. In May 1995, Banco Bilbao-Vizcaya signed a letter of intent to buy Banco Mexicano, and in May 1998, Citibank entered into a sale agreement to buy Banca Confía.[56]

The third stage of the opening up of the market took place at the end of 1998 with the anticipation of the calendar proposed in the NAFTA so, one year before schedule, all restrictions to foreigners having an interest in the Mexican banking system were lifted. This meant that the three major banks of the system could merge with foreign banks. In August 2000, Banco Bilbao y Vizcaya bought Bancomer. In August 2001, Citibank purchased and then merged Banamex via a stock market operation that was considered controversial by analysts. The acquisition of the largest Mexican bank by one of the largest international financial corporations has been the most emblematic event of the process of internationalization of Mexican banks. Later in November 2002, the Hong Kong and Shangai Bank Corporation (HSBC) took control of the shares of Bital. Two other medium-size Mexican banks with solvency difficulties were also bought by foreign credit institutions banks: Serfin, bought by Santander Mexicano in May 2000, and Banco Inverlat, bought by the Bank of Nova Scotia in March 2001[57]. Table 2 shows this process in detail.

Several affiliates of foreign banks also established themselves in Mexico, including: Tokyo-Mitsubishi, Bank of America, Fuji Bank, Banco Bilbao y Vizcaya, ABN Amro Bank, BNP, BankBoston, HSBC Bank, Republic National Bank of New York, Societé Genérale, Dresdner Bank, ING Bank and First Chicago Bank in 1995; American Express Bank and Nations Bank in 1996, and Comerica in July 1997. No other foreign bank established itself in Mexico until 2000, except for the Bank of Nova Scotia that bought Inverlat, and Deutsche

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55 *Ibid.*
56 *Ibid.*
57 *Ibid.*

Bank. The foreign affiliates that ceased operating were Fuji Bank and Nations Bank in 1999, Societé Genérale in 2000 and B.N.P. in 2002.[58]

The opening up of the banking sector increased foreign investment in the Mexican financial system and changed the nature of foreign institutions' participation and the structure, ownership and control of the Mexican financial system. In 2003, foreign capital represented 82.3% of all the system's assets.[59] Table 4 shows a break down of foreign investment in the Mexican banking system, in terms of assets. The Mexican banking system is that which has one of the highest levels of foreign investment.

Table 4. Ownership of Mexican Banks by National Origin (2003)

Country	Market Share of Equity
Mexico	17.7
Spain	37.6
USA	27.6
UK	10.1
Canada	4.7
Other countries	2.3

Sources: Murillo, J.A., 2005; Quijano, J., 2003.

58 *Ibid.*
59 *Ibid.*

Epilogue: Towards the future

The challenge of the Mexican banking system of today is to play a greater part in the future economic development of the country. Mexico needs an efficient and comprehensive financial system so as to use its membership of the NAFTA to benefit its economy. The overall condition of the banking sector, its ownership and control in particular, represents a major challenge for managers, regulators, supervisors and other decision makers.

The future of the Mexican financial system depends on a number of factors, some of which I shall now discuss upon conclusion of this document: the first is the importance of having an effective and adequate legal framework; the second is having proper regulations that is improved progressively, and the third is opening up new areas of competition in the financial sector.

The rule of law in Mexico has perhaps been one of the most algid constraints to financial development. For example, one of the most discussed aspects of the 1995 banking crisis was the absence of an appropriate legal framework that provided both certainty and legal security for financial transactions, with regard to a legal framework governing financial transactions and better corporate governance. Reforms have recently bee made to improve these difficulties.

Legal reforms were made to the provisions related to the guarantees system and the regulation of bankruptcy in April 2000, established in the *Ley General de Títulos y Operaciones de Crédito*, and the *Ley General de Instituciones de Crédito*, in order to establish a more complete legal framework to regulate loan collateral/guarantees mechanisms and bankruptcy situations.

The lynchpin of these reforms was the establishing of two types of collateral mechanisms in the *Ley General de Títulos y Operaciones de Crédito*: the *Fideicomiso de Garantía* (guarantee trust) and the *Prenda sin Desplazamiento de Posesión* (pledge without transfer of possession). The *Ley de Quiebras y Suspensión de Pagos* (bankruptcy and suspension of payments law) was reviewed more or less at the same time, a law that had remained virtually untouched since 1943. The main reason for making this reform was that the law was too biased towards borrowers' interest and brought about perverse incentives to delay the resolution of cases. The Bankruptcy Law was promulgated in May 2000 and the pervious law was repealed. The new law included measures to guarantee the legal security of creditors and borrowers, and to simplify legal proceedings, in order to cut down the time spent on resolving bankruptcy cases.[60]

[60] Murillo, J. A., 2005.

A number of reforms to the entire legal framework of the financial system were approved on April 30, 2001, including improvements to the *Ley de Instituciones de Crédito*, the purpose of which was to correct the corporate practice of credit institutions, establish preventive and correction and supervisory measures and encourage innovation in services and products.[61]

The regulatory improvements made to corporate practices benefited minority shareholders. This is very important, as it is considered in Mexico that minority shareholders are generally at a disadvantage. In particular, the regulation that gave Series "A" shareholders automatic control of the bank's board of directors was repealed. The number of members on boards of directors was reduced and at least 25% of board members had to be independent, with strict limits being established regarding who could hold such a position. Boards of directors would be legally valid when at least 51% of its members were represented, of which at least 25% had to be independent. Another measure taken that affected corporate governance of credit institutions was establishing the obligation to stipulate all matters to be discussed at shareholders' meetings, including those that come under the heading of general matters. In addition, all information and documents concerning the matters discussed had to be made available to shareholders at least fifteen days before the meeting.[62]

Additional restrictions were added to the regulations regarding insider lending operations. Banks used to be able retain related loans in their balance of up to 100% of their basic capital, a figure similar to that in other countries, however, the reform made on April 30, 2001, restricted the maximum amount of these transactions to 75% of basic capital. It also repealed the authority of the *Comisión Nacional Bancaria* to establish exceptions in this regard. Related credits whose value exceeded two million UDIs (investment units) or 1% of equity had to be approved by the bank's board of directors with a majority of at least 75% of board members present.[63]

In addition to improvements to the legal system, the *Comité de Mejores Prácticas Corporativas* (committee for best corporate practices), an analysis group comprising several public and private organizations, issued the *Código de Mejores Prácticas Corporativas* (code for corporate best practices) in June 1999. The code included a set of recommendations to improve the formation and functioning of boards of directors and the divulging of information to shareholders.[64]

The entire financial system requires prudential regulation and supervision, and progressive improvements need to be put into place. For example, the Basle Accord II had emphasized more complex and detailed risk management

[61] *Ibid.*
[62] *Ibid.*
[63] *Ibid.*
[64] IMEF, 2003.

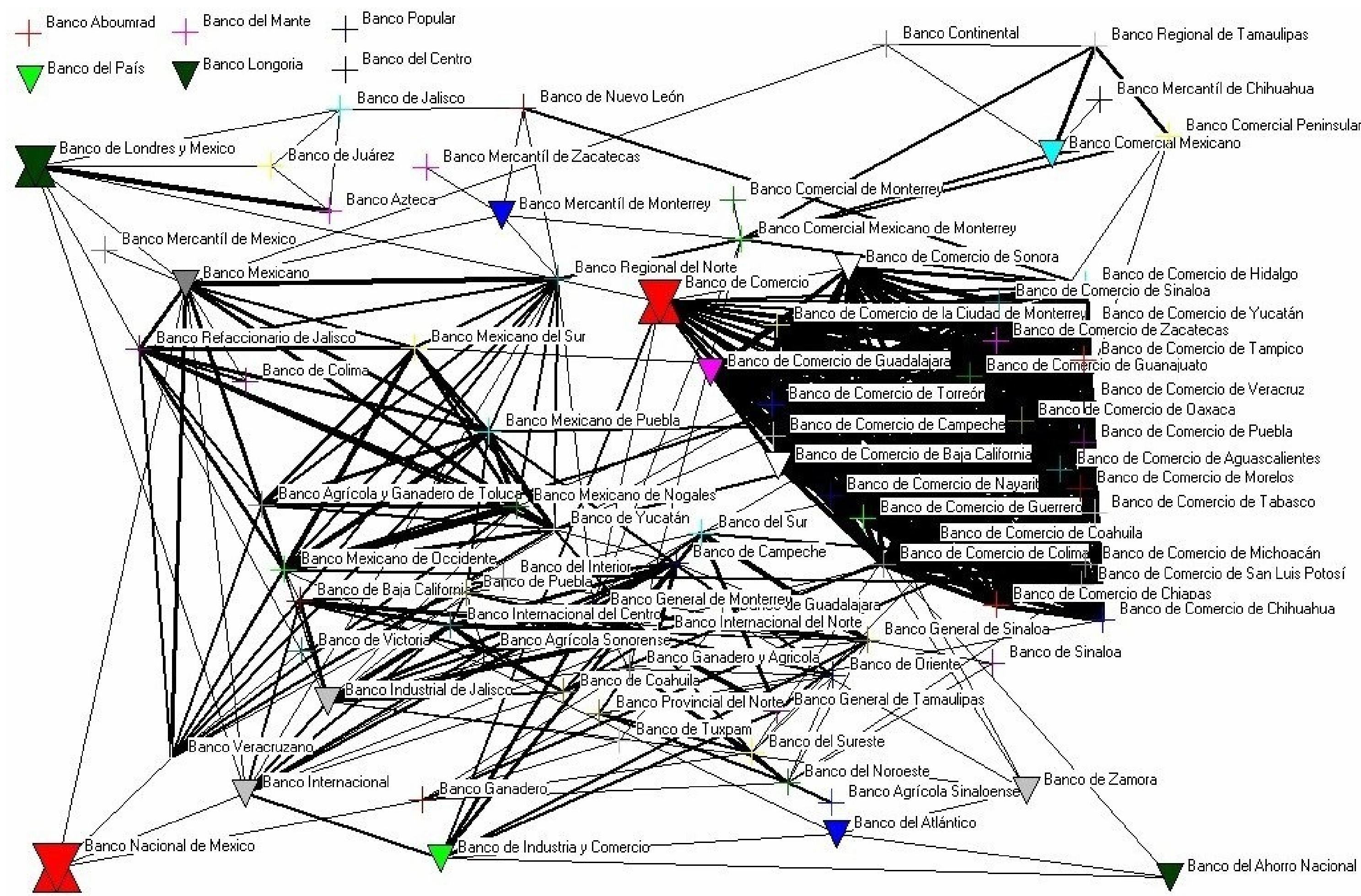
mechanisms. The Basle Accords also underlined the importance of making known any transactions exposed to risk and the need to improve the dialogue between supervisors/regulators and financial intermediaries regarding the measures to be taken to analyze risks.[65] This is not only necessary because of the increasing number of financial strategies and instruments that the sector uses, but also because risks have recently become more complex in the face of events such as natural disasters.

Another vital aspect regarding the future of the Mexican financial system is providing new intermediaries the opportunity to compete against banks. It is still not known if these intermediaries will be absorbed and consolidated by the banking sector, or whether they will form market segments that will compete with the banks. This is the case of specialized financial intermediaries in Mexico, SOFOLES (non-bank banks) in particular and of intermediaries operating micro-financial markets (most working as *microfinancieras*. The substantial increase in the number of these intermediaries in recent years has meant that more credit has been granted to areas in which banks had not been involved. Nevertheless, some banks are now trying to penetrate these sectors and will probably consolidate intermediaries or transactions of this nature.

The future of the Mexican financial system is an unknown number. The Mexican banking sector and the rest of the financial system have experienced a new stage of growth in recent years and have had excellent financial results. This renaissance comprises a better environment for financial transactions, improved practices implemented by international banks and, up to a point, increased competition among them and by new intermediaries. However, in Mexico, we have learned to take a rather conservative standpoint regarding these results; only time will tell. The economic development of one of the members of NAFTA will shape the future.

[65] Del Ángel, G., ed., 2003.

Figure 1. Network of Interlocking Directorates among Mexican Banks. Sample of year 1968



Source: Del Ángel, G., 2003.

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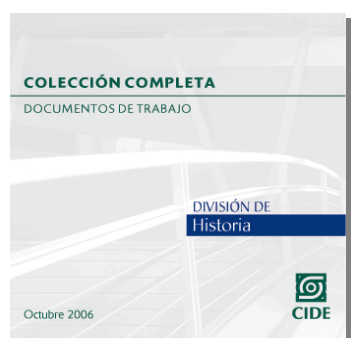

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