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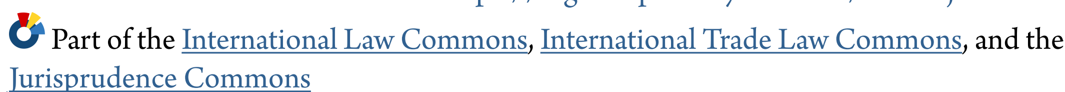
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FOREIGN INVESTMENT IN THE FINANCIAL SECTOR OF MEXICO

MIKE LUBRANO*

INTRODUCTION

In the early 1980's the oil industry collapsed, leaving Mexico with huge international debts it could not repay, and causing a period of substantial inflation.[1] As a result of the collapse, changes occurred within Mexico's economy. In 1982, Mexico nationalized its banks in order to give the government control over the currency market. Then, under President Miguel de la Madrid's administration, Mexico joined the General Agreement on Tariffs and Trade, helping to stem rising inflation.

Although these changes fostered stabilization, further reform was necessary to help the Mexican economy. In 1989, Foreign Investment Regulations were liberalized to permit foreign investors to own up to 100 percent of Mexican businesses. Then, in 1990, the Mexican Constitution was amended to allow private ownership of commercial banks. The Mexican financial system was further reformed in 1990 by the promulgation of the *Ley de Instituciones de Crédito* (Credit Institutions Law) and *Ley para Regular las Agrupaciones Financieras* (Financial Groups Law). Following these reforms, Mexico privatized its banking industry and other parastatal industries. Much of the money derived from the privatization process was used to pay off a significant portion of Mexico's external debt. These changes led to a further stabilization of the economy.

In short, as a result of Mexico's constant nationalistic attitude and the desire to promote industrialization, Mexico maintained a restrictive foreign investment policy until the mid 1980's. The protective policy greatly limited the amount of foreign investment allowed in Mexico. Realizing the poor condition of its economy, the Mexican government relaxed foreign investment in the late 1980's and allowed substantial investment by foreigners. As a result of this and other changes, private sector interest in Mexico was eventually revitalized and direct foreign investment more than doubled between 1985 and 1990.[2] This paper will focus on this remarkable turnaround. More specifically, this paper explores the effects of privatization, the North American Free Trade Agreement (NAFTA), and the peso crisis on foreign investment in Mexican banks.

I. BANK INVESTMENT BACKGROUND

As stated earlier, the Mexican banking sector was nationalized in 1982. With the exception of Banco Obrero and Citibank,[3] Mexican banks were brought under

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1. M. Delal Baer, *North American Free Trade, Foreign Affairs*, Fall 1991, at 132-33.
2. John A. Barrett, Jr., *Mexican Insolvency Law*, 7 PACE INT'L L. REV. 431 (1995).
3. Karen Macallister, *NAFTA: How the Banks in the United States and Mexico Will Respond*, 17 Hous. J.Int'l L. 273, 307 ("Citibank was the only foreign bank operating as a full branch. Since the other banks pulled out in 1938, no foreign bank had been allowed to open a full banking operation. They had only representative offices. Therefore, all other banks were Mexican banks.").

government control.[4] There were several reasons for this nationalization. First, banks were perceived as causing the major financial debt the Mexican economy was experiencing.[5] Moreover, Mexican banks had acquired substantial shareholding control in industrial enterprises. Therefore, the Mexican government had incentive to take over the Mexican banking system, giving the government not only control over the banks, but also substantial control over the Mexican economy.[6] Thus, the Mexican constitution was amended to make banking a state monopoly.

After the oil crisis in the early 1980's and the nationalization of banks in 1982, President Madrid significantly liberalized foreign investment. Most importantly, there was a progressive rollback of the states' one hundred percent interest in the banks. Minority private interests were permitted through *certificados de participación ordinaria* (certificates of ordinary participation – CPOs). Initially CPOs were issued only to Mexican investors. However, between 1982 and 1987, the broker-dealers took an eager role in the financing of an active banking sector, given the absence of an active banking sector. Most notable was the commercial paper market. It was staffed primarily with former management and employees of the banks. As a result, the commercial paper market became a substitute for bank loans. Thus, lending by the banking sector became a relatively small percentage of the Gross Domestic Product.

By 1987, the banks had progressively invested a larger percentage of their assets in government securities and loans to government-controlled businesses. In fact, only one-third of banking assets were actually in private-sector loans. At least two-thirds of their assets were committed to government credits, which were resold to the public. In December 1989, the Foreign Investment Regulations were liberalized, allowing foreign investment in Mexican banks. Specifically, non-Mexican banks were allowed to own up to thirty-four percent of a bank's equity and individuals could own up to five percent. This attracted the interest of a number of foreign banks, most notably Banco Santander of Spain.[7] As a result of the admission of foreign investment in the different sectors of the Mexican economy, the Mexican authorities were pressured to open the financial sector to even greater foreign investment.

As a result of the pressure, constitutional amendments were adopted to reverse the 1982 amendments that made commercial banking a state monopoly. In addition, *Ley de Instituciones de Crédito* (Credit Instituion Law) and *Ley para Regular las Agrupaciones Financieras* (Financial Groups Law) were promulgated, creating the universal banking model.[8] Under these new laws, foreign investment in banks was

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4. The reason why Banco Obrero and Citibank were not nationalized was labor union movements owned the former and the latter had been operating under a special grandfather charter. See Ewell E. Murphy, *Making the Most of NAFTA*, 6 MEX. TRADE & L. REP. 11, 19 (1995).

5. Macallister, *supra* note 3, at 283 ("The foreign banks were creating the massive debt that eventually crippled the economy and the Mexican banks were advising clients export their wealth to more stable currencies and countries, thus facilitating the capital flight from Mexico.").

6. Macallister, *supra* note 3, at 286 (control over sixty percent of the Mexican economy).

7. Banco Santander is now operating in Mexico under the new rules and has articulated a regional strategy for its development in the Americas.

8. The Europeans characterize this as a universal-banking model because there are separate institutions operating in different areas, but wholly owned by a single holding company. *See* Roy A. Karaoglan & Mike Lubrano, *Mexico's Banks After the December 1994 Devaluation: A Chronology of the Government's Response*, 16 NW. J. INT'L L. & BUS. 1 (1995). (The *Ley de Instituciones de Crédito* and the *Ley para Regular las Arupaciones*

limited to thirty percent of equity and ranked as Class C shares. The investment was subject to a general limit of five percent per investor, with the ability to invest a maximum of ten percent with special approval by the Ministry of Finance.[9] In June 1992, L shares were issued. Although, the issuance of L shares permitted the economic interest of foreigners to be as high as forty-six percent, the voting rights were still limited to thirty percent.[10] As a result, banks were bought at very high multiples over their book value with the majority being purchased by brokerage houses.[11]

The resulting expansion of services and lending was based on the general assessment of Wall Street that Mexico was an extremely under-banked country with great possibilities. With only eighteen banks, market share would become a critical element to Mexican banks achieving their growth goals. Indeed, a fight over market share ensued quite rapidly. In the aftermath of privatization, loans increased at roughly 24-25% a year in real terms while the economy was growing at a much lower rate.[12]

In sum, although, the Mexican government nationalized the Mexican banking system in 1982, subsequent actions by the government heightened the amount of domestic and foreign investment. This investment lessened the amount of government control over the banks. These subsequent actions and the liberalization of investment led to the privatization of the Mexican banking system in 1992.

II. NAFTA AND FOREIGN INVESTMENT

In December 1993, as a result of the proposed adoption of NAFTA and the changes to the Mexican financial laws, Mexico created a dual banking system. Under the dual banking system, foreign-controlled entities were subject to the proposed NAFTA market share limitations while Mexican-controlled banks were not.[13] When NAFTA was enacted in 1994, the dual banking system remained in force.

On January 1, 1994, NAFTA was instituted,[14] creating free trade amongst the United States, Canada, and Mexico. This agreement effected the operations of many entities, including Mexican banks. Under NAFTA, Mexico permitted U.S. and Canadian financial institutions to provide financial services to Mexico via the establishment of Mexican subsidiaries.[15] Although NAFTA allowed the U.S. and Canada to invest in Mexico's banking market, the agreement created both per-

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Financieras established the basis for the conglomerate banking model in effect in Mexico today.).

9. Mike Lubrano, *Mexico Amends Financial Sector Legislation to Attract Greater Investment Reinforce Supervision*, NORTH AMERICAN CORPORATE LAWYER, 90, 91 (1995).

10. *Id.* at 91.

11. Stephen L. Fluckiger, *The Mexican Banking Crisis: Remedies and Opportunities*, 50 Consumer Fin. L.Q. Rep. 76 (1996) ("Brokerage houses generally have a higher risk tolerance than banks.").

12. Karaoglan, *supra* note 8, at 2.

13. Karaoglan, *supra* note 8, at 10.

14. North American Free Trade Agreement, Dec. 17, 1992, U.S.-Can.-Mex., (effective Jan. 1, 1994) [hereinafter NAFTA].

15. Fluckiger, *supra* note 11, at 76. See NAFTA, *supra* note 14.

institution and overall limits on foreign participation in commercial banks, securities houses, and insurance companies.[16]

These limits were measured as a percentage of aggregate capital. Thus, the size of a foreign-owned financial institution in Mexico was limited in relation to the size of the market. The individual limits on banks were one and a half percent of the aggregate capital of all banks in Mexico, for broker-dealers it was four percent, and for insurance companies it was one and a half percent.[17] A global limit of eight percent for all foreign-owned financial institutions operating in Mexico was enacted. In the case of banks, the eight percent limit would increase to fifteen percent seven years from the date of implementation.[18]

NAFTA created the limits for several reasons. Primarily, Mexican-owned institutions needed time to catch up after years of state ownership. Mexicans believed that any value which still existed in the Mexican enterprises would be lost if they had to face immediate competition from their Canadian and U.S. counterparts. The Mexican financial system was relatively small, so it would not take a significant foreign interest to dominate the banking system. Next, NAFTA limitations were in response to domestic political concerns. The Mexican government was concerned about their lack of control over the people running the banks. Without this power, the government could not sufficiently regulate the payment system, money supply, or interest rates.

Even though NAFTA's limiting approach was created for the benefit of the Mexican economy, it raised several concerns. The primary problem was it stifled the ability of banks to obtain foreign technology and modernize the financial system. An additional problem was the notion that domestic banks were not under pressure to compete efficiently. This notion existed because there was not the threat of innumerable foreign companies investing in Mexico due to barriers created by NAFTA.[19]

III. PESO CRISIS AND FOREIGN INVESTMENT

The peso crisis of 1994 had very damaging effects on the Mexican financial system. Fortunately, the system stabilized quickly and was successfully operating again in late 1995. At the outset of the crisis in 1994 there was not major activity within the recently privatized start-up banks.[20] In the immediate aftermath of the crisis, however, it became obvious to the Mexican government that it needed to attract more capital to the system.

16. NAFTA, *supra* note 14. *See also* M. Angeles Villarreal, *Mexico's Changing Policy Toward Foreign Investment*, 3 No. 8 MEX. TRADE & L. REP. 16, 20 (1993).

17. Fluckiger, *supra* note 11, at 77. *See also* David A. Gantz, *The United States and the Expansion of Western Hemisphere Free Trade*, 14 ARIZ. J. INT'L & COMP. L. 381, 386 (1997).

18. Gantz, *supra* note 17, at 386.

19. For instance, a minimum of sixteen million dollars was required to apply for a charter under the NAFTA rules. The first application was received in the summer of 1994. By the end 1996, charters had been issued to ten financial groups, eighteen commercial banks, fifteen securities firms, eighteen insurance companies, eleven non-bank banks, twelve leasing companies, five factoring companies, two bonding companies, and a foreign exchange house.

20. This occurred for several reasons: (1) they were small and the only foreign controlled entity that was of any importance in the Mexican financial sector at that point was Citibank and (2) they had just organized and obtained their charters.

In order to attract more foreign capital, the Mexican government decided to abolish the banking restrictions faster than anticipated by NAFTA. In February 1995, amendments were made to the laws controlling credit institutions and financial groups, thereby increasing the possibilities for both domestic and foreign investments.[21] The maximum individual holdings were raised to twenty percent and the maximum security houses' holdings were raised to fifteen percent.[22] Foreign investment in the voting stock of Mexican-controlled holding companies was increased to a maximum of forty-nine percent. The limit on limited voting right L shares was raised to forty percent of their ordinary capital.[23]

More importantly, changes were enacted to permit foreign banks to take over troubled Mexican banks without being subject to the NAFTA limitations. Foreign investors could exceed the one and a half percent limit if they merged with a troubled Mexican bank upon approval of the Ministry of Finance.[24] Congress amended the legislation to impose a six percent individual limit, which basically excluded the largest three banks from being purchased or taken over by foreigners.[25] An aggregate limit on foreign ownership in the banking sector was fixed at twenty five percent, effective until January 1, 2000.[26] The amount that a foreigner would have to hold in a foreign-controlled banking institution was reduced from ninety-nine percent to fifty-one percent.[27]

In sum, it became self-evident that the Mexican government needed to encourage foreign investment after the peso crisis of 1994. In order to do so, the NAFTA limitations were removed and amendments were made to the banking laws allowing foreigners to maintain a larger percentage of a Mexican bank's equity.

IV. RECENT MERGERS

The liberalization by the Mexican government did spur foreign investment. As of 1995, several mergers and agreements with Mexican banks have resulted. For

21. Lubrano, *supra* note 9, at 90. ("In addition to the amendments to financial sector legislation discussed in this article, the Mexican government has responded to the effects of the current crisis in the financial sector with the introduction of a new inflation-adjusted unit of account, *Unidad de Inversión* (UDI), and a program to assist banks to restructure their loans to private sector borrowers unable to service their loans on their existing terms. A special program has also been established to provide temporary capital to Mexican banks suffering decreases in their capital ratios as a result of the crisis. Under this temporary capitalization program, *Programa para Capitalización Temporal* (PROCAPTE), banks may raise temporary capital by mandatory convertible subordinated debt to the bank support fund, *Fondo Bancario de Protección al Ahorro* (FOBAPROA). The two principal elements of these reforms to the Law of Credit Institutions, Financial Groups Law and Capital Markets law are (1) modifications to Mexican laws governing the shareholding structure of financial holding companies, commercial banks and brokerage firms. These changes are intended to encourage greater investment in the equity of financial institutions by Mexican corporations and foreign financial institutions and portfolio investors; and (2) toughening of federal laws governing; (a) purchase by commercial banks of shares of affiliates; (b) pledges of the equity of financial institutions as collateral for "preventive support" provided by FOBAPROA *and Fondo de Apoyo al Mercado de Valores* (FAMV) the support funds for banks and broker-dealers, respectively; and (c) administrative and management intervention of financial holding companies.").

22. Lubrano, *supra* note 9, at 91.

23. *Id.*

24. Fluckiger, *supra* note 11, at 79.

25. Lubrano, *supra* note 9, at 91-92. The three largest banks are *Banco Nacional de Mexico*, *Bancomer*, and *Banca Serfin*.

26. Karaoglan, *supra* note 8, at 10.

27. *Id.* at 91.

example, in May of 1995, Spain's Banco Bilbao Vizcaya reached an agreement with the Mexican government to purchase a controlling interest in Probursa.[28] In addition, Wells Fargo announced a strategic alliance with Mexico's largest bank, Banamex.[29] Two other important foreign purchases of Mexican banks have also occurred – Bank of Nova Scotia's investment in Inverlat and Bank of Montreal's purchase of a sixteen-percent stake in Grupo Financiero Bancomer.[30]

Foreign banks have not been the only entities entering into agreements with Mexican banks. For example, Grupo Financiero Ford Credito de Mexico and Grupo Financiero Associates have been authorized to operate in Mexico.[31] Another example is TransUnion entering into an agreement with several Mexican banks to automate their consumer credit information.[32] There are also agreements with Mexican banks and foreign entities to provide leasing services, credit card processing, wire transfer services, and automatic teller machines.

In conclusion, the Mexican government lacked the resources to save their failing banks after the peso crisis. Therefore, it was in desperate need of external funding. Fortunately, foreign entities were willing to invest in Mexican banks because it provided the opportunity for new markets and technological advancement.

V. CONCLUSION

The Mexican economy, as well as its banking system, has gone through a progression of changes. After the oil crisis in the early 1980's, the Mexican government monopolized its country's banking system. The government nationalized the banking system in order to stabilize the country's economy, but the nationalization was unsuccessful. Therefore, subsequent events initiated by Mexico's government produced the opportunity for external sources of capital. This manufacture of capital created the potential for further foreign investment into the Mexican banking system. To maximize the amount of foreign investment, the banking system was privatized. The privatization of the banking system has helped Mexico's economy as well as its banks to flourish, creating the incentive for continued foreign investment.

QUESTIONS AND COMMENTS

STEPHENSON: Is there any policy reason why non-bank organizations are prohibited from acquiring Mexican banks now?

LUBRANO: The only legal requirement under NAFTA and the Mexican legislation is that the foreign financial institution be engaged in the same business in their domestic countries. That can be construed broadly. For example, a U.S. commercial bank could own a broker-dealer in Mexico. It would be pretty easy to demonstrate that the same skills are involved in the bank's permitted securities activities in

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28. Lubrano, *supra* note 9, at 92.
29. Fluckiger, *supra* note 11, at 82.
30. *Id.*
31. *Id.*
32. *Id.*

the U.S. and in the securities house in Mexico. There is no reason that it has to be a bank for a bank, or securities house for securities house.