

Mexican Banks Get Ahead of New Global Capital Standards

By Edward C. Skelton

Mexico is a prominent example of an emerging-market economy with a world-class macroeconomic policy framework and stable financial system.¹ Even when the Mexican economy contracted 6 percent and per-capita gross domestic product (GDP) dropped almost 10 percent in 2009, the banking system remained strong. Although earnings have fallen over the past three years, Mexican banks have managed to post relatively healthy and consistent profits for more than a decade (*Chart 1*). By comparison, U.S. institutions lost money in 2009 and subsequently recorded a return on assets of about half the Mexican sum.

The impending adoption of world-class capital adequacy standards highlights the Mexican system's advances. Following the global financial crisis, the Basel Committee on Banking Supervision released new capital and liquidity requirements for the industry worldwide.² Mexico has announced it will install the Basel III capital standards by early 2013 and plans to be one of the first countries to complete full implementation. Financial regulators elsewhere are also introducing new capital regulations consistent with Basel III. However, most countries, including all of the industrialized economies, have indicated they will phase in the more stringent requirements over the next few years.

What Is Basel III?

Basel III is the third set of international rules to which central bankers and financial system regulators have agreed since the initial Basel Accord in 1988.³ The rules are designed to address weaknesses exposed during the most recent financial crisis. Basel III consists of three pillars:

- Enhanced minimum capital and liquidity requirements.
- Enhanced supervisory review for firmwide risk management and capital planning.
- Enhanced risk disclosure and market discipline.

- Enhanced risk disclosure and market discipline.

New Rules on Capital

Under the new rules, banks must more than triple the amount of top-quality, or core, capital held in reserve (*Table 1*).⁴ Capital is important to banks because it represents the cushion allowing them to absorb losses and ride out difficult times. The common equity requirement essentially limits core capital to retained earnings and common stock issued (*see "Basel III Definitions" on page 19*).

The new standards will be phased in by Jan. 1, 2019. Upon full implementation, banks must maintain a ratio of total core capital to risk-weighted assets of at least 7 percent, compared with a pre-Basel III standard of 2 percent.

Perhaps more importantly, the Basel III standards create internationally consistent capital standards and also improve financial institutions' transparency. The

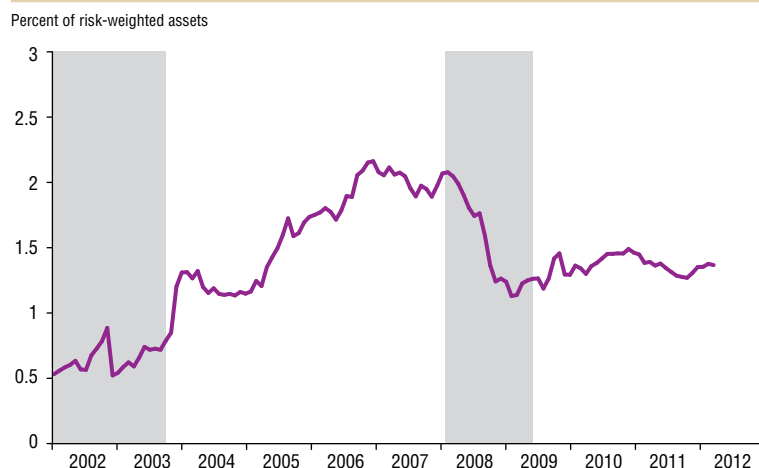
Basel committee developed a standardized template that banks will use to disclose their capital positions and their progress toward full bank safety-net compliance. The new disclosure requirements take effect June 30, 2013.

Applying Lessons Learned

Mexico began setting the stage for world-class capital standards long before global regulators contemplated Basel III. The country undertook a comprehensive financial system reform and modernization following the so-called Tequila Crisis of 1994, after the near-collapse of the financial system, which was marked by a sudden devaluation of the peso and spike in inflation.⁵

Following the crisis, the government bailed out the banking system at a cost of about \$100 billion, or 17 percent of Mexico's GDP. The fallout included a 10-year credit crunch, with bank loan portfolios contracting by more than half between 1994 and 2004.⁶ Although the portfolios have grown

Chart 1 Mexican Banks Maintain Profitability



NOTE: Shaded areas denote recessions as defined by the Instituto Nacional de Estadística y Geografía (INEGI).
SOURCES: Mexico Banking and Securities Commission; INEGI.

relatively consistently in recent years, the ratio of bank credit to GDP remains low by international standards. According to the World Bank, domestic credit to the private sector amounted to 26 percent of Mexican GDP in 2011. Within Latin America, Mexico's ratio is similar to that posted by Venezuela and Guatemala and well below that of Chile, Brazil, Honduras, Costa Rica and Colombia. For most industrialized countries, the ratio is well above 100 percent.

After the Tequila Crisis, there were insufficient domestic funding sources from which banks could rebuild their balance sheets, prompting a recapitalization via foreign firms' purchases of Mexican institutions. In 1994, only two foreign banks operated in Mexico, representing a 1.3 percent market share based on assets. As of April 2012, foreign entities owned four of the country's five largest banks, with a total market share of 74 percent.

The country, while dealing with the Tequila Crisis, learned the importance of world-class regulatory practices. Mexican financial system regulations now generally conform to international regulations and are often even more demanding in terms of risk management, internal controls and capital adequacy. The conservative standards have helped maintain the system's solid financial condition; bank loan portfolios quickly resumed growing as the most recent global economic downturn ended.

While many of Mexico's banks are foreign owned, regulations stipulate that a Mexican subsidiary be run on a stand-alone basis, with separate operations, capital, lending and funding. To insulate the domestic financial market from problems in foreign-held banks' home offices, rules on related-party lending limit Mexican operations' ability to repatriate capital and support offices in other countries.

Mexican Banks Well Positioned

Mexico's capital adequacy standards offer a striking example of the country's financial modernization. Basel III does not require the 7 percent ratio of core capital to risk-weighted assets to be in place until January 2019. Current Mexican capital requirements are already consistent with Basel III standards, and no Mexican banks are expected to need additional capital or

Table 1 | New Standards Require Higher Quantity, Quality of Bank Capital

	Prior to Basel III (percent)*	Basel III (percent)*
Minimum common equity	2	4.5
+ Capital conservation buffer	0	2.5
= Total core capital requirement	2	7
Minimum tier 1 ratio	4	8.5
Minimum total capital ratio	8	10.5
Countercyclical buffer	0	Up to 2.5

*Percent of risk-weighted assets.

SOURCE: Bank for International Settlements, Basel Committee on Banking Supervision.

to change their balance-sheet structure. Capital ratios for the banking system as a whole from year-end 2006 are shown in Chart 2. The system reported a core capital ratio of 13.7 percent as of April 30, 2012.⁷ The bank with the lowest level of core capital reported a ratio of 9.8 percent, well in excess of the fully implemented Basel III minimum.

By comparison, many European and U.S. banks fall short of the new, more-stringent capital standards. As of June 30, 2011, Europe's 27 biggest banks would have confronted a combined core capital shortfall of €242 billion (\$351 billion at the then-prevailing exchange rate) if Basel III regulations were in place, a European Banking Authority research report found.⁸ Similarly, the Federal Reserve indicated that the 19 largest U.S. banks are at least \$50 billion short of meeting the fully phased-in capital requirements, and smaller lenders are about \$10 billion short.

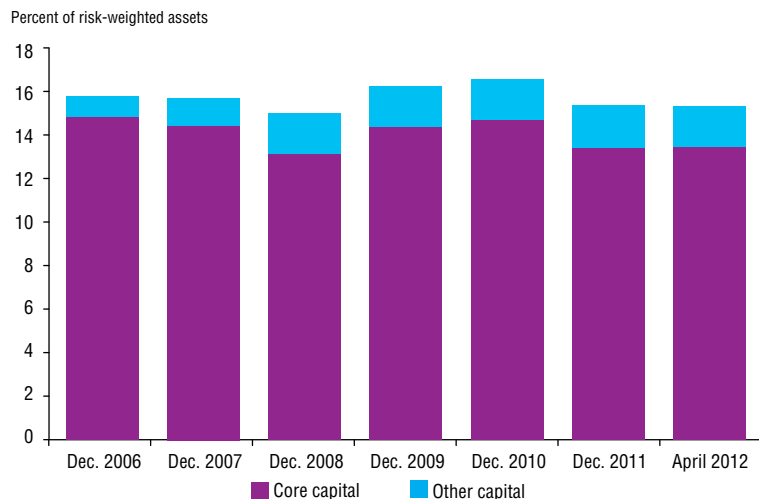
Mexico's main adjustment to capital

standards will be implementation of the countercyclical capital buffer, requiring banks to hold additional capital equal to between zero and 2.5 percent of risk-weighted assets. The countercyclical buffer is designed to take effect during times of excessive credit growth or any other condition resulting in system-wide accumulation of risk. Implementation will depend on national circumstances, the Basel committee said, suggesting that the countercyclical buffer would be rarely needed—no more than once every 10 to 20 years. The requirements are "marginal" for Mexico, and banks won't need additional capital to meet them, according to Guillermo Babatz, president of Mexico's Banking and Securities Commission.¹⁰

Capital Weaknesses Remain

Mexican institutions, however, aren't completely compliant. Bank accounting standards fall short of Basel III standards for complementary, or noncore, capital. For

Chart 2 | Mexican Banks Remain Well Capitalized



SOURCE: Mexico Banking and Securities Commission.

► *The nation's banking system remains a lightning rod for public criticism due to the Tequila Crisis bailout, foreign bank ownership and a continued perception of limited credit availability.*

example, subordinated, nonconvertible debt counts as complementary capital under Mexican bank regulations.¹¹ Subordinated debt represented 81 percent of the banking system's complementary capital and 10 percent of total capital as of April 30 of this year. The capital ratios for the five largest banks in Mexico and the system as a whole are shown in Chart 3.

To make Mexican standards consistent with Basel III, instruments that cannot be converted to equity will be considered debt and not counted as equity beginning next year. Mexican authorities have not disclosed the length of a phase-out period or any implementation details. Although the Basel III accord phases out these instruments over 10 years, Mexico will likely adopt a shorter time frame.

Moreover, early signs suggest that subtracting subordinated debt from complementary capital will have some positive effects on the Mexican banking system. New capital regulations raised the minimum capital ratio in January. They stipulated that subordinated debt could be included in regulatory capital only if the instrument could be converted to equity and was issued by a publicly listed bank. Most of the country's banks aren't on the local stock exchange because the costs were believed to exceed the potential benefits. The rule seeks to entice medium-sized banks and the Mexican subsidiaries of foreign

banks to list their shares locally.

A recent announcement by the Mexican subsidiary of Spanish bank Santander suggests this regulatory change is already paying dividends. Parent company Grupo Santander recently disclosed an initial public offering (IPO) equal to a 24.9 percent ownership stake in its Mexican subsidiary. The sale is estimated to be worth \$4.3 billion, which would make it Mexico's largest-ever IPO.

Through the new regulations, authorities gain more oversight over locally listed multinationals' financial firms. At the same time, the listing can benefit the foreign company, raising brand awareness while providing its headquarters office a market-based measure of local unit performance. There are also liquidity and funding advantages. The financial group can use its existing subsidiary as an acquisition vehicle, financing a purchase by issuing new stock locally.

Local public listings have allowed some European banks to raise funds amid difficult conditions at home by selling emerging-market assets that still command high valuations, rather than issuing new shares in Europe at a steep discount. Similarly, a local listing makes it easier to sell small chunks of an emerging-market subsidiary and maintain ownership control.

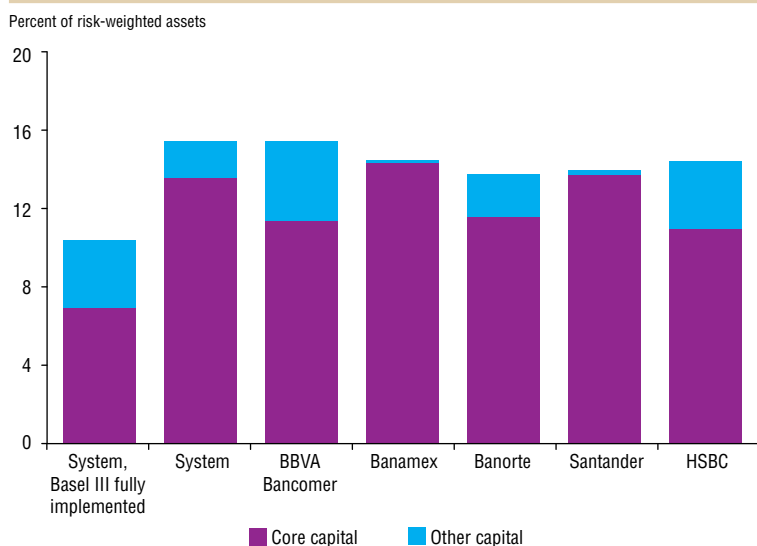
Although Mexican financial authorities do not foresee problems meeting the Basel III capital standards, concerns have arisen within emerging markets in general about unintended consequences. Banks in developed countries may decide to strengthen their capital ratios by shedding assets in developing countries. Such a move could reduce competition and increase the cost of credit by causing the banking industry to become more concentrated as local units consolidate.

Capital Levels Buttress Mexico

In the mid-1990s, Mexico learned the hard lesson that the social costs of failed banks can be very large. The nation's banking system remains a lightning rod for public criticism due to the Tequila Crisis bailout, foreign bank ownership and a continued perception of limited credit availability.

Greater levels of required capital allow institutions to absorb losses without disrupting operations, thereby reducing the risk of financial difficulties. Higher capital levels can reduce lending by raising the cost of credit

Chart 3 Mexican Banks Retain Reliance on Subordinated Debt
(Data as of April 30, 2012)

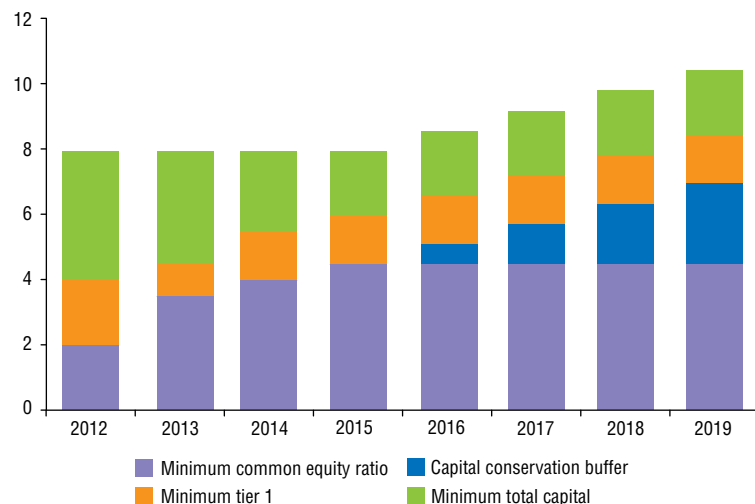


NOTE: Subordinated debt accounted for 81 percent of other capital and 10 percent of total capital systemwide.
SOURCE: Mexico Banking and Securities Commission.

Chart 4

Basel III to Be Implemented Gradually Through 2019

Percent of risk-weighted assets



SOURCE: Bank for International Settlements, Basel Committee on Banking Supervision.

and/or reducing funding available to businesses and households. However, in the long run, higher capital levels are socially beneficial because they ensure a financial system that operates more smoothly and reduces taxpayers' exposure to loss.

The Basel III Accord is designed to improve the stability of the financial system, address some weaknesses exposed by the volatility experienced since 2008, and create more consistent global reporting and regula-

tory standards. Although these requirements won't be fully implemented until 2019 (Chart 4), Mexico is already on pace to be one of the first countries to comply. The impending early adoption of the new, more stringent capital and liquidity standards is an example of the country's commitment to policy discipline.

Skelton is a business economist in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Basel III Definitions

Common equity capital: The highest-quality capital—generally consisting of common stock and retained earnings—held by banks to guard against risk on their balance sheets.

Capital conservation buffer: Additional high-quality capital that banks must hold against potential future losses.

Tier 1 capital: All core capital, plus any common-stock share premium, preferred stock convertible to equity, and other instruments that are 1) loss-absorbing, 2) do not contain incentives to be redeemed before their maturity and 3) can be converted to equity at the discretion of the holder or regulator.

Countercyclical buffer: Additional common-equity capital that regulators may require banks to hold during times of very high credit growth or if authorities determine that certain institutions or the system face a greater risk exposure.

Risk-weighted assets: Total of all assets weighted by credit risk, with riskier assets receiving a higher weight and less-risky assets a lower weight. The greater the weight of the assets, the more capital is necessary to protect against potential losses.

Notes

¹ See "The Conquest of Mexican Inflation" by Mark Wynne and Edward C. Skelton, *Globalization and Monetary Policy Institute 2011 Annual Report*, pp. 13–20.

² The capital standards can be found at www.bis.org/publ/bcbs189.pdf, and the liquidity standards are available at www.bis.org/publ/bcbs188.pdf.

³ Basel I, also called the 1988 Basel Accord, focused on credit risk and set minimum capital requirements that took effect in 1992. Basel II superseded the 1988 agreement and was initially published in June 2004. The goal of Basel II was to strengthen capital requirements by establishing an international standard for financial system regulators. However, it was politically difficult for many countries to implement Basel II. Progress was slow until the 2008 crisis caused the Basel Committee to turn its attention to preparing the Basel III Accord.

⁴ For simplicity, common equity capital is referred to as core capital in the article.

⁵ For more detail on the evolution of Mexico's financial system after the Tequila Crisis, see "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubl and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2002.

⁶ For more information about the impact of the banking crisis on lending, see "Mexico Emerges from 10-Year Credit Crunch," by Robert V. Bubl and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2005.

⁷ Current Mexican bank regulations refer to high-quality, tier 1 capital as *capital básica*; the standards for this type of capital are consistent with Basel III standards for core capital.

⁸ The report can be found at www.eba.europa.eu/cebs/media/Publications/Other%20Publications/QIS/EBA-BS-2012-037-FINAL--Results-Basel-III-Monitoring-.pdf.

⁹ The Federal Reserve study divided U.S. banks into the 19 largest whose total assets exceeded \$150 billion and those with assets below \$150 billion.

¹⁰ From comments before the Mexican Bankers Association annual convention, May 17, 2012.

¹¹ Subordinated, nonconvertible debt is publicly issued debt bearing a maturity of at least 10 years. It is usually unsecured, and the holders of this instrument are paid after other debt holders but before shareholders.