



Issues

Fiscal Therapy: The Mexican Banking Industry in Rehab

The new reforms should enable Mexico's banks to further strengthen their recovery and facilitate their fiscal rehabilitation.

An ambulance rushes to the hospital, sirens blaring. The patient inside is in critical condition and must be saved. The ambulance arrives at the hospital, where doctors are waiting to meet the patient the instant the vehicle stops. The patient is wheeled into the emergency room on a gurney. All the while, doctors are frantically doing everything they can to save him. Finally, the patient is stabilized, moved to intensive care and hooked up to a life-support machine.

This scene has been shown on television sets all across Mexico. But it is not Mexico's top-rated television show or *ER* with subtitles. Rather, it is a television commercial and, more specifically, a government communication.

The patient represents the Mexican banking industry. The life-support machine represents the emergency financial reform mechanism known as Fobaproa (Fondo Bancario de Protección al Ahorro). Ever since the Mexican financial crisis emerged in late 1994, Fobaproa has provided much of the life support to Mexico's banks by insuring all deposits and liabilities and purchasing or assuming a substantial portion of the industry's problem assets.

But while Fobaproa proved effective in stabilizing the banking industry through a number of bank rescue programs, it was not fully equipped to provide the necessary rehabilitation to restore the banking system to full health. Further financial reforms were necessary to improve the government's ability to efficiently finance and dispose of the problem assets Fobaproa had acquired. As a result, the Mexican government, after

months of debate, recently adopted several financial reforms that should more effectively address the bank rescue's residual costs and also promote the safety and soundness of Mexico's financial system. These rehabilitating actions include the establishment of a new independent entity with the authority to collect or sell Fobaproa assets and to develop alternative funding options for carrying Fobaproa debt into the future. The reform measures also restructure the government's guarantee behind deposit insurance, establish a debtor assistance package and allow greater foreign investment in Mexico's largest banks.

By removing much of the uncertainty that had existed over the future of the bank rescue, the new reforms should enable Mexico's banks to further strengthen their recovery and facilitate their fiscal rehabilitation.

Fobaproa's Mission: Life Support

In 1982, the Mexican government nationalized the commercial banking system and subsequently merged many of its banks. In 1990, while the banks were still government-owned but slated for privatization, Fobaproa was established as a government trust managed by the Bank of Mexico, the central bank. Fobaproa's original purpose was to protect savings and uphold the fulfillment of commercial banks' obligations. This meant a 100-percent government guarantee of all deposits and all other bank liabilities. Fobaproa was also given responsibility to provide financial assistance to troubled banks in the event of a financial crisis. In this way, the Mexican government hoped to increase

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the domestic savings rate and promote financial system stability. Supervision and regulation of the newly privatized banking system was vested with the Comisión Nacional Bancaria y de Valores (CNBV), a decentralized organization under the Ministry of Finance but with technical autonomy.

During 1991 and 1992, the Mexican government privatized the banking system by auctioning 18 individual banks to domestic buyers. During the next three years, while seeking returns on their premium investments, Mexican banks rapidly expanded credit. But one of Mexico's worst economic crises emerged in December 1994 following a sharp peso devaluation and the subsequent decision by the Mexican authorities to let the peso float. As a result, foreign investment fled, international bond prices plummeted and the country experienced its worst financial crisis in contemporary history.

Poor lending practices, resulting in many cases from inexperienced bank ownership and management and in some cases from alleged fraud, coupled with the impact of the economic collapse on borrowers' repayment capacity, caused massive loan defaults in 1995 and 1996.

To stem the financial crisis, the Mexican government, mostly through Fobaproa, took immediate steps to support and strengthen its banking system. However, the extent of the support that was eventually given to the banking system was likely never envisioned. Consequently, like the Federal Savings and Loan Insurance Corporation during the 1980s U.S. financial crisis, Fobaproa did not have sufficient resources, power or independence to accept and manage the volume of assets in its possession.

Loan Purchase and Recapitalization Program. One of the earliest and largest support programs was designed to clean up the banks' balance sheets as quickly as possible and strengthen their capital positions. Through this program—known as the Loan Purchase and Recapitalization Program—the Mexican government agreed to purchase loans (actually the cash flows from the loans) from the banks. In exchange, the government issued 10-year zero-coupon notes to the banks and received each bank's commitment to raise capital equal to 50 percent of the loans sold to the government. The Fobaproa notes earn interest at an average rate equal to that offered on the 28-day CETES (Mexican Treasury bills).

The banks continued to manage the loan portfolios sold to the government, including responsibility for collection. The

banks and Fobaproa were to share any losses from the asset resolution, generally with the banks and the Mexican government obligated for 25 percent and 75 percent, respectively, of any loan losses.

The ultimate goal of the Loan Purchase and Recapitalization Program was to clean up the balance sheets of potentially strong banks by removing bad loans and putting needed capital into the banks. In so doing, the government anticipated the banks would be able to obtain the funding they needed to make new loans in support of renewed economic growth. However, several problems remained with the banks that worked against the realization of this goal. First, the banks' balance sheets were not entirely cleaned up, as a high volume of problem loans remained. The banks did not sell these loans to Fobaproa because they could not commit to further capital enhancements or they did not recognize the loans as problems until after the program ended in December 1996. Second, loan demand ground to a halt. Large companies found cheaper financing in the international markets, and Mexican banks discovered they could not compete given their higher cost of funds. Lastly, the Fobaproa notes the banks received in exchange for the bad loans were not negotiable, which gave the banks a large illiquid asset.

Bank interventions and restructuring. For many ailing banks, the Loan Purchase and Recapitalization Program and other government support programs were insufficient. For these banks, the loss exposure in the remaining problem loans was large enough to threaten the eventual depletion of capital, and, as a result, immediate government intervention was required. The Mexican government also intervened in banks where fraud and mismanagement had been detected. Interventions were necessary to protect the banking system from continued deterioration as a result of inefficient operations or fraudulent activities. Upon intervention by Fobaproa, financial information ceased to be publicly reported. However, it is estimated that Fobaproa intervened in banks that held approximately one-third of Mexican banking assets in 1994.¹

The Mexican government determined that most of the intervened banks had value as going concerns, and many were subsequently sold to either foreign banks or existing domestic banks. Each buyer brought new capital to the bank, and, for the most part, the previous owners lost their investment.

The structure of the sale of each inter-

Table 1

Estimated Cost of the Mexican Bank Rescue, February 1998

(Millions of U.S. dollars)

Fobaproa liabilities	55,788
Estimated value of Fobaproa assets	22,091
Estimated Fobaproa deficit	33,697
Cost of toll road rescue	1,899
Cost of other debtor rescue programs	11,394
Cost already realized	8,131
Total estimated cost of bank rescue	55,121

NOTE: Figures have been converted from pesos to dollars at the rate of 9.9:1 that existed on December 31, 1998. The rate of exchange in February 1998 was 8.5:1, which reconciles the rescue cost to the widely reported \$65 billion.

DATA SOURCE: Finance Secretariat of Mexico as reproduced by Salomon Smith Barney.

vened bank differed on a case-by-case basis. In many instances, particularly with the smaller intervened banks, only branch assets and deposits were sold. In other cases, loan portfolios were sold together with the fixed assets and deposits of the branches. In deciding to transfer problem loans, the government determined it would be less expensive for the acquiring banks to collect the problem loans than for the loans to remain in government hands. (See box for a summary of the Mexican banking industry's consolidation.)

Other support programs. The government implemented numerous other programs to provide liquidity to the banks and to assist nonperforming borrowers by discounting their payments to a level where they could keep their loans current. The loan discount programs involved primarily mortgage, agricultural and small-business borrowers. Other government actions included the allowance of partial foreign ownership of banks in an effort to attract new capital, improvements to the banking supervisory system to strengthen prudential regulation and oversight, and changes to accounting policies and procedures to improve transparency and develop greater consistency with international standards.

Results of support programs. The Loan Purchase and Recapitalization Program and the bank intervention and restructuring program were carried out through Fobaproa and financed by Fobaproa-issued debt, guaranteed by the Mexican government. As a result of these two programs, Fobaproa has retained a large portfolio of bad assets, making these two programs the costliest of all government assistance and placing Fobaproa at the forefront of the bank rescue.

As of February 1998, the Mexican government estimated the cost of all its bank rescue programs to be 545.7 billion pesos (approximately \$55 billion based on the exchange rate in December 1998).² This cost includes Fobaproa's estimated negative net worth of 333.6 billion pesos, the cost of other debtor programs of 131.6 billion pesos and the costs already realized by Fobaproa through February 1998 of 80.5 billion pesos. Table 1 summarizes these estimated costs in U.S. dollars. According to the Mexican Ministry of Finance, the cost of the support programs has increased to \$67 billion as of December 1998 due to the accrued interest on Fobaproa liabilities. Moreover, opportunity costs continue to climb as Fobaproa holds on to a high volume of nonperforming assets.

The Mission at Hand: Fiscal Rehabilitation

After nearly four years of acquiring bank assets, Fobaproa has made little progress toward liquidating its problem asset portfolio, though some notable sales occurred recently. For example, during fourth quarter 1998, sale of loan portfolios associated with various smaller intervened banks to professional liquidators at auction involved loss-sharing agreements and collection incentives; thus, a market for problem bank assets may be developing. Nevertheless, one of the Mexican banking system's main weaknesses is the absence of a developed secondary market where banks can package and resell loans.

Additional reforms to facilitate the liquidation of Fobaproa's huge asset portfolio were necessary for two important reasons. First, a large portion of the portfolio is nonperforming, and the slow liquidation of these assets means prolonged carrying costs. Second, asset liquidations will be insufficient to repay all Fobaproa liabilities when they become due in the next seven to eight years. As a result, supplemental sources of funding will eventually be necessary, and an established, reliable entity with a clear mission and a proven track record must exist to obtain favorable refinancing terms in the future.

In April 1998, the Mexican government presented several financial reform proposals to its Congress. Two of these proposals address the large volume of problem assets held by Fobaproa. The first, to minimize the carrying costs of Fobaproa liabilities, would recognize the Fobaproa debt as public debt. The second, to better manage asset resolution, would split Fobaproa into two new

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agencies: one responsible for disposing of nonperforming loans and other assets purchased or acquired through government programs and intervention and the other responsible for deposit insurance. Another proposed financial reform would establish limits on government-guaranteed bank obligations.

Other financial reform proposals included removing all limitations on foreign ownership of banks, increasing the independence of the CNBV and giving the central bank complete control over monetary and exchange rate policy. The removal of limitations on foreign control was designed to open the banking market to additional capital, technology and banking expertise. Increased independence would give the CNBV greater strength in enforcing many new prudential regulations without undue government influence. Finally, control over monetary policy would provide the central bank greater independence from political influences.

The most controversial and politically charged reform concerned the proposal to recognize Fobaproa debt as public debt. Since the Mexican government guarantees this debt, most international financial analysts already recognize the Fobaproa debt as public. Nonetheless, the Fobaproa reform proposals fueled an open debate about how the banking system rescue was handled, including contentions of fraud and abuse of power. For this reason, the proposed financial reforms languished in Congress.

A Rehabilitation Program

On December 12, 1998, the lower house of the Mexican Congress approved a banking reform bill, and the Senate passed the same bill the very next day. The new law largely resolves the Fobaproa debate and removes all limitations on foreign ownership of Mexican banks. In addition, the new law includes a debtor relief program. In early 1999, Congress will address plans to give the central bank complete control over monetary and exchange rate policy and increase the CNBV's autonomy.

Administration. Instead of the two entities originally proposed to replace Fobaproa, Congress created only one new entity: Instituto para la Protección del Ahorro Bancario (IPAB), or the Bank Savings Protection Institute. IPAB will assume all the administrative functions of Fobaproa and most of its balance sheet. The Mexican Senate must approve IPAB's board, but any officials linked to the bank rescue process from 1995 to 1997 will be barred

from the board, including the current chairman of the Bank of Mexico and the current president of the CNBV. Banks will be required to contribute higher quotas to IPAB than they currently pay to Fobaproa—an increase from 3 cents to 4 cents for every \$1,000 of risk assets.

Fobaproa assets. The legislation transfers to IPAB all Fobaproa assets except those determined to be fraudulent by an independent audit arranged by Congress. The banks will remain liable for 25 percent of any losses on all other loans sold to Fobaproa and transferred to IPAB. To address the concerns that the government, in some cases, may have bailed out irresponsible bank ownership, any sale of fraudulent loans associated with the existing banks that participated in the Loan Purchase and Recapitalization Program will be voided and the loans will revert to those banks. As such, those banks that reacquire fraudulent loans will be responsible for 100 percent of any losses. The Mexican government continues to pursue legal action against former bank officials against whom fraudulent activities have already been alleged. Once the independent audit of Fobaproa is complete, Fobaproa will be extinguished.

Asset resolution. IPAB will assume Fobaproa's role in the recovery and sale of assets acquired through various support programs. The sale of assets will be accomplished through auctions. In addition, some loans may be converted into medium- and long-term instruments. Though specific details concerning IPAB's powers are not yet available, the reason for forming a new, congressionally approved entity was to establish an efficient administration with the power and authority to recover and sell Fobaproa assets. In addition, with a stronger, better defined agency, the possibility and costs of future financial crises should diminish.

Fobaproa liabilities. IPAB will assume all Fobaproa's liabilities and will subsequently exchange the non-negotiable Fobaproa notes payable to the banks for new negotiable notes. To supplement repayment of the new entity's liabilities, the Mexican Congress will approve annual debt-service allotments as part of its budget process. Also, debt repayment will be supplemented with cash flows generated by asset liquidations and the increase in premiums the banks will pay to IPAB. In emergency situations, IPAB will be allowed to contract additional financing, without prior congress-

sional authorization, up to 6 percent of the banking system's total liabilities.

These provisions substantially strengthen IPAB's funding sources and options and, moreover, provide additional liquidity to the banks. The new, fully guaranteed government notes to be issued in exchange for current Fobaproa notes will be similar to the existing Fobaproa notes in all respects except that the new notes will be negotiable. The new notes will continue to carry a zero coupon and are expected to have seven- to eight-year maturities. Because the new notes will be negotiable, banks may sell them in a secondary market, which can include foreign investors and, within limits, Mexican pension funds. As a result, banks will be able to improve their liquidity by selling a previously illiquid and non-cash-generating asset, thereby freeing capital for other uses. IPAB will determine more specific characteristics of the new securities and the exchange mechanism.

Deposit insurance. A new deposit insurance program will also be established. IPAB will administer the program, and all banking liabilities will be guaranteed initially. Beginning in 1999, however, a transition program will be published with the objective of limiting deposit insurance to 400,000 UDIs (around \$90,000) per person per institution by the year 2005.³ The cap is intended to reinforce the objective of minimizing potential costs to the government by imposing greater market discipline while still promoting savings. Mexican officials hope to build public confidence in the banking system by protecting small savers and promoting sound banking practices.

Deposit insurance will continue to be funded by premiums paid by banks and backed by a government guarantee. Risk-based premiums are being considered whereby sound banks with less risky funding sources and lending practices would pay lower premiums than banks with riskier balance sheets and lending practices. If a bank is liquidated or becomes insolvent, the new agency would safeguard deposits to the specified limit. In addition, the government may safeguard all deposits and other obligations if systemic risk is perceived to exist.

Debtor relief. A new debtor relief program that was not contemplated in the original financial reform proposals has been established. Under this program, borrowers who have remained current on their debt or can bring their debt current under the original or previously renegotiated terms will receive discounts on their loan bal-

ances. These discounts will range from 45 percent to 60 percent on the principal balance of loans to mortgage borrowers, farmers, fishermen and small-business owners who have remained current on their payments.

However, the new discounts will not be in addition to any discounts already applied to these borrowers under previous government discount programs. For example, if a borrower has already received a 30 percent discount under a previous program and the limit that applies to his loan under the new program is 45 percent, the borrower will only receive an additional 15 percent discount. Both the banks and the government will share in the cost of this new program.

Foreign investment in banks. Foreign investors now will be permitted to own a controlling share of a Mexican commercial bank's voting stock, regardless of the bank's size. Under the previous law, foreign investors were not permitted to hold more than 20 percent of the outstanding shares of banks that held in excess of 6 percent of the aggregate capital of the Mexican banking system. As such, foreign control of the three largest banks in Mexico was prohibited. Under the new law, both class A shares, which previously could not be acquired by foreign investors, and class B shares will be replaced by new class O shares, or ordinary shares, which can be acquired by any investors regardless of their nationality. The characteristics of class L shares, which are largely nonvoting and similar to preferred stock in the United States, will remain unchanged.

Conclusion

A primary goal of recent financial reforms in Mexico was to establish an efficient administration to recover and sell Fobaproa assets and to strengthen funding options while these assets remain in the hands of the Mexican government. These recoveries are important because each peso collected helps reduce the fiscal cost of the rescue, thereby reducing both the burden on taxpayers and the strain on a government budget already stressed by depressed oil prices. The new law establishes a clear mandate for the IPAB to manage Fobaproa's liabilities and systematically sell its assets to minimize costs.

The Fobaproa reforms should facilitate the fiscal rehabilitation of the Mexican banking system by eliminating much of the uncertainty over the future administration and funding of bank rescue programs and by

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imposing greater market discipline through limits on deposit insurance. Medium to small borrowers were provided with one last assistance package, and the largest banks can now fully explore opportunities available in global capital markets. Together, the reforms should enable both the banks and their customers to contribute to the recovery of the Mexican economy and restore confidence in, and stability to, the Mexican banking system.

—Robert V. Bubel
Edward C. Skelton

Notes

- ¹ This calculation is based on banking system data provided in the *Boletín Estadístico de Banca Múltiple* and produced originally by the CNBV.
- ² These figures are from the Finance Secretariat of Mexico as reproduced by Salomon Smith Barney, *Mexican Banking System, Analysis of Proposed Financial Reforms*, May 8, 1998.
- ³ A UDI (Unidades de Inversiones) is a unit of measure with real constant value that was created in 1995 to diminish the uncertainty produced by inflation over real returns on investments and the cost of loans. The UDI value is adjusted by changes in the Mexican National Consumer Price Index.

Table B1
Acquisitions, Mergers and Interventions of Mexican Banks, June 30, 1994–September 30, 1998

Completed Acquisitions and Mergers				
Acquiring bank	Acquired bank	Date of merger or acquisition	Date of acquired bank intervention	Comments
Internacional	Sureste	1998	2Q96	Acquired branch assets and assumed deposits.
Internacional	Atlantico	1998	4Q97	Acquired branch assets and assumed deposits but is still negotiating government financial assistance for rest of the bank.
Mercantil del Norte	Centro	3Q97	3Q95	Acquired whole bank but only some of the loans.
Mercantil del Norte	Banpais	4Q97	1Q95	Acquired whole bank but none of the loans.
Afirme	Obrero	1997	2Q95	Acquired branch assets and assumed deposits.
Atlantico	Interestatal	1997	3Q95	Acquired branch assets and assumed deposits. Atlantico was later intervened.
Promex	Union	1997	3Q94	Acquired branch assets and assumed deposits. Promex was later intervened.
Bancrecer	Banoro	1Q97	NA	Banoro merged into Bancrecer. Bancrecer was later intervened.
Santander–Mexicano (Spain)	Mexicano	2Q97	NA	Acquired whole bank with some government financial assistance.
Santander–Mexicano (Spain)	Santander de Negocios	4Q97	NA	Formed prior to acquisition of Mexicano. Subsequently merged.
BBV–Probursa (Spain)	Probursa	1Q96	NA	Acquired whole bank.
BBV–Probursa (Spain)	Oriente	1997	1Q95	Acquired branch assets and assumed deposits.
BBV–Probursa (Spain)	Cremita	1997	3Q94	Acquired branch assets and assumed deposits.
Citibank (U.S.)	Confia	3Q98	3Q97	Acquired whole bank with government financial assistance.
Chase (U.S.)	Chemical (U.S.)	2Q96	NA	Merged following the merger of their affiliate banks in the United States.
GE Capital (U.S.)	Alianza	4Q97	NA	GE Capital entered Mexican banking industry by acquisition of Alianza.
Pending Acquisitions and Mergers				
Proposed acquiring bank	Unresolved intervened bank	Date of merger or acquisition	Date of unresolved bank intervention	Comments
Bancomer	Promex	Pending	1Q98	Bancomer has agreed to acquire whole bank with government financial assistance.
Bank of Nova Scotia (Canada)	Inverlat	Pending	3Q95	Bank of Nova Scotia agreed to acquire whole bank with government assistance in year 2000.
NA	Bancrecer	For sale	4Q97	Search for a foreign buyer for whole bank with government assistance.
NA	Industrial	NA	4Q97	Government plans to liquidate whole bank.
NA	Promotor	NA	3Q96	Government plans to liquidate whole bank.
NA	Capital	NA	2Q96	Government plans to liquidate whole bank.
NA	Anahuac	NA	4Q96	Government plans to liquidate whole bank.

DATA SOURCE: Compiled from quarterly data provided by Comisión Nacional Bancaria y de Valores, *Boletín Estadístico de Banca Múltiple* and press releases of acquiring banks.

Consolidation of the Mexican Banking Industry

Of the original 18 domestic banks Mexico privatized in 1992, 10 have been intervened by the Mexican government and an additional three have merged into other banks.* One other domestic bank, which existed prior to privatization, was also intervened. Of the 17 domestic banks that were newly chartered beginning in 1993, six have been intervened and one was purchased by a foreign entity. Excluding any remaining intervened banks controlled by the government, Mexico currently has 15 domestic banking groups. One banking group owns three banks, including two previously intervened banks that it recently purchased from the government.

Mexico also has 20 foreign-owned banks, 11 of which belong to financial institutions in the United States. One foreign bank—Citibank—existed prior to privatization, three others entered Mexico through acquisitions of domestic banks, and the other 16 were formed with new charters beginning in the first quarter of 1995. Table B1 summarizes bank interventions and merger and acquisition activity from June 30, 1994, just prior to the first bank interventions, through September 30, 1998.

Despite the larger number of foreign banks, domestic banks controlled 82.6 percent of the Mexican banking system's assets as of September 30, 1998. This figure does not include assets of the intervened banks, the amount of which is not publicly available. The five largest domestic banks controlled 77.1 percent of the banking market. On a pro forma basis, based on two announced but not consummated mergers and assuming a third intervened bank currently for sale will be bought by a foreign interest, domestic bank market share would decline to 73.8 percent. Table B2 shows the current and pro forma market share of the largest domestic and foreign banks in Mexico as of September 30, 1998.

*Banks that were intervened continue to remain open but operate under government control. The assets and liabilities of these banks can be sold in whole or in part by the Mexican government.

Table B2
Mexican Banks' Current and Pro Forma Market Share as of September 30, 1998

	Total assets (millions of pesos)	Pro forma total assets (millions of pesos)	Current market share (percent)	Pro forma market share (percent)
Domestic banks				
Bancomer ¹	255,384	293,614	22.8	22.5
Banamex	263,071	263,071	23.5	20.2
Serfin	159,610	159,609	14.3	12.2
Internacional	97,633	97,633	8.7	7.5
Mercantil del Norte:				
Banorte ²	35,418	87,372	3.2	6.7
Banpais	29,875	—	2.7	—
Centro	22,079	—	1.9	—
Largest domestic banks	863,070	901,299	77.1	69.1
Ten other domestic banks	61,057	61,057	5.5	4.7
Total domestic bank assets	924,127	962,356	82.6	73.8
Foreign-owned banks				
Unknown/Bancrecer ³	—	90,330	—	6.9
Santander–Mexicano	72,202	72,202	6.5	5.6
Banco Balboa Viscaya	66,290	66,290	5.9	5.1
Bank of Nova Scotia/Inverlat ⁴	—	56,311	—	4.3
Citibank	27,698	27,698	2.5	2.1
Largest foreign banks	166,190	312,831	14.9	24.0
Seventeen other foreign banks	28,520	28,520	2.5	2.2
Total foreign bank assets	194,710	341,351	17.4	26.2
Total system assets ⁵	1,118,837	1,303,707	100.0	100.0

¹Pro forma includes the proposed acquisition of Promex (assets as of 12/31/97).

²Pro forma assumes that Mercantil del Norte will eventually merge Banorte, Centro and Banpais.

³Pro forma assumes a foreign entity will purchase Bancrecer (assets as of 9/30/97).

⁴Pro forma assumes Bank of Nova Scotia will exercise its option in 2000 to acquire control of Inverlat (assets as of 6/30/95).

⁵Pro forma system assets include those of the intervened banks for the last quarter prior to intervention.

DATA SOURCE: Compiled from quarterly data provided by Comisión Nacional Bancaria y de Valores, *Boletín Estadístico de Banca Múltiple* and press releases of acquiring banks.

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