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THE FUTURE OF MEXICAN FINANCIAL SERVICES INCLUDING MONEY LAUNDERING REGULATIONS

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Some recent changes in the money laundering regulations have had a notable impact in Mexican financial circles. Also, there are two or three major legal developments that are occurring or about to occur in Mexico which deal with the current banking crisis by addressing *anatocismo*[1], a provision in Mexican law that forbids lenders to charge interest on interest, and the *Fondo Bancario para Protección de Ahorros* (*FOBAPROA*)[2]. For a complete understanding of the current banking situation it is also necessary to address the creation of credit bureaus, the impact of reforms in the Banking and Securities Comission and the need to modernize the Mexican system for the perfection of security interests.

MONEY LAUNDERING

Mexican law first recognized the concept of money laundering in 1989 when the provisions sanctioning it were added to the tax code[3]. However, it enjoyed little implementation or enforcement until 1995 when money laundering provisions were added to the criminal code. The criminal code defines money laundering as the activities of a person who acquires, transfers, exchanges or moves funds or assets either within Mexico, or from Mexico to a foreign country, knowing that those funds or assets are from illegal sources, for the purpose of hiding the assets or funds.[4] The penalty for money laundering is between five and fifteen years of imprisonment, plus an administrative fine. Officers and directors of financial intermediaries who knowingly aid or abet anyone in the commission of money laundering may also be charged with money laundering and be subject to the same penalties. In late 1995, a number of financial laws were amended to empower *Hacienda*[5] to issue money laundering regulations.

In 1997 the *Secretaria de Hacienda* (hereinafter *Hacienda*) issued money laundering regulations which impose five key responsibilities on Mexican banks: 1) to identify clients; 2) to report certain transactions to the National Banking Commission; 3) to maintain confidentiality; 4) to prepare and maintain operating

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1. Anatocimso: Anatocism. "In the civil law, repeated or doubled interest; compound interest; usury." BLACK'S LAW DICTIONARY 84 (6th ed. 1990)

2. *FOBAPROA*: Fondo Bancario para Protección de Ahorros. Bank fund for the protecion of savings. FOBAPROA is similar to the U.S. Federal Deposit Insurance Company (FDIC).

3. Art. 115, Código Fiscal de la Federación (hereinafter C.F.F.), Diario Oficial de la Federación (hereinafter D.O.), 28 de diciembre de 1989.

4. Art. 400, Código Penal para el Distrito Federal en Materia Común y para toda la Republica en Materia Federal, D.O., 14 de agosto de 1931.

5. Secretaria de Hacienda. Public Finance Ministry

manuals and systems; and 5) to disseminate money laundering concepts and manuals among their employees. [6]

Transactions that have to be reported to the Banking Commission are of two types. "Relevant transactions," in excess of US$ 10,000.00 in cash, foreign currency, travelers' checks or metals, which must be reported quarterly to the Banking Commision. "Suspicious transactions," which could constitute money laundering because of the type of transaction, the frequency of transactions, the nature of the transaction, or a transaction which is either remarkably consistent or inconsistent with past acts of the client.

Mexican banks are neither required nor permitted to stop money laundering activities. The banks are not to take the role of the police. Banks are required to allow the transactions to take place and thereafter report to the Banking Commission. The Banking Commission in turn reports the transactions to the *Procuraduría General de la Republica* (Attorney General of the Republic), who determines whether further monitoring or investigation is needed. As of mid-1998, there were roughly three million reported relevant transactions of which between 50 and 100 cases are under investigation by both the general tax attorney's office and the district attorney's office.

The changes in money laundering laws have also had the collateral effect of shutting many *casas de cambio*, small scale currency exchanges, because they are not in a position to comply with some of the requirements. Many of the *casas de cambio* are very thinly capitalized and, as a consequence, cannot invest in automated systems. However, the law permits *casas de cambios*, as well as banks, to use manual record keeping systems. Another reason they may not comply with money laundering rules is that some of those with only one or two outlets cannot afford to put together a program to detect money laundering. The smallest program I have seen is 80 pages long and usually based on models used by other banks or based on the manuals of their foriegn parent banks. The set of rules created by *Hacienda* was not suited for the *casas de cambio*. I am not saying that *casas de cambio* should continue to exist as they do today, merely that the responsibility of compliance was disproportionate to the size of their businesses

ANATOCISM

Anatocism, as conceived in Neo-Romanistic Civil Law, is the charging of 'interest on interest'. The Mexican Supreme Court is currently preparing a decision to reconcile discrepancies among the lower federal courts as to whether *anatocismo* is valid.[7] The issue surrounding *anatocismo* began following the privatization of the Mexican banking system when the banks went on a lending spree, granting thousands of mortgage loans. Since interest rates have been fairly high for the last

6. "Disposiciones de carácter general a que se refiere el articulo 115 de la Ley de Instituciones de Credito, D.O., 10 de marzo de 1997.

7. At the time to the conference the Mexican Supreme Court had not yet issued a decision on the validity of the capitalization of interest, or anatocism. Two principal cases challenging the validity of antocism based on alleged contradictions in the law were under consideration. The two cases were known as 2/98 and 11/98, for the dates on which they were submitted to the Supreme Court. At the time of publication, decisions resolving the issues in favor of permitting anatocism had been issued by the Supreme Court.

thirty years in Mexico, banks created mechanisms to permit borrowers to pay a minimum amount every month. This frequently was insufficient to amortize the monthly accrued interest. Banks then applied two different mechanisms to redress the unpaid interest. The first method used, which is fairly elementary, was to provide in the loan documents that unpaid interest would further accrue interest. The second mechanism employed, which is much more creative, provided for the existence of a line of credit to cover unamortized interest with the unpaid interest as its principal, which would in turn accrue additional interest.

After the 1994 devaluation of the peso interest rates skyrocketed and many mortgage borrowers had difficulty paying on their loans. As banks initiated foreclosure proceedings, they encountered a common defense. The borrowers argued that the scheme used by the banks to postpone interest payments, either by charging interest on interest or through the use of a separate line of credit, was illegal as the *Código Civil* (civil code) forbids charging interest on interest at the inception of the transaction.[8]

The debtors argue that *Código de Comercio* (Commercial Code) states that if the purpose of the funds borrowed are not mercantile the loan is not a commercial transaction, hence a civil transaction.[9] Nevertheless, they argue that even if the mortgages were commercial transactions (as opposed to civil transactions[10]), the Commercial Code states that past-due interest cannot accrue interest. However, the Commercial Code does permit contracting parties to capitalize past-due interest. [11] The claim asserted that this provision of the commercial code would only be enforceable if the agreement to capitalize interest was not made at inception.

The impending Supreme Court's decision will be critical for mortgage loans created between 1991 and 1994 and, perhaps more importantly, it will influence future lending practices. It seems apparent that the court will rule in favor of the banks for three or four reasons. First, the disputed loans were not documented in the form of loan agreements but as lines of credit. This is an important distinction as the provision of the Commercial Code that permits parties to capitalize past-due interest pertains to loan agreements, not lines of credit.[12] In fact, lines of credit are not even governed by the commercial code, but by the *Ley de Títulos y Operaciones de* Crédito (Law on Credit Instruments and Transactions).[13] So if the mortgages are regarded as lines of credit, by law the transaction will be a commercial transaction, not a civil transaction. Hence, they would not be governed by provisions of the Civil Code. Furthermore, if mortgages are not lines of credit and the Civil Code is to be applied, it is unclear whether an agreement to capitalize interest made at the

8. "Código Civil para el Distrito Federal en Materia Común y para toda la República en Materia Federal, Artículo 2397", D.O., 26 de marzo 1928. "Las partes no pueden, bajo pena de nulidad, convenir de antemano que los intereses se capitalicen y que produzcan intereses."

9. "Codigo de Comercio, Art. 358", D.O., del 7 al 13 de octubre de 1889. "Se reputa mercantil el préstamo cuando se contrae en el concepto y con la expresión de que las cosas prestadas se destinen a actos de comercio y no para necesidades ajenas a éste. Se presume mercantil el préstamo que se contrae entre comerciantes."

10. In Mexican law there is an important distinction between "Commercial Transactions" and "Civil Transactions" which determines under which codes or laws disputes will be adjudicated.

11. "Código de Comercio, Art. 363", D.O., del 7 al 13 de octubre de 1889. "Los intereses vencidos y no pagados no devengarán intereses. Los contrantantes podrán, sin embargo, capitalizarlos."

12. In Mexican Law there is an important distinction between a "Loan Agreement" and a "Line of Credit" which determines under which codes or laws disputes will be adjudicated.

13. "Ley General de Títulos y Operaciones de Crédito", D.O. 15 de septiembre de 1932.

inception of the loan is null and void. In fact, I understand that the court believes the provisions of the commercial code, assuming that they apply to lines of credit, permit agreements to capitalize interest made at the inception of a loan.

The next element which the court has been asked to consider is whether the additional line of credit was granted in violation of the Banking Law which requires banks to prepare a viability analysis for loans that are being made.[14] The borrowers argue that the additional lines of credit were created without the required viability analysis and therefore are invalid. In my opinion, the lack of that analysis should not affect the court's decision. If, in fact, there was a violation of law, it would be an administrative law violation which may subject banks to sanctions by the banking commission.

A third element that the court will be asked to consider concerns the base rate used to calculate the interest. The contested mortgage agreements use as their base rate the higher of *CETES*, treasury bills; the *CPP*, the basic banking cost funding; the *TIIE*, the inter-bank rate; or, any other rate. The argument borrowers assert is that because no specific base rate was specified the loan agreements were incomplete. Therefore, the borrowers should not be required to pay any interest calculated using the terms of the agreement. I do not think this can legally nullify the agreements. In an attempt to correct the ample flexibility banks have enjoyed the banking commission issued a ruling in 1995 forbidding Mexican banks from using different base rates in their peso loans.[15] Consequently, Mexican banks can now use only one of three or four base rates. Hence, they can no longer say the interest rate "is going to be a spread on top of the base rate and the base rate will be the higher of the following rates: CETES, CPP, TIIE, etc . . ."[16]

If the court rules in favor of the banking system there are still two potential setbacks predicated on basic contract law but for the contested mortgage loans. The first potential setback is that, in some instances, banks induced borrowers to take mortgage loans on the argument that at the end of twenty years the loan would be fully paid. If a borrower can prove that he relied on that representation, he could demand the court declare the contract null and void on the grounds that his consent was given in error.

The second possibility once again deals with the concept of error. It is based on the terms of the agreements, claiming it is almost impossible to understand the manner in which interest is deferred and thereafter subject to further interest charges. The risk for the banking system is for *Jurisprudencia*[17] to be created on these arguments. So far, there have been at least two or three cases in which lower courts have ruled in favor of the borrower, though this has no precedential value. If there is *jurisprudencia* on these grounds, the mortgage contracts will be deemed null and void, the borrower will be required to return the principal amount of the loan, and the bank will be required to return the interest payments to the borrower.

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14. "Ley de Instituciones de Crédito, Art. 65", D.O., 18 de julio, 1990.

15. *Circular 2019* issued by the Mexican Banking Commission in 1995.

16. For example, on April 28, 1999 28-day Cetes were at 18.65%, the CPP was 19.16%, and the 28-day TIIE was 22.515%. Eleazar Rodríguez, *Mercado Primario*, El Financiero (Mexico City), April 28, 1999, at 4A-5A.

17. Jurisprudencia. The Mexican equivalent of precedential value or Stare Decisis which incurs when 5 cases with nearly identical facts have been decided in the same manner by the Mexican Supreme Court or certain Circuit Courts (Tibunales Colegiados de Circuito).

FOBAPROA

The *Fondo Bancario para Protección de Ahorros, FOBAPROA,* is a private trust managed by the central bank, to which banks make periodical contributions. I would like to address some of the initial activities of *FOBAPROA* in 1995, and what seems the most likely outcome of the *FOBAPROA* dispute.

FOBAPROA's purpose was to insure deposits. It was funded by the banks, mangaged through a trust and supervised by a management committee. When a bank requests support from *FOBAPROA* the management committee, before authorizing any support, is required to look to the viability of the support and to assure that there will be adequate guaranties for repayment. In 1995, as a consequence of the financial crisis, the purpose of *FOBAPROA* was broadened using the existing ample powers of its charter. *FOBAPROA*'s new mandate was to provide support to the beleaguered banking system through two distinct programs.

Through the first program, "the capitalization program," *FOBAPROA* would purchase non-performing loans from banks on a one-to-one basis with notes guaranteed by the federal government. Under this program *FOBAPROA* required that a bank's shareholders contribute, for example, $1.00 as capital to the bank for every $2.00 of non-performing loans received by *FOBAPROA*. Hence, it transfered huge packages of non-performing loans from the banks to *FOBAPROA* in exchange for government guaranteed promissory notes that were accruing interest at market rates. Although the loans *FOBAPROA* received were accruing interest, it was not being paid and frequently it was unlikely that even the pricipal could be recovered.

Under the second program, the "clean-up program," *FOBAPROA* purchased non-performing loans from banks at one-to-one with notes guaranteed by the federal government to facilitate the divestiture of the non-performing loans from the banks to third parties.

One of the debates on the *FOBAPROA* issue was whether the government had the power to guarantee the *FOBAPROA* notes. Without getting much into the details of Constitutional Law, I do not think the government had the power to guarantee those loans. Primarily, because the rules established in the constitution were not followed.[18] Secondly, because the promissory notes and guarantees were not registered in the public debt registry maintained by *Hacienda*. In March 1998, the amount of registered internal debt in Mexico was roughly US$ 40 billion and the amount of non-performing loans acquired by *FOBAPROA* was approximately US$ 65 billion, that is about 13-14% of Mexico's 1998 GNP.

On a side note, one of the reasons that the financial package presented to Congress in May of 1998 got stuck was Congressional unwillingness to approve converting the *FOBAPROA* notes into public debt, in the sense that the government would guarantee to pay the debt over a certain number of years. The current status of the notes is that they are only paid to the extent autorized by Congress in each annual budget. The issue is therefore whether the debt will remain as it is, be voided, or become direct public debt.

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18. Art. 73, VIII, Constitución Politica de los Estados Unidos Mexicanos.

On September 30, 1998 there seemed to be the serious possibility of a resolution when an agreement was reached outside of Congress by all political parties[19] except the *Partido Revolucionario Democratico.*[20] However, because the PRD represents a minority, its approval is unneccesary should it go to a vote.

There are four or five basic points in the proposed solution.[21] The first, which I think is one of two critical points, is that *FOBAPROA* will return to the non-intervened banks all loans in excess of five million pesos, roughly half a million dollars, in exchange for smaller non-performing loans. Initially, *FOBAPROA* received corporate loans, as opposed to small loans made to individuals. The banks taking back the major or corporate loans will therefore be re-assuming their full non-performance risk.

Secondly, there will be a new relief program for small borrowers which should also provide incentives to performing borrowers. The third point calls for the creation of a new vehicle to dispose of the assets retained by *FOBAPROA*. The fourth point, requires that a new entity be created to insure deposits.

Finally, the fifth requirement is that the *FOBAPROA* notes not be converted into direct public debt. Ideally the *FOBAPROA* notes will be repaid using first funds received through repayment of loans held by *FOBAPROA*; secondly, by divestiture of the assets guaranteeing loans held by *FOBAPROA*; thirdly, using funds contributed by the banks themselves; and, finally, using only those amounts that Congress approves yearly. Also, there should be a major overhaul of the Mexican legal system to provide a better setting for banking activities.

One issue that makes me skeptical is that in the last three or four years *FOBAPROA* has not been able to divest assets of the non-performing loans either directly or through any other method such as the now defunct *VVA.*[22] Because the problems impeding diveseture have been mainly legal and tax issues I am skeptical that the proposed changes will have impact on divesteture.

For example, in March or April of 1998, the net worth of the assets acquired by *FOBAPROA* were roughly US$ 30 billion, though it had issued notes worth US$ 65 billion. Therefore, even if those assets could be collected or liquidated all at once, *FOBAPROA* would have a shortfall of US$ 35 billion. Judging from experience, where there is a bad loan in Mexico, the longer it takes to reach a solution, the less value the ultimate lender will receive.

FERNANDO MONTES, The World Bank: I have one question regarding the agreement between the banks and *FOBAPROA* for the purchase of bad assets in exchange for a capitalization agreement. On top of that agreement they had capped the losses of the banks at between 25% and 30% at the end of the sale of the bad

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19. The agreement was made between the ruling *Partido Revolucionario Institucional* (hereinafter PRI) or Institutional Revolucionary Party; and, the *Partido de Acción Nacional* (hereinafter PAN) or National Action Party, the principal Mexican right wing opposition party.

20. Partido Revolucionario Democratico. The Democratic Revolucionary Party, the principal Mexican liberal opposition party.

21. At the time of the conference, no resolution had been formalized. However, shortly before publication an agreement had been reached which created the IPAB, or the *Instituto para Proteción de Ahorros Bancarios,* to replace *FOBAPROA.*

22. VVA. *Valuación y Venta de Activos S.A. de C.V.* (Valuation and Liquidation of Assets, Inc.) A stock company organized by FOBAPROA for the purpose of divesting bank loans and forfieted assets. It was created in 1996 and is now in the process of being liquidated.

loans. All the proposals indicated this agreement would not be honored, or would be changed. Do you see this as a potentially contentious issue, maybe up for legal action? For example, if I am a commercial bank, I sell a hundred pesos of bad loans to *FOBAPROA* in good faith, I cap my losses at 25 pesos. Now all the proposals say, "No, you are going to get 100% of the bad loans at the end."

NADER: What you are saying is that when the banks sold their portfolio to *FOBAPROA*, *FOBAPROA* had recourse to the banks basically for 25% of the unpaid amount. So the banks would share 25% of the loss. Your question, as I understand it, is that if the agreement is implemented, where will the commercial banks stand? Could *FOBAPROA* make them take the bad loans back? Technically I think the answer is no. By the same token, I do not think that the banks can collect from the government on the *FOBAPROA* note, without the government guarantee it is worthless. If the recent agreement among the political parties is implemented, I think the government will have to create a consensus with the banks.

However, I am not sure that the banks will be in a worse position than they are today because I do not know what type of small loans the banks are going to transfer to *FOBAPROA* in exchange for the big loans. Assuming the small loans are as bad as the big loans, perhaps the banks will unwittingly come out better. If you have hundreds or thousands of small mortgages with bad loans and it is difficult to find the borrower, difficult to find the assets and very expensive to collect, as a bank you might be better off trying to work out, restructure, or divest a smaller number of big loans. This in no way means there is no issue but, at the end of the day the *FOBAPROA* note is not very valuable without a government guarantee. However this may be the leverage neccesary to forge a consensus between the government and the banks.

BANKING AND SECURITIES COMISSION REFORM

In the late 1980s the government merged the *Comissión Nacional de Bancos (CNB)*, Banking Commission, and the *Comissión Nacional de Valores (CNV)* Securities Commission, creating a new commission, the *Comissión Nacional Bancaria y de Valores (CNBV)*, to regulate banking and securities firms, leasing companies, factoring companies, exchange houses, and perhaps a few other financial industries. At the same time Mexico was moving away from having financial intermediaries specialized in financial services (there were no anti-trust issues as there might be in other countries), towards the concept of universal banking. Mexico did this by creating holding companies whose only purpose would be to own the controlling share of financial intermediaries. This raised the issue of who would supervise the holding company: the Banking Commission, Securities Commission, or Insurance Commission (*Commisión Nacional de Seguros y Fianzas, CNSF*). It was decided that the holding company would be regulated by the commission that would otherwise regulate the pre-eminent intermediary owned by the holding company. So, if the pre-eminent intermediary was an insurance company, then the holding company would be governed by the Insurance Commission.

Having the Insurance Commission regulate a holding company that has a bank, a securities firm, a leasing company and a larger insurance company is not necessarily the best decision. The decision to regulate the holding company based

on its largest intermediary was made by default. This has impaired the ability of the Commissions to monitor the holding companies, and especially to accurately monitor the intermediaries that would otherwise be regulated by other commissions.

In all fairness to the government and the Comissions, regarding conflicts of interest, there was an explosion of intermediaries between 1990 and 1994. Before Mexico privatized the banking system in 1990 and 1991, there were roughly eighteen commercial banks. Afterwards there was a point when there were over forty commercial banks. Therefore, the banking comission had to supervise more than twice the number of banks they had previously in their charge, in addition to all the leasing companies and other intermediaries which they also supervise. So I think the problem was an inappropriate infrastructure not fit for the market conditions. Furthermore, there was quite a bit of duplication of reporting requirements for intermediaries. There are many intermediaries that essentially file the same information with the Central Bank and the Banking Commission, changing the format only.

There have been cases where the banking commission did not do their work properly, though it may not have constituted a conflict of interest. An example is the case of *ABACO-CONFIA,* which is a conglomerate of a very prominent securities firm, *ABACO,* who acquired a very solid bank, *CONFIA.* A holding company, *ABACO-CONFIA* was created to manage the two intermediaries. It was no secret that the bank, *CONFIA*, was going through a difficult time and yet the *CNBV* allowed the holding company to issue a large volume of convertible bonds that eventually were converted into equity and now have no value. I think that having to supervise more than one type of intermediary at a time has impaired the ability of the Banking Commission to do its job and is not the best alternative.

CREDIT BUREAUS

There are at least a couple of trends that are worrisome. One is the creation of credit bureaus. Banks cannot grant loans to their customers without consulting credit bureaus for the preparation of a credit analysis.[23] When a credit bureau issues a negative report on a customer, banks are required to reserve up to 100% for that specific loan.

Unfortunately, some banks use the credit bureau in a manner that is contrary to it's purpose and works against the system. In certain instances banks are using the credit bureaus to exact certain conditions from their borrowers and also from their shareholders. As I read the law and the rules, there is nothing that permits a bank to issue a credit report on shareholders who have no privity with the bank. The government will have to take this issue into account because a number of credit bureaus have already been created and some are starting to be implemented. The worst thing that could happen would be for those credit bureaus to be used for a purpose other than the one for which they were created.

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23. "Circular 1413" issued by the National Banking and Securities Commission on September 30, 1998 requires Mexican Banks to obtain a report from a Credit Bureau before granting a credit. If a bank issues a credit without consulting a credit bureau report they must maintain reserves of up to 100% of the credit amount.

The second trend I see developing more and more is that banks are exerting pressure on non-performing borrowers to evict them out of the banking system. There are a number of cases in which banks discontinue banking services such as deposits, check cashing or wire transfers for borrowers with whom they have troubled loans. There are banks that have created groups to support each other in evicting these borrowers from the banking system. Clearly banks are entitled to recover their loans. However, such coordinated action by banks could fall within the jurisdiction of the *Comisión de Competencia Económica*.[24] Unfortunately, by the time an anti-trust case is cleared, a borrower that has not been able to bank with a number of banks may be irreparably harmed. In addition to these two examples, I think there are a number of practices both within the banking system and among borrowers that need to be monitored. Eventually the government will have to create a more efficient mechanism to prevent those practices.

MODERNIZATION OF THE MEXICAN SYSTEM FOR THE PERFECTION OF SECURITY INTERESTS

There is an urgent need to modernize Mexico's system for the creation of security arrangements. One of the stumbling blocks is the State-run registration system. There is at least one public registry in each State. According to the Ministry of Commerce the registries do not have the funds to invest in the creation of a new system. The modernization of the system would neccessarily entail a reduction of registration fees. In many jurisdictions (in all I believe, other than Mexico City), registration fees are a percentage of the amount that is being secured. This creates significant revenue for each State. In addition to the substantive obstacles a significant political stumbling block must also be overcome to create a system that could compete with other systems in the world.

Finally, the future of financial services needs reform to facilitate contracting, foreclosure, litigation and insolvency procedures. There is also significant pressure on the opposing parties to assure that white collar crime is more effectively punished.

24. *Comisión Nacional de Competencia Económica* (National Commission of Economic Jurisdiction) The division of the Mexican Government which detects and penalizes Anti-Trust policies.