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THE RESTRUCTURING OF BANKING AND FINANCIAL SERVICES IN MEXICO: THE LEGAL REFORM OF THE MEXICAN FINANCIAL SYSTEM

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On December 13, 1998, the Mexican Congress approved the *Ley de Protección al Ahorro Bancario* (hereinafter, the "Banking Savings Protection Law" or the "Law").¹ This ended an unprecedented legislative process, which began almost nine months earlier on March 31, 1998, when the President of Mexico sent Congress an initiative to reform the legal framework of the Mexican financial system. For the first time in Mexico's history, the reform sent to Congress by the President of Mexico was not approved by Congress.

The Presidential initiative proposed to reform the existing legal framework by:

- (i) increasing the participation of foreign capital in the shareholder structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses;
- (ii) granting the *Comision Nacional Bancaria y de Valores* (National Banking and Securities Commission "CNBV") greater autonomy and increased attributions in financial regulatory matters;
- (iii) establishing a new system for the protection of deposits, the *Fondo de Garantía de Depósitos*, (Deposit Guarantee Fund), which would limit the guaranteed amount of deposits to be implemented gradually before the year 2008; and
- (iv) by creating a special entity, the *Comision para la Recuperacion de Activos*, (Commission for the Recovery of Assets), which would manage and sell the assets and rights of the "Fondo Bancario de Protección al Ahorro" commonly known by its acronym "Fobaproa."²

At the center of the legislative debate was the consolidation into the national public debt of the obligations entered into by Fobaproa and the "Fondo de Apoyo al Mercado de Valores" (the "Securities Market Support Fund" or "Fameval").

The reform finally approved by Congress differs from the Presidential initiative both in scope and focus, particularly with respect to granting the CNBV more autonomy and powers. The reform includes the enactment of two new laws, the *Ley de Protección al Ahorro* (Banking Savings Protection Law) and, the *Ley de Protección y Defensa al Usuario de Servicios Financieros* (the "Law to Protect Users of Financial Services"). It also amends Mexico's central banking law, the

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1. LEY DE PROTECCIÓN AL AHORRO BANCARIO, D.O., 19 de enero de 1999 (has been in full force and effect since January 20, 1999).

2. See Roy Karaoglan and Mike Lubrano, *Mexico's Banks After the December 1994 Devaluation - a Chronology of the Government's Response*, 16 NW. J. Int'l L. & Bus. 24 (1995) (provides a detailed account of the steps taken to ensure that the banking and payments system of the country continued to operate despite the sharp contraction in the economy that resulted from the 1994 devaluation of the Mexican peso).

Ley del Banco de México (the "Law of the México Central Bank"), the *Ley de Instituciones de Crédito* (the "Banking Law"), the *Ley del Mercado de Valores* (the "Securities Market Law") and the *Ley para Regular las Agrupaciones Financieras* (the "Financial Groups Law").³

The amendments most notably relate to the ownership structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses. As a result of the reform Mexico has a substantially modified legal framework for its financial system. These modifications include:

- (i) more open participation of foreign capital in the shareholder structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses;
- (ii) a new deposit insurance entity, the *Instituto para la Protección del Ahorro Bancario* (the Banking Savings Protection Institute or "IPAB"), has been created to manage a new system for the protection of deposits, which limits the amount and type of guaranteed obligations and is to be gradually be implemented before the year 2005;
- (iii) Fobaproa will continue temporary operations, with the limited purposes of managing the "capitalization and purchase of portfolio" program, as well as conducting the audits mandated by Congress; and,
- (iv) the creation of a special Commission to protect the rights of financial services users.

BANKING SAVINGS PROTECTION LAW

It is important to highlight that along with the 92 articles of the Law, the "*Transitorios*", which are 21 additional articles, contain important elements for the interpretation and application of the Law. The main features of the Law and the *Transitorios* follow.

Perhaps the most important feature of the Law is the replacement of the unlimited coverage of unsubordinated obligations of banks and brokerage houses. Prior to the passage of this law Fobaproa and Fameval provided banks an exclusive, limited and selective coverage of certain guaranteed obligations. Under the new Law these services will be provided by the new entity, the IPAB. The protection for investors in the securities markets, formerly provided by Fameval, is now extinguished. This new approach to deposit insurance is akin to that of other countries, such as the one provided by the Federal Deposit Insurance Corporation of the United States of America.

The Law provides for the creation of the IPAB, its organizational structure and functions. The IPAB is a public administration entity. It will manage the new banking savings protection system in favor of the persons entering into guaranteed obligations (banking deposits and loans) and it will regulate the financial support to be granted to banks for the protection of savings.

3. LEY DE PROTECCIÓN Y DEFENSA AL USUARIO DE SERVICIOS FINANCIEROS, D.O., 18 de enero de 1999, and LEY DE PROTECCIÓN DE LA FEDERACIÓN, D.O., 18 de enero de 1999 (in full force and effect since January 20, 1999).

The deposit insurance to be provided by the IPAB will be paid upon a determination of the liquidation, suspension of payments or bankruptcy of a bank. The IPAB will act as liquidator or receiver in the liquidation, suspension of payments, or bankruptcy of banks, either on its own or by designating a representative. The IPAB will pay guaranteed obligations up to the 400,000 investment units, which are inflation-adjusted units of account ("UDIS"), per person, per bank.⁴

Banks will have the obligation to pay the IPAB ordinary and extraordinary contributions to be determined by the Governing Board of the IPAB. The Governing Board of the IPAB may determine ordinary contributions according to the particular risk exposure of each bank, their level of capitalization and other elements to be determined in the Internal Statute of the Governing Board (to be published). In any event, ordinary contributions should not be less than 0.004 of the deposits from banks and will be payable on a monthly basis. The IPAB may also require extraordinary contributions from banks that may not exceed 0.003 of the deposits of banks in one year. The *Transitorios* provide that the applicable rules, with respect to contributions, must be issued on or before May 1999. The IPAB will also receive funding authorized by Congress yearly in the Expenditure Budget of the Federation.

In exceptional cases the IPAB may grant financial support to banks. The granting of such extraordinary support will be subject to special requirements such as the preparation of a technical study, the favorable opinion of the CNBV, a plan to solve the financial situation of the bank receiving the support, and a resolution of the Governing Board of the IPAB. The duration of the extraordinary support may not exceed six months, a period which may be extended only once. Such support will be guaranteed with the representative shares of the capital stock of the bank receiving the support in favor of the IPAB, which may foreclose on such shares.

The Law provides that in those cases in which the IPAB grants financial support to a bank, its Governing Board may decree its "*Administración Cautelar*" or "Preventive Management." Through Preventive Management, the Governing Board of the IPAB may appoint a Sole Administrator of the Bank to replace the Shareholders Meeting and the Board of Directors. The Law provides that banks have the obligation to provide the IPAB with all the information it may require to assess their financial situation, as well as the obligation to notify the IPAB of any situation which may affect their financial stability. The Law expressly exempts banks from the banking secrecy provisions contained in the Law of Credit Institutions. Furthermore, the Law establishes that the IPAB and the CNBV will share their documentation and databases of banks.

The IPAB shall manage and sell the credits, rights, shares and any other asset (hereinafter, the "Assets"), that it acquires to perform its activity according to the Law in order to maximize their recovery value. The IPAB must ensure that the sale of the Assets is made public and that the procedures are objective and transparent. The IPAB will monitor the performance of the banks or specialized third parties with respect to the recovery, sale, transfer and management of the Assets trusted to them. The IPAB shall present an annual report to Congress with a detailed account of the transactions executed as of December 31 of each year.

4. As of March 30, 1999 one UDI equals to \$2,495,831 Mexican pesos.

The IPAB will have a Governing Board of seven members: the Secretary of the Ministry of Finance and Public Credit, the Governor of the Banco de México, the President of the CNBV, and four other members appointed by the President of Mexico, with the approval of two thirds of the Senate. The four latter members will be appointed for a period of four years and may be appointed for one additional period. The *Transitorios* provide that any person who served as the *Secretaría de la Hacienda y Crédito Público* (Secretary of the Ministry of Finance and Public Credit), Governor of the Banco de México, or President of the CNBV between 1995 and 1997, and in such capacity acted as member of the technical committee of Fobaproa, may not participate in the Governing Board of the IPAB nor act as its Executive Secretary.

The Governing Board and the Executive Secretary of the IPAB should have been designated by February 20, 1999 and the IPAB must begin operation 15 days later, by March 7, 1999. The Law provides that the IPAB subsequently must issue general rules, as well as the internal statute of its Governing Board.

Media in Mexico and abroad have created the misleading impression that the IPAB began operations as provided in the Law, it is important to highlight that it did not begin operations due to the delay in the approval by the Senate of the four members of the Governing Board appointed by the President of Mexico, which occurred on April 10, 1999. On May 6, 1999 the Executive Secretary of the IPAB was designated by the Governing Board and presumably the IPAB should begin operations by mid-May of 1999.

The Law provides that the IPAB must issue within the next three months General Rules, as well as the Internal Statute of its Governing Board. The General Rules should provide a mechanism for the exchange of the current rights of banks guaranteed by the "Fobaproa Notes," so that it is possible to replace them with negotiable instruments, to be issued by a trust and subsequently offered to investors through a public placement (the "IPAB Notes"). The IPAB Notes will permit banks to obtain liquidity. At this moment we do not know the characteristics of the IPAB Notes.

The *Transitorios* provide that Fobaproa will continue operations, with the limited purposes of managing the "capitalization and purchase of portfolio" program and to complete the audits mandated by Congress. The Congressional mandated audits should be finalized six months after the enactment of the Law, July 1999. The Ministry of Finance and Public Credit and the Banco de México will perform the necessary actions to extinguish both Fobaproa and Fameval.

The *Transitorios* provide that the IPAB system of guaranteed obligations shall enter into effect before December 31, 2005, allowing a transition period. Before May 1999, the Governing Board must publish in the *Diario Oficial de la Federación* (Official Gazette of the Federation) the agenda for the gradual implementation of the new deposit insurance system during the transition period.

OWNERSHIP STRUCTURES AND MANAGEMENT OF FINANCIAL INSTITUTIONS

It is important to highlight that the shareholder structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses was reformed to allow broader participation by foreign corporation and individuals. Prior to the legislative reform, voting shares of Mexican-controlled financial

holding companies, commercial banks and brokerage firms were classified as Series "A" shares, which represented at least 51% of the capital stock and Series "B" shares which represented the remainder. Only Mexican individuals and companies that were majority-owned and controlled by Mexicans were permitted to hold Series "A" shares. Both Mexican and foreign individuals and corporations were allowed to invest in Series "B" shares. Series "L" shares, were eligible for ownership by both Mexicans and foreigners and could be issued up to 40% of the capital stock.

After the legislative transformation of the Law of Credit Institutions into the Securities Market Law and to the Financial Groups Law, the shareholder structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses provides that the common stock of such financial institutions is to be represented by a single series of shares to be denominated Series "O." Series O shares are to be freely issued, thus allowing a broader participation in the aforementioned Mexican financial entities by both Mexican corporations and foreign corporations entities and individuals.⁵ A portion of additional capital stock may continue to be represented by Series "L" shares. Existing Series "B" shares of multiple banking institutions will be governed by the provisions applicable to Series "O" shares.

The reform includes the elimination of the restriction that forbade foreign financial entities to hold a controlling interest in a bank in which the net capital exceeds 6% of the sum of the aggregate net capital of all banking institutions. The reform also includes the obligation to inform the National Banking and Securities Commission of any transmission or acquisition of shares that represent more than 2% of the ordinary capital stock of the aforementioned financial institutions. The obligation to request authorization to acquire more than 5% of said capital, without exceeding 20%, is preserved. However, it is important to mention that a new exception to this limitation is introduced. Foreign financial institutions, affiliate holding companies, holding companies of financial groups, and multiple banking institutions are permitted to acquire 20% of shares when they acquire shares pursuant to programs approved by the National Banking and Securities Commission and only with the purpose of contributing to the proper functioning of a multiple banking institution or a brokerage house. Such exception will be granted by the Ministry of Finance and Public Credit.

Also, the number of directors in any of the aforementioned Mexican financial entities is limited to a maximum of 15 persons. The majority of such directors must be Mexicans or foreigners with residence in Mexico.

LAW TO PROTECT USERS OF FINANCIAL SERVICES

The Law to Protect Users of Financial Services was published in the Official Gazette of the Federation published on January 18, 1999, and will be in full force and effect on April 18, 1999. This law provides the creation of the *Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros* (the National Commission for the Protection and Defense of Users of Financial Services, the "Commission") which will be charged with enforcing the Law. The

5. By operation of law, Series "A" and "B" shares, became Series "O" shares on January 20, 1999.

main purpose of the Commission is to protect and defend the rights and interests of the users of financial services and to act as arbitrator in related disputes.

The Commission may issue recommendations to financial institutions; advise financial institutions regarding the needs of the users; require amendments to the standard forms of agreements used by financial institutions; inform the public regarding services provided by the financial institutions; and require information and credit reports necessary in arbitration. The Commission must maintain strict confidentiality regarding information and documentation provided to it by financial institutions. The Commission and its officers will be liable in case of breach of their confidentiality duty.

The Commission will be managed by a Governing Board of nine members. Each of the following institutions will appoint one member: the Ministry of Finance and Public Credit, the *Banco de Mexico*, the National Banking and Securities Commission, the National Insurance and Bonding Commission, the National Saving Funds Commission, and a Chair appointed by the Ministry of Finance and Public Credit. The remaining three members will be appointed by the "Consejo Consultivo Nacional" ("Consulting National Council", or the "Council"). All members may appoint alternates. Five members will constitute a quorum. The Chair will have a deciding vote.

The Council will have twelve members. Each of the following institutions will appoint one member: the National Banking and Securities Commission, the National Insurance and Bonding Commission, the National Saving Funds Commission, and the Ministry of Finance and Public Credit will appoint two members. Financial institutions will appoint three members, and users of the financial institutions will appoint the remaining three members. The Chair of the Council will be appointed by the Ministry of Finance and Public Credit.

The Commission will also manage a Financial Services Institutions Registry (the "Registry"). Public officers in charge of authorizing the incorporation of new financial institutions will have the obligation to inform the Registry of the granting of authorizations to new financial institutions. The Commission will also have the authority to request financial institutions' information regarding its products, interest rates and services provided. The Commission will manage the arbitration processes currently assigned to the National Banking and Securities Commission. In case the parties appoint the Commission as arbitrator, it will conduct an arbitration process as established in the applicable laws. The Commission may grant free legal advice to those users with no economic resources to pay independent legal advice.

SUMMARY

Mexico has a substantially modified legal framework for its financial system. It is more open to the participation of foreign capital in the shareholder structure of the controlling entities of financial groups, multiple banking institutions and brokerage houses. The Law created a new deposit insurance entity, the IPAB, to manage a new system for the protection of deposits, limiting the amount and type of guaranteed obligations. This new system will be gradually implemented before the year 2005. Fobaproa will continue temporary operations, with the limited purpose of managing the capitalization and purchase of portfolio program and

completing the Congressional- mandated audit. Finally the Law created a special Commission to protect the rights of financial services users.

