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# FOREIGN BANKS IN MEXICO: ON THE VERGE OF A NEW ERA?\*

JOHN E. ROGERS and ADRIAN ZUBIKAIRI ARRIOLA\*\*

## INTRODUCTION

Mexico is currently seeking to rescue its banking system from the lingering effects of the December 1994 peso devaluation and the more recent impact of the worldwide financial uncertainty which began with the economic turmoil in Asia in the latter half of 1997 and intensified with the August 1998 financial crisis in Russia. In that context, the role of foreign banks might appear to be relatively minor, but in fact foreign banks may hold the key to the strengthening of the Mexican banking system, through the capital and expertise which they could bring to remedy some of the deficiencies of the Mexican system.

Foreign banks played an important role in the Mexican financial system until the era of the Mexican Revolution, which led to a reduction in foreign investment in the banking sector and legal restrictions which lasted until the early 1990's. With the changes in Mexican banking laws that were implemented as a result of the North American Free Trade Agreement ("NAFTA") and the 1994 devaluation, and the further changes which have been proposed by the Zedillo administration, which are expected to be enacted once the crisis of the *Fondo Bancario para la Protección al Ahorro* ("FOBAPROA") is resolved, Mexico may find foreign banks once more playing a key role in the country's financial system.

## I. FOREIGN BANKS IN MEXICO 1882-1993

By 1882 foreign investors had established significant stakes in the Mexican banking system. It has been estimated that at that time foreign investors controlled as much as 94% of the capital of the Mexican system. Of the total foreign investment, 60% was from France, 21% from the United States, 11% from England, 7% from Germany and 1% from the Netherlands. Banco Nacional de México ("Banamex") was then controlled by French investors who owned 70% of its stock. Investors from France also owned 46% of the capital of Banco de Londres, Sudamérica y México ("Banco de Londres"), 60% of Banco Central Mexicano, 50% of the Banco del Estado de México and 34% of Banco Peninsular Mexicano. Major institutional investors included the Société Financière pour l'Industrie au Mexique, the Société Franco-Suisse pour l'Industrie Électrique and the Société

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\* Since this paper was written, important legislation was enacted in Mexico which affects foreign investment in Mexican banks and the handling by the financial authorities of problems in the banking system. The legislation incorporated some but not all of the elements of the Reform Bill referred to in part IV of this paper. See *Ley de Protección al Ahorro Bancario* (Bank Savings Protection Law) and amendments to the Banco de México Law, the Credit Institutions Law, the Capital Market Law and the Financial Groups Law, *Diario Oficial de la Federación*, January 19, 1999, at 7.

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Financière Franco-Suisse. The investments were in both commercial banks and in specialized mortgage banks around the country.<sup>1</sup>

U.S. investors had minority interests in Banamex, Banco de Londres and others, and controlled the Banco Internacional Hipotecario de México. There was a U.S.-owned institution called "American Bank" with offices in Mexico City and in Torreón, and trust companies such as "United States and Mexico Trust Company" and "International Bank and Trust Company of America." Other interests were scattered around Mexico, in various regional and small banks. British investment seems to have been concentrated initially in the Banco de Londres, but British investors evidently relinquished control of that bank to French and U.S. investors at some point.<sup>2</sup> Clearly the foreign investment during this period was overwhelmingly European in nature, with European investors having 79% of the total; U.S. investors were a relatively small factor, with only 21% of the total.

Banco de Londres (founded in 1864) and Banamex (founded in 1881)<sup>3</sup> were by far the largest banks in Mexico during most of the administration of the dictator/President Porfirio Díaz (often called the "Porfiriato"), particularly from 1890 to 1911. Many of the other banks were based outside of Mexico City. In 1875 the Chihuahua state legislature chartered the Banco de Santa Eulalia, and in 1878 a similar charter was granted to the Banco Mexicano by such legislature; each bank was owned by U.S. investors.<sup>4</sup> The Banco de Nuevo León was founded in 1891 and grew rapidly during the Porfiriato; by 1910 it had taken the place of Banco de Londres as the second largest bank in the country.<sup>5</sup>

During this period two key laws were enacted affecting the banking system, the Commercial Code of 1884 and the General Law of Credit Institutions adopted in 1897, which established a set of general rules to replace a system of concessions and privileges that greatly favored the largest banks. Nevertheless the 1897 law ratified the position of Banamex and Banco de Londres as the only banks authorized to issue banknotes in the Federal District.<sup>6</sup>

Domestic investment in the banking sector gradually increased during the Porfiriato, and the reduction of British investment in Banco de Londres in favor of local investors was encouraged or forced by President Díaz. The other foreign-owned banks were also increasingly encouraged to accept Mexican investors as joint-venture partners.<sup>7</sup> The Mexican Revolution began in 1910, and the revolutionary turmoil sharply affected the foreign-owned banks; a number of them became insolvent, and others became Mexican-owned with the sale of controlling interests to Mexican shareholders. The only new foreign entrant into the banking sector was National City Bank of New York (later called First National City Bank

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1. Rafael J. Dávila Arriaga, *El sistema bancario mexicano hasta 1911*, at 54 (1965) (unpublished thesis, Universidad Nacional Autónoma de México, Escuela Nacional de Economía, Tesis (Mexico City)) (on file with author). See also Enrique C. Creel, *Finanzas de México, sus bancos y su sistema monetario*, Mesones 156 (1930), Mexico City, at 17-51.

2. Dávila Arriaga, *supra* note 1, at 55.

3. It seems that this was a branch office of London-based Bank of London and South America, which in Mexico was known as Banco de Londres, México y Sud América. See *id.* at 68.

4. Heliodoro Dueñes, *Los bancos y la Revolución*, Editorial "Cvltvra" Mexico City (1945), at 55.

5. Dávila Arriaga, *supra* note 1, at 65, 73.

6. *Id.* at 90-92.

7. Miguel S. Wionczek, *Foreign Banking in Mexico*, The Banker (London), Sept. 1970, at 988.

and then Citibank), which established a branch office in 1929 primarily to finance trade between Mexico and the U.S.<sup>8</sup>

From the end of the Revolution until 1965, it seems to have been legally possible for additional foreign banks to establish a presence in Mexico, but economic and political conditions were not sufficiently encouraging to foreign banks to want to establish more than representative offices, and thus Citibank continued to be the only foreign bank with branches in Mexico. There were, however, investments by Banque Nationale de Paris in Banco del Atlántico and by Banco Popular Español in Banco del Valle de México (later absorbed by Banco del Atlántico). Then, just as Mexico began to be a more attractive place for foreign investment in the early 1960's because of the rapid economic growth it had enjoyed, the General Law of Credit Institutions was amended in 1965 to exclude foreign investment in the banking sector. Citibank's operations were permitted to continue as before, but they accounted for less than one percent of the assets of the Mexican banking system as a whole and the branches were prohibited from taking savings deposits or engaging in trust operations.<sup>9</sup>

Over the years, a large number of foreign banks came to have representative offices in Mexico. By 1970, there were over 30 such offices in Mexico City, representing U.S., British, Canadian, German, Spanish, French, Italian and Swiss banks. These offices were (and still are) strictly limited as to the activities they may perform in Mexico. One of the activities that such offices are often suspected by the government of engaging in is that of illegally soliciting or taking deposits from Mexicans, whether through the foreign banks' private banking units or otherwise.<sup>10</sup>

When the Mexican debt crisis erupted in August of 1982, the Mexican government took the dramatic step of nationalizing the Mexican banking system. The López Portillo administration took this action on the ground that the owners of the banks had contributed to causing the crisis, but many viewed the government as attempting to make the owners scapegoats for the government's own policy failures. In any event, for the next eight or nine years, the issue of foreign bank participation in the Mexican banking system was blunted by the fact that the system was controlled by the government. It seemed unlikely to many during that period that privately-held foreign banks would be permitted to participate in the Mexican banking system if Mexican banks in general were not permitted to be owned by private investors. However, once the Mexican banking system began to be returned to private ownership during the administration of Carlos Salinas de Gortari in the early 1990's, the barriers to foreign participation in the system began to weaken as well.

## II. NAFTA AND FOREIGN FINANCIAL AFFILIATE

During the negotiation of NAFTA during the early 1990's, as the re-privatization of the Mexican banks was occurring, one of the key objectives of the U.S. negotiating team was to open up Mexico to investment by U.S. banks. This issue

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8. *Id.* at 989; see also Miguel Angel Calderón R., *El impacto de la crisis de 1929 en México*, Mexico City: 1982, at 49 et seq.

9. Wionczek, *supra* note 8, at 991.

10. *Id.* at 992.

seems to have been fiercely contested by the Mexican negotiators, who were concerned that Mexican banks, which were just returning to private ownership after almost a decade of government control, were not prepared to compete directly with their counterparts in the U.S. and Canada. The outcome of this part of the negotiation was Chapter Fourteen of NAFTA on Financial Services, which liberalized cross-border financial services between the three signatories of NAFTA, and, more specifically, Annex VII(B) to NAFTA, which sets forth the reservations and commitments of Mexico with respect to the establishment and operation in Mexico of foreign-owned financial institutions.<sup>11</sup>

Under Annex VII(B), Mexico agreed to a gradual opening of its financial system to foreign investment on the condition that (among other things) such investment would have to be through Mexican subsidiaries rather than branches.<sup>12</sup> One of the arguments for this requirement was that it was necessary to ensure the Mexican government's control over the country's money supply. However, because it meant that a foreign bank's Mexican subsidiary's operations would be limited by the subsidiary's capital rather than by the capital of its parent bank, the requirement had the effect of substantially reducing the capacity and usefulness of a foreign bank's Mexican operations, at least until such time as the limitations on the size of such subsidiary might be loosened. Citibank would have been permitted to continue operating through branches, but if it had done so it would not have been entitled to any of the benefits of Annex VII(B), including the eventual elimination of the size restrictions. Evidently for this reason, Citibank eventually decided to convert its Mexican branches into a subsidiary operation.<sup>13</sup>

The gradual opening under Annex VII(B) to foreign commercial banks, securities firms, insurance companies and nonbank banks was structured so that during a six-year transition period their capital participation would be limited to specified percentages of the total capital of the corresponding part of the financial system. In the case of commercial banks, the maximum capital that would be authorized for a Mexican subsidiary of a foreign bank organized under the laws of the U.S. or Canada was to be 1.5% of the total capital of the Mexican banking system. In addition, the aggregate capital of all of the Mexican subsidiaries of U.S. and Canadian banks was not to exceed 8% of the total capital of the Mexican commercial banking system, with this aggregate limit to gradually increase to 15% of such total capital by the end of the transition period (i.e., by January 1, 2000).<sup>14</sup>

At the end of this transition period, the subsidiaries will cease to be subject to the limitations except that, if the aggregate capital of all such foreign-owned subsidiaries should exceed 25% of the total capital of the Mexican banking system prior to the end of 2003, Mexico can exercise a safeguard provision in Annex VII(B) that would slow the growth of the foreign bank presence. Under this provision, participation of the foreign-owned subsidiaries would be frozen at the

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11. North American Free Trade Agreement, drafted Aug. 12, 1992, revised Sept. 6, 1992, U.S.-Can.-Mex., 32 I.L.M. 605 (entered into force Jan. 1, 1994) [hereinafter NAFTA], Article Fourteen, Annex VII(B) - Mexico.

12. Under Article 7 of the Credit Institutions Law or *Ley de Instituciones de Crédito*, *Diario Oficial de la Federación*, December 23, 1993 (Second Section), [hereinafter CIL], branches of foreign banks may be authorized, but only to engage in transactions with persons not resident in Mexico.

13. Cf. NAFTA Annex VII(B).

14. *Id.* at paragraph 9.

percentage of the system's total capital existing at the time the freeze is imposed, but the freeze could not be in effect for more than three years.<sup>15</sup> It is noteworthy that although NAFTA was intended to primarily benefit investors from its three signatory countries, the agreement permitted institutions based outside of North America to take advantage of the provisions as to the market opening in Mexico so long as they utilized operating subsidiaries organized under the laws of the U.S. or Canada as the vehicles for their investment in Mexico.

NAFTA became effective on January 1, 1994, but in anticipation of it coming into force, Mexico enacted amendments (also effective on January 1, 1994) to its *Ley de Instituciones de Crédito* (Credit Institutions Law or CIL) which gave effect to the provisions of Annex VII(B) with respect to commercial banks (or *instituciones de banca múltiple*, as commercial banks are called under that law).<sup>16</sup>

The new Mexican subsidiaries of foreign banks would be permitted to be formed as Foreign Financial Affiliates of foreign financial institutions, and could either be stand-alone banks or operate as members of foreign-owned financial groups formed under amended provisions of the Financial Groups Law (*Ley de Agrupaciones Financieras*).<sup>17</sup> Each of these laws now contains a chapter on "Affiliates" or "Holding Company Affiliates" of Foreign Financial Institutions, prescribing the rules for investment by such institutions in their Mexican bank subsidiaries or financial group holding company subsidiaries. Such subsidiaries must be organized under Mexican law and have at least 99 percent of their capital stock held by the foreign financial institution.<sup>18</sup>

To implement these new provisions, on April 21, 1994 the Ministry of Finance and Public Credit (the *Secretaría de Hacienda y Crédito Público* or "SHCP") of Mexico published its Rules for the Establishment of Affiliates of Foreign Financial Institutions, prescribing the procedures for applications by foreign financial institutions for authorizations by the SHCP to establish Affiliates or Holding Company Affiliates under the CIL, the LRFG, the Securities Market Law and related laws.<sup>19</sup> Since that date over 100 applications were made to the SHCP and many of such applications were approved. By September 1996, 69 Affiliates had been authorized and were operating, of which there were 17 banks, 9 securities firms, 11 financial leasing companies, 5 financial factoring companies, 10 nonbank banks, 15 insurance companies and 2 bonding companies.<sup>20</sup>

Based on the membership of the Association of International Financial Institutions (*Asociación de Instituciones Financieras Internacionales S.C.* or AIFI) in mid-August 1998, at least seventeen Mexican bank subsidiaries of foreign banks were operating, including at least four as members of financial groups. Ten of the

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15. *Id.*

16. CIL, *supra* note 12, at 12.

17. Law to Regulate Financial Groups or *Ley de Agrupaciones Financieras*, D.O., Dec. 23, 1993 (Second Section) [hereinafter LRFG].

18. Cf. CIL Arts. 45-A to 45-N, and LRFG Arts. 27-A to 27-N. For further detail and analysis, cf. John E. Rogers & Adrián Zubikarai A., *Recent changes to Mexican controls on foreign investment in financial institutions*, 64 BNA's Banking Report 935 (1995).

19. "Reglas para el Establecimiento de Filiales de Instituciones Financieras del Exterior," D.O., April 21, 1994.

20. Secretaría de Hacienda y Crédito Público, *Directory of Foreign Financial Intermediaries*, Sept. 1996.

banks were owned by U.S. institutions,<sup>21</sup> and of the remainder, two are owned by French banks, two by Dutch banks, one by a Spanish bank, one by a Japanese bank and one by a German bank, although it appears that the European and Japanese institutions utilized subsidiaries in the U.S. or Canada as vehicles for their investments. Interestingly, so far no Canadian bank has established a subsidiary as an Affiliate under the NAFTA-inspired provisions of the CIL. However, a couple of Canadian banks have acquired significant interests in existing banks, pursuant to 1995 amendments to the CIL and LRFG (see part III below),<sup>22</sup> which may at some point convert into Affiliates.

AIFI members also included two Mexican securities firms or *casas de bolsa* (owned by Bankers Trust and Goldman Sachs),<sup>23</sup> seven nonbank banks and 64 bank representative offices, representing banks from Germany (9), the United States (7), Spain (7), France (7), Japan (5), Canada (4), the United Kingdom (4), Switzerland (3), Italy (2), Belgium (2), South Korea (2), multilateral institutions (2), Israel (2), Netherlands (1), Australia (1) and various countries in Latin America and the Caribbean (6). In addition, four foreign securities firms have representative offices that are AIFI members.<sup>24</sup>

### III. THE FEBRUARY 1995 OPENING

When it had become clear that the December 1994 devaluation, and the financial crisis that resulted therefrom, would imperil the solvency of the Mexican banking system, the government determined to go beyond its NAFTA commitments and make it possible for foreign banks to provide additional capital to the system. Further amendments to the CIL were enacted in February 1995, which made it possible for foreign banks to acquire up to 100% of the capital of existing Mexican banks through "programs approved by the [SHCP] for the purpose of converting the respective multiple banking institution into an Affiliate."<sup>25</sup> However, these 1995 Amendments excluded any bank with capital exceeding 6% of the total capital of the banking system— then meaning the three largest banks, Banamex, Bancomer and Banca Serfin — from eligibility for any such foreign takeover.<sup>26</sup> This would change under the amendments proposed by the Zedillo administration in March of 1998 (see part IV below).

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21. Two additional U.S.-owned Affiliates were on the SHCP list by Sept. 1998. Telephone conversation with SHCP on Sept. 1, 1998.

22. As of August 13, 1998, such bank subsidiaries were said to be those of ABN AMRO Bank, American Express Company, Bank of Boston, Banco Santander de Negocios, Bank of America, Bank of Tokyo-Mitsubishi, Banque Nationale de Paris, Chase Manhattan Bank, Citibank, Comerica Bank, Dresdner Bank, First Chicago Bank NBD, GE Capital, ING Barings, J.P. Morgan, Republic National Bank of New York and Société Générale. Of these, according to the *Asociación de Instituciones Financieras Internacionales S.C.* [hereinafter AIFI] membership list the four that are members of Mexican financial groups formed under the LRFG were Chase, Citibank, ING Barings and J.P. Morgan. Affiliates of Nations Bank, Fuji Bank and Banco Bilbao Vizcaya appear not to be members of the AIFI.

23. SHCP has indicated that authorizations for securities Affiliates have also been granted to Bankers Trust, ING Barings, Deutsche Morgan Grenfell and Merrill Lynch. See note 20 above.

24. Fax message dated Aug. 13, 1998 from AIFI to Carlsmith Ball.

25. "Decreto que reforma, adiciona y deroga disposiciones de la Ley para Regular Agrupaciones Financieras, de la Ley de Instituciones de Crédito y de la Ley del Mercado de Valores," D.O., Feb. 15, 1995 [hereinafter the 1995 Amendments].

26. *Id.*

In the four years since the adoption of the 1995 Amendments, there have been only four cases known to the authors in which foreign banks have taken control of Mexican banks: (i) Banco Bilbao Vizcaya acquired control of Probusa; (ii) Banco Santander purchased control of Banco Mexicano; (iii) The Bank of Nova Scotia acquired control of Banco Inverlat; and (iv) GE Capital purchased control of Banco Alianza. Given the continuing limitations on foreign investment in the three largest banks, the foreign stakes in the most troubled of the three, Banca Serfín, have been limited to less than 20%. The Hongkong Shanghai Banking Corporation has acquired slightly less than 20% of the capital of Serfín and it has been reported that J.P. Morgan has also acquired slightly less than 9% of the stock of Serfín. The Bank of Montreal has also acquired a significant interest in Bancomer, and Spanish and Portuguese banks have obtained interests in Banco Internacional, now called Bitel, which recently merged with Banco del Atlántico.

It soon became clear that the 1995 Amendments were not going to be enough, in the short and medium term, to solve the problems of the Mexican banking system. Many of the possible foreign bank candidates either were reluctant to purchase a Mexican bank until they had more information about the condition of such banks, or had other priorities in terms of expansion in their home countries or in foreign countries other than Mexico. Others may have been constrained by concerns about Mexican laws and regulations that might affect the profitability of a Mexican banking franchise. In any event, the Mexican government soon began to concentrate on other mechanisms for assisting the banking system, including intervening in the most troubled banks and in acquiring the weakest portions of the loan portfolios of the somewhat more secure banks. In each approach, the government came to rely heavily on programs directed by the Banking Fund for the Protection of Savings (the *Fondo Bancario para la Protección del Ahorro* or FOBAPROA). In the latter case, the problem loans were typically acquired by FOBAPROA against issuance by it to the selling bank of government notes. By early 1998, it was estimated that FOBAPROA was administering loans with a face value equivalent to as much as U.S. \$61 billion or more.

#### IV. THE 1998 PROPOSALS

In early 1998, the Zedillo administration developed a financial reform package which it proposed to the Mexican Congress.<sup>27</sup> The package would effect numerous changes to the financial system with respect to the operation and role of FOBAPROA, the conversion of FOBAPROA obligations into public debt, the structure and powers of the National Banking and Securities Commission (the *Comisión Nacional Bancaria y de Valores* or CNBV) and a variety of other matters. With regard to the issue of foreign investment in the banking sector, the package would eliminate most remaining restrictions on such investment. The proposed changes would, in large part, focus on changes in the classifications of the shares of capital stock issued by Mexican banks (the portion of the package that would

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27. The proposed package is contained in two letters dated March 26, 1998 from President Zedillo to the secretaries of the Chamber of Deputies of the Mexican Congress.



affect the supervision of the banking system and foreign investment in the banks is herein sometimes referred to as the "Reform Bill").

Under the Reform Bill, the CIL and the LRFG would be amended to eliminate the existing classifications of shares of bank capital stock.<sup>28</sup> Under current law, at least 51% of a bank's capital must be represented by class "A" shares, and the remaining shares are to be class "B" shares or, as noted below, class "L" shares.<sup>29</sup> With some noted exceptions, as set forth below, current law restricts ownership of class "A" shares to Mexican nationals.<sup>30</sup> Although taken alone class "B" shares are currently generally unrestricted as to foreign ownership, the current law generally provides that no one, including foreigners, acquire more than 5% of class "A" and "B" shares, collectively, of any bank.<sup>31</sup>

Current law provides the SHCP with the authority to consent to a transfer of up to 20% of class "A" and "B" shares to any one party, provided that control of the bank does not end up in the hands of foreigners.<sup>32</sup> In addition, if the capital of the Mexican bank being acquired does not exceed 6% of the sum of the net capital of all Mexican banks, the SHCP has the power to approve a foreign financial institution's acquisition of greater than 20% of class "A" and "B" shares of a Mexican bank, but only if the acquisition is for the purpose of setting up a Mexican affiliate of the foreign institution under the provisions of the CIL relating to foreign financial affiliates.<sup>33</sup> In place of the present system of "A" and "B" shares, the proposed changes to the CIL and LRFG would authorize a single category of shares for Mexican banks. The new class would be designated class "O,"<sup>34</sup> and foreigners would not be prohibited from owning class "O" shares due simply to their foreign status (unless they are foreign governmental authorities or agencies).<sup>35</sup>

Under current law, upon obtaining approval from the CNBV a Mexican bank may also issue a third class of stock, class "L" shares, in addition to class "A" and "B" shares.<sup>36</sup> The proposed law would also allow banks to issue class "L" shares in addition to class "O" shares.<sup>37</sup> Class "L" shares have limited voting rights, but may have the right to a cumulative preferred dividend.<sup>38</sup> Class "L" shares may not represent more than 40% of the total capital of any bank.<sup>39</sup> Neither the current law nor the Reform Bill prevent foreigners from owning class "L" shares.<sup>40</sup>

Under the proposed changes to the CIL and the LRFG, the sale or acquisition of more than 2% of a bank's class "O" shares would have to be reported to the CNBV within 3 business days of the transfer.<sup>41</sup>

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28. Cf. CIL, *supra* note 12, Art. 11, second paragraph.

29. CIL, *supra* note 12, Art. 13(II).

30. CIL, *supra* note 12, Art. 14, first paragraph, and Art. 19, first paragraph.

31. CIL, *supra* note 12, Art. 17, first paragraph.

32. *Id.* This authority was granted pursuant to the 1995 Amendments.

33. Cf. CIL, *supra* note 12, Art. 17(VII) and penultimate paragraph of Art. 17.

34. CIL, *supra* note 12, Art. 11 under the Reform Bill.

35. CIL, *supra* note 12, Art. 13 under the Reform Bill.

36. CIL, *supra* note 12, Art. 12.

37. CIL, *supra* note 12, Art. 11 under the Reform Bill.

38. CIL, *supra* note 12, Art. 12.

39. CIL, *supra* note 12, Art. 11 under the Reform Bill.

40. Cf. CIL, *supra* note 12, Art. 12.

41. CIL, *supra* note 12, Art. 14 under the Reform Bill.

As with class "A" and "B" shares under current law, an individual's ownership of a bank's class "O" shares under the Reform Bill would be limited to 5% of the bank's total outstanding shares.<sup>42</sup> Yet, as under the current law, the Reform Bill would also allow an individual to increase his percentage ownership in class "O" shares to up to 20% of a bank's total capital upon obtaining approval therefor from the Mexican authorities, although under the Reform Bill the approval would have to be obtained from the CNBV instead of from the SHCP.<sup>43</sup> Moreover, the new law would grant the CNBV powers similar to those of the SHCP under the current law to approve a foreign financial institution's acquisition of greater than 20% of the class "O" shares of a bank for the purpose of the setting up a Mexican affiliate of the foreign institution.<sup>44</sup> In addition, the proposed law would also grant power to the CNBV to permit a foreign financial institution to acquire greater than 20% of a bank's capital if the shares of said entity are being acquired under a program deemed by the CNBV to "advance the existing functions" of the bank being acquired.<sup>45</sup>

The key change in this regard would be the elimination of the limitation in the current law that prevents a foreign financial institution from obtaining approval of the authorities for acquiring a Mexican bank which has a capital stock that exceeds 6% of the total capital of all of the Mexican commercial banks.<sup>46</sup> In other words, the Reform Bill would open up the possibility of foreign banks acquiring any of the three largest banks in Mexico, i.e. Banamex, Bancomer or Serfin. Of the three, Serfin seems the most likely to acquire a foreign owner, in that it has been the one in the greatest financial difficulty and it already has two foreign shareholders with significant stakes who have indicated an interest in increasing their shares.

Under the proposed changes to the CIL and LRFG, the board of directors of a bank would have to consist of 15 members, instead of the 11 members required by current law. However, the provision for the possibility of separate classes of members representing different classes of shares would be eliminated, since the only class of voting shares would be class "O" (class "L" shares do not have the right to vote for Board members).<sup>47</sup> As under the current law, all board members would have to reside within Mexico, although they may be foreigners.<sup>48</sup>

Except with reference to the CNBV taking over the duties and powers of the SHCP, and provisions for the new class "O" shares, in all material respects Chapter III of the CIL and Chapter II of the LRFG, which govern bank Affiliates and Holding Company Affiliates, respectively, would remain unchanged under the Reform Bill. Nonbank banks (*sociedades financieras de objeto limitado* or SOFOLs) would be regulated under the Reform Bill by the CNBV instead of the SHCP.<sup>49</sup>

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42. CIL, *supra* note 12, Art. 17 (currently and under the Reform Bill).

43. CIL, *supra* note 12, Art. 17, first paragraph, under the Reform Bill.

44. CIL, *supra* note 12, Arts. 17(VII) and 17 bis under the Reform Bill.

45. CIL, *supra* note 12, Art. 17(VIII) under the Reform Bill.

46. CIL, *supra* note 12, Art. 17, penultimate paragraph.

47. Compare CIL, *supra* note 12, Art. 22, as now in effect with the provision under the Reform Bill.

48. Compare CIL, *supra* note 12, Art. 23, last paragraph, as now in effect with the provision under the Reform Bill.

49. CIL, *supra* note 12, Art. 103(IV) under the Reform Bill.

The Reform Bill is currently under consideration by the Congress, where it has been stalled by opposition charges that FOBAPROA has been inefficient and corrupt, and has enabled wealthy bankers and businessmen to profit from the system while leaving depositors and taxpayers at risk. The portions of the Reform Bill pertaining to opening up the banking system to greater foreign investment have received much less prominence. The general expectation is that, whatever happens to the FOBAPROA portion of the Reform Bill, the bank regulatory and investment portions are likely to be approved eventually by the Congress substantially as proposed by the Zedillo administration.

## V. PROSPECTS FOR THE FUTURE

In weighing the likely effects of the Reform Bill on the future of foreign banks in Mexico, there are at least three aspects to keep in mind, which may be summarized as regulatory, legal/environmental and industry/environmental. "Regulatory" aspects would include the issue of permitted foreign ownership of Mexican banks, as well as the regulatory framework affecting Mexican banks in general. The "legal/environmental" issues would refer to the other legal conditions affecting bank activities in Mexico, including the enforceability of bank loan obligations, the effects of the Bankruptcy and Suspension of Payments Law (the *Ley de Quiebras y de Suspensión de Pagos* or "Bankruptcy Law"), the conditions affecting collateral security for bank loans and conditions affecting the ability of banks (or their financial group affiliates) to engage in activities other than traditional lending. The "industry/environmental" issues would be those affecting the activities of banks worldwide and particularly of the banks that are potential investors in Mexico.

The "regulatory" aspects of the Reform Bill seem, overall, to encourage greater investment by foreign financial institutions in the Mexican banking system. The three largest Mexican banks would become available for investment in up to 100% of their voting capital, as well as in any percentage of their limited-voting "L" shares, by foreign institutions under programs approved by the CNBV. The simplification of the share classes, by replacing "A" and "B" classes with a single "O" voting class, should provide for greater flexibility in shareholdings by foreign institutions. The replacement of the two classes of Board members with a single class is a further step in the direction of simplification. In addition, the Reform Bill's strengthening of the CNBV as a quasi-independent supervisory body separate from the SHCP may provide greater objectivity in supervisory decision-making. The main "regulatory" barrier remaining is perhaps the prohibition on foreign banks operating direct branches in Mexico.<sup>50</sup> This prohibition means that foreign banks are constrained in using their entire capital strengths in making loans to Mexican borrowers through their local presence. However, given that corporate borrowers often seek dollar-denominated rather than peso-denominated loans because of the lower interest rates that have applied to dollar loans, such loans can be made at least

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50. Except for the branches permitted under CIL, *supra* note 12, Art. 7 for offshore transactions. Cf. note 12.

as easily by the U.S. or other offices of a foreign bank as they could through any Mexican branch thereof.

For any foreign bank considering the acquisition of an existing Mexican bank, the key concern is normally going to be with respect to the Mexican bank's loan portfolio. Some steps have recently been taken to loosen bank-secrecy restrictions to enable prospective purchasers of a Mexican bank, as well as prospective purchasers of part of a bank's loan portfolio or of the right to service and collect any of such loans, to perform the kind of due diligence exercise (in terms of reviewing credit files, loan documentation, any litigation files, etc.) necessary to enable it to determine the quality and value of such loans. FOBAPROA has recently made substantial efforts to facilitate this process with respect to the loan portfolios that are under its supervision or control, and has overseen several recent auctions of such portfolios. The agency appears disposed to provide similar assistance in connection with the purchase of entire banks.

The prospects for improvements on the "legal/environmental" side are less encouraging than on the regulatory front. Many of those involved in the FOBAPROA debate, who have focused on the issue of self-dealing by bankers and other corrupt lending practices, seem to have lost sight of those aspects of the legal environment that helped to produce the high level of problem loans, e.g. the antiquated Bankruptcy Law and laws governing collateral security, the difficulties involved in the enforcement of loan obligations (including the frequent use by debtors of *amparo* proceedings<sup>51</sup> to prevent enforcement of such obligations) and formalistic aspects of the corporate laws which provide many traps for unwary bankers.<sup>52</sup> The availability to banks of reliable credit information is still limited, particularly with respect to consumers, because of strict bank-secrecy restrictions that have until recently prevented the development of effective credit bureaus.<sup>53</sup>

The "industry/environmental" aspects are more difficult for Mexican lawmakers and regulators to address, since they involve rapidly changing industry conditions and trends as well as laws and regulations in other countries. In general, commercial banks worldwide are finding themselves in competition with a wide variety of institutions, including securities firms and investment banks, insurance companies, pension funds and nonbank banks. The profitability of traditional bank loans has declined while their risk and drain on capital and reserves have increased.

Banks find themselves competing increasingly with the commercial paper market as well as the stock and bond markets for the business of large corporate customers. As a result, many large commercial banks have sought to enter these other markets, either directly or (where legal restrictions apply, as in the United States) indirectly. In lending to the middle market, banks are now competing with commercial finance companies and other nonbank banks. In retail banking, the industry is rapidly consolidating and many smaller and midsize banks are being absorbed or forced out

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51. Proceedings for the enforcement of protections provided under the Mexican Constitution.

52. See, e.g., César Castruita, *Impiden las leyes en México un buen funcionamiento del sistema bancario*, *El Economista* (Mexico City), May 21, 1998, at 27; and Alicia Salgado, *El saqueo de empresas aumentó las pérdidas: CNBV, El Financiero* (Mexico City), May 21, 1998, at 7. These articles report on statements made by Eduardo Fernández, chairman of the CNBV.

53. This situation is changing due to recent amendments to LRFG Arts. 33 and 33-A, permitting exceptions to the bank secrecy rules with respect to credit bureaus (called "credit information companies" or *sociedades de información crediticia*); also see CIL, *supra* note 12, Art. 117.

of the businesses of consumer lending, deposit-taking and credit-card issuance. Burdensome regulation and reserve requirements, lender-liability risks, stock-market sensitivity and intense competition in many countries, among other things, make commercial banking a difficult and sometimes unrewarding business. Added to this at times is a high level of volatility in international currency and capital markets, particularly in emerging markets, which makes many banks reluctant to expand internationally to places such as Mexico. Rapid technological changes raise questions about the relative utility of extensive branch systems.

Besides, such banks often find, when they examine conditions in Mexico, that some of the activities in which they engage or are seeking to develop within other countries are difficult to develop in Mexico.<sup>54</sup> For example, the widespread loan participation markets in the U.S. and other countries face obstacles in Mexico due to restrictions on the legal right of Mexican banks to assign or sell participations in their loans.<sup>55</sup> The ability of banks to securitize large portions of their portfolios of mortgage loans, consumer loans or credit-card receivables, enabling them to free up their capital to make additional loans, is extremely difficult, if not impossible, to accomplish in Mexico.<sup>56</sup> On the other hand, restrictions in some countries (particularly the United States) on banks or their affiliates engaging in the insurance or securities businesses do not exist to the same extent in Mexico, which permits a variety of financial services to be offered by members of a single financial group under the provisions of the LRFG.

## CONCLUSION

Some of the legal conditions for an expansion of the foreign bank presence in Mexico were established in the wake of NAFTA and then the December 1994 devaluation. Further steps would be taken in this direction with the enactment of the Reform Bill, although the Reform Bill would not lift the restriction on foreign branches. The Mexican regulatory authorities would appear to be strengthened and made more effective as a result of the Reform Bill, and they have already indicated a willingness to assist prospective buyers of the more troubled banks, with the purpose of encouraging further capital injections into the banking system. However, it appears that foreign banks must wait longer for other improvements in the Mexican legal environment, with respect to the laws affecting bankruptcy, collateral security and loan enforcement.

The rapid changes in the banking industry worldwide will cause some banks to wait for industry trends to be clearer before they commit substantial funds to establishing a significant presence in Mexico. Other banks will probably elect to push ahead with such investments in the interest of acquiring a market share in Mexico that will perhaps enable them to compete more easily later on, and possibly

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54. *In general, see John E. Rogers, Mexican Corporate Banking in a North American Market, Mexico Trade & L. Rep.*, Sept. 1992, at 3, reprinted at Philip T. Von Mehren, ed., *Doing Business in Mexico*, New York: 1993, Part Nine, Chap. 3.

55. *Cf. CIL, supra note 12, Art. 93. The Reform Bill would loosen but not eliminate this restriction.*

56. Part of the problem is with CIL, *supra note 12, Art. 93*, but there are other problems with mortgage loans, relating to requirements that mortgage recordations be amended upon the loans being assigned. Some credit-card receivables have been securitized, but largely through offshore transactions which might be difficult to carry out with some portfolios.

to be better positioned to face any future legal restrictions, as there may be some risk that Mexico will react to the heavy costs to it of globalization by turning inward and becoming nationalistic again with respect to its banking industry. Each potential approach by the foreign banks will have its defenders and detractors. Presumably the next few years will demonstrate which approach is the wiser one.

