

Mexican Banks Open to Foreign Investors

In response to the recent fall in the value of the peso, Mexico's legislature passed reforms to its banking law that significantly reduce barriers to entry for U.S. and Canadian financial entities seeking to penetrate the Mexican banking market. These reforms substantially liberalize the market share restrictions previously set forth in the North American Free Trade Agreement (NAFTA).

Of particular importance is the change that allows U.S. and Canadian banks to wholly acquire, with the approval of the Ministry of Finance, all but the three largest Mexican banks. Such acquisitions provide purchasers with market share advantages, access to established customer relationships and extensive branch networks. The major benefit for Mexico from further opening its banking markets to foreign institutions is the enhancement of capital flows into its banking system. The state of Texas undertook a similar plan during its

severe economic recession in 1986 when it removed long-standing restrictions preventing out-of-state banking organizations from acquiring banks within its borders. Capital brought by the new entrants into the Texas banking scene played an important role in the recovery of the regional financial sector.

Acquisition of Existing Mexican Banks

NAFTA established a six-year transition period during which a U.S. or Canadian financial entity (commonly known as a NAFTA bank) could not acquire an existing Mexican bank if the acquisition left the NAFTA bank in control of more than 1.5 percent of the aggregate capital of all commercial banks in Mexico. As a result, at the time of NAFTA's ratification, only two of the 20 Mexican banks were eligible for acquisition.

Prospects for acquisitions after NAFTA's transition period, while greater, were still limited. The purchase of an existing Mexican bank was not to be allowed if the transaction left the NAFTA bank in control of more than 4 percent of the total capital of all commercial banks in Mexico. Thus, even after the six-year waiting period, the six largest Mexican banks would not have been

eligible for acquisition. These six banks control about 70 percent of Mexico's commercial banking assets.

Revisions to Mexico's banking law, which became effective February 16, 1995, significantly reduce NAFTA's market share restrictions and facilitate a foreign bank's ability to acquire a significant presence in the Mexican banking market. Subject to the Finance Ministry's approval, NAFTA banks may now acquire any existing Mexican bank whose capital does not exceed 6 percent of the total capital of all commercial banks in Mexico. Under the new law, only the three largest banks in Mexico—Banco Nacional de México, Bancomer and Banca Serfin—are ineligible for foreign acquisition. These three banks control about 50 percent of the total commercial banking assets in Mexico. The next three largest banks—Banco Mexicano, Multibanco Comermex and Banco Internacional—now are eligible for acquisition. These banks control 18 percent of Mexico's commercial banking assets. Now, NAFTA banks, in the aggregate, may control up to 25 percent of the total capital in Mexico's banking system, which substantially exceeds NAFTA's previous transitional limit of 9 percent for 1995.

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Derivatives: In the Wake of Disaster

Over the past year, a growing list of organizational casualties has raised concerns about the safety of trading financial derivatives—contracts whose value depends on, or derives from, the value of some underlying asset, index or reference rate. Around the world, corporations, municipalities, mutual funds and financial services organizations have found their names added to the list of derivatives losers. Severe derivatives-related losses, such as those leading to the Orange County bankruptcy and the collapse of Barings, have cast a pall over derivatives activities. As a result, policymakers find themselves searching for answers to a host of disturbing questions about the perceived dangers of financial derivatives.

U.S. policymakers are particularly concerned with the derivatives activities of insured commercial banks, given the government's effective guarantee of the safety of many of the liabilities used to fund those institutions. Recent derivatives-related failures outside the U.S. banking industry have raised concerns that similar losses could occur among U.S. banks.

But a careful consideration of the risks and rewards derivatives offer suggests that recent derivatives-related failures do not warrant new legislative and regulatory measures against the use of derivatives by commercial banks. Instead, market forces themselves, coupled with prudent government supervision, can reduce the potential for derivatives-related bank failures while provid-

ing the financial flexibility banks need to manage risk effectively in today's financial marketplace.

Bankruptcy of Orange County

On December 1, 1994, news reports first surfaced that an investment fund managed in Orange County, California, dropped by an estimated \$1.5 billion. Reports indicated that the fund was highly leveraged using risky financial derivatives.

Borrowed funds apparently were used to leverage about \$7.5 billion of the county's investment pool into a \$22-billion portfolio. The county reportedly used most of this leverage to invest in financial derivatives called inverse floaters, a type of structured note.¹

Those bonds quickly lost value as interest rates rose throughout 1994. Soon, the county needed cash quickly to pay off the maturing reverse repurchase agreements that had been sold to purchase the structured notes. However, those funds remained tied up in the structured notes, which had not yet matured and whose value had fallen significantly. Orange County was forced to file for bankruptcy protection after several banks and Wall Street firms refused to renew their short-term refinancing agreements with the county. Current estimates peg the Orange County loss at \$1.69 billion.

Collapse of Barings

Barings, a 233-year-old British merchant bank that helped finance the Louisiana Purchase and the Napoleonic wars, was forced into administration—the equivalent of U.S. bankruptcy protection—after initial press reports indicated that the firm lost more than \$1 billion in Asian financial markets. Apparently, a trader in Barings' Singapore office had used standard, exchange-traded derivative contracts to make large speculative and unprofitable bets that ultimately caused Barings to fail.

The trader appears to have made trades in hopes that the Nikkei 225 stock index would remain in a narrow band. Such a strategy is profitable when the target index or price remains between two given values, but the potential for great losses is high if the index moves outside those values. Barings ran into trouble when the Nikkei plummeted after the Kobe earthquake. The trader was able to continue his losing gamble long enough to force Barings into bankruptcy. Current estimates peg the Barings loss at \$1.36 billion.

Policy Concerns

These two bankruptcies and similar derivatives-related losses have caused the financial world to question the adequacy of internal controls used to manage derivatives trading. Concerns also have surfaced over regulators' ability to detect and control potential derivatives losses. Furthermore, derivative instruments themselves are being implicated as the culprits in these failures.

Orange County's and Barings' losses probably would not have been as great had financial instruments other than derivatives been used. One important lesson of these bankruptcies is that derivatives, if used improperly or as part of a speculative investment strategy, can seriously magnify losses.

Yet to blame these failures solely on derivatives is to miss the point. Derivatives are essential tools in the modern science of financial management. The proper use of derivatives provides risk management and economic benefits that can better prepare organizations to meet their corporate objectives. As with any tool, the derivatives user should understand the tool's intended function and take the necessary safety precautions before using it. To paraphrase a familiar saying: derivatives don't kill...speculators do! The question financial policymakers now face is how to limit the potential for derivatives losses,

particularly among insured commercial banks and yet still provide financial institutions the flexibility needed to manage risk effectively.

Legislative and regulatory restrictions are not the answer. Because of the perceived risks in trading derivatives, some policymakers advocate tighter derivatives regulation or even an outright ban on derivatives trading. However, given the rapidly evolving use of sophisticated financial strategies involving derivatives in today's financial markets, enforcement of simple, standardized rules most likely would only impair banks' ability to manage risk effectively.

Instead, a better answer lies in greater reliance on market forces to control derivatives-related risk-taking, together with more emphasis on government supervision, as opposed to regulation.

Control Through Market Forces

No government entity intervened to guarantee funds in Orange County's investment pool. Rather, the county was forced to confront its problem by liquidating assets and cutting spending. Similarly, Barings was allowed to fail, and a search for potential buyers of the firm's assets began immediately.

The decisions to let Orange County and Barings fail, rather than to provide rescue through government guarantees, puts other organizations on notice that the burden of managing derivatives trading rests squarely on the trader, not the government. Through this approach, discipline provided by the market mechanism can promote self-regulation and improve organizations' internal control of derivatives activities.

Role of Government Supervision

For U.S. insured commercial banks, which can freely trade in derivative instruments, the current federal deposit guarantee structure potentially reduces the discipline

provided by market forces. In particular, the presence of the federal safety net has shifted some of the responsibility for disciplining bank risk-taking from bank creditors to the government.

Given that the current federal deposit guarantee system will remain in place, regulators are adopting new measures to lessen the potential for derivatives-related losses. In this regard, the best regulations are not those that eliminate derivatives entirely, but those that guard against the misuse of derivatives. Derivatives-related losses typically can be traced to one or more root causes: an overly speculative investment strategy, a misinterpretation of how derivatives reallocate risks, an ineffective internal risk-management audit function or the absence of systems that simulate adverse market movements and help develop contingency solutions.

To address these concerns, supervisory reforms should focus on increasing disclosure of derivatives holdings and the strategies underlying derivatives use, appropriate capital adequacy standards and sound risk management guidelines.

A bank's internal safety net—its risk management systems and internal controls—must keep pace with the expanding number and sophistication of financial instruments. Each bank's board of directors and senior management must ensure that derivatives activities are consistent with the institution's tolerance for risk. An independent risk management audit function must have skilled personnel to provide strong internal control. Self-monitoring of the institution's financial performance with respect to its actual risk profile must be comprehensive and timely. And finally, banks must incorporate stress tests and market simulations to respond to adverse market movements.

Implications for the Future

While large losses from derivatives-related activities almost certainly

will occur again, little evidence exists to suggest that derivatives-related failures pose a high risk of systemic difficulties. Both Orange County's bankruptcy and the collapse of Barings tested the world financial system's capacity to absorb derivatives-related failures, and no serious spillover effects were evident. It would not seem wise, then, to ban derivatives usage or tighten derivatives regulation to prevent future derivatives-related failures.

This conclusion is especially true because derivatives have become important tools in the management of risk exposure. As new financial innovations continue to improve risk management practices, organizations that choose not to use derivatives could be putting themselves at a competitive disadvantage. Derivatives offer a proven method for organizations to break risk into component pieces and manage them independently. Almost every organization—whether a corporation, municipality or insured commercial bank—has inherent in its business and marketplace a unique risk profile that can be better managed through derivatives trading.

Attempts to limit the potential for derivatives-related losses through overly restrictive legislative and regulatory rules would likely be successful only in impairing the ability of financial institutions to manage risk effectively. Instead, policymakers should rely on supervisory efforts to promote increased disclosure, capital adequacy and effective internal controls.

—Thomas F. Siems

Note

¹ Structured notes are derivative securities that are customized (or structured), to meet the specific investment needs of money managers. They are basically bonds that pay interest according to some mathematical formula. Inverse floaters are floating-rate notes whose coupon rate increases as market rates decline and decreases as market rates rise.

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Participation by Noncontrolling Investors

Before the recent reforms, the maximum aggregate participation by foreign investors not seeking a control position in the voting stock of a Mexican bank was limited to 30 percent of the bank's outstanding stock. With the reforms, this limit rose to 49 percent. The individual maximum shareholder limit also increased. With the Finance Ministry's approval, a single investor now can directly or indirectly own up to 20 percent of the total outstanding voting stock of a Mexican bank. Per-shareholder limitations under the prior law were 10 percent. These reforms should afford Mexican banks greater opportunities to raise foreign capital.

Joint Ventures

Previously, NAFTA banks were required to own 100-percent interest in any bank that was acquired or established in Mexico. The reforms eliminate the sole-ownership requirement and permit a foreign entity to own only 51 percent of any bank acquired or established. This liberalization should increase possibilities for the formation of joint ventures between NAFTA entrants and Mexican investors. For Mexican investors, a U.S. or Canadian joint venture brings new technology and greater access to international markets. For U.S. and Canadian investors, joint ventures reduce the learning curve for penetrating new markets, increase the possibility of expanding into other Latin American countries and provide greater insight into Mexico's legal and regulatory framework. In the past two years, joint enterprises between Mexican companies and foreign entities have been common in service industries such as credit card, mortgage, consumer finance and insurance firms.¹

Reforms Complement Recapitalization Efforts

These liberalizations complement Mexico's capital enhancement program, known as Procapte, a recently developed government plan to aid Mexican banks hurt by the decline in the value of the peso. Under the Procapte program, Fobaproa (Mexico's bank insurance fund) will buy subordinated convertible debentures from banks with capital levels below the minimum 8-percent total risk-based capital requirement. For those banks that participate in Procapte, the government will purchase an amount of subordinated debentures sufficient to increase the participating bank's risk-based capital ratio to 9 percent. Although the debentures will mature in five years, the government has set forth criteria whereby it has authority to convert the debentures to equity if the bank is poorly managed or if insolvency is likely. The government plans to sell immediately any shares acquired through the conversions.

Concluding Remarks

Passing of banking reform legislation that liberalizes market share restrictions of foreign financial entities entering Mexico is an important step for the country and a proven vehicle for attracting capital flows. Texas' banking system realized capital inflows when Texas liberalized its banking laws to allow out-of-state banking organizations into its market. Mexico hopes to achieve similar results with its revised banking law.

—Skip Edmonds

Note

¹ See Ricardo Anzaldúa-Montoya, "Joint Ventures in Financial Services—Challenges and Opportunities" (Paper presented at the Mexican Banking Conference, sponsored by Executive Enterprises, Washington, D.C., February 1995).

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