“Mexico: Its Response to the 1994-1995 Crisis”

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INTRODUCTION
“Rather go to bed without dinner than to rise in debt.”
Benjamin Franklin (1706-1790)

“I thought sovereign debt was probably going to be seen as a really academic and obscure topic, of interest just to specialists”. Unfortunately events have proved him wrong. [Pádraig Ó Riordáin, Arthur Cox-page 31]

Exclusive of emerging market economies? No longer an “emerging market country” problem. Look at the list of countries:

Mexico-Brazil-80’s
South Korea, Indonesia-90’s
Russia 1998
Argentina 2002
Uruguay 2003
Greece (with bonds subject to Greek law, issued in 2001, prior to its joining the Eurozone), Ireland, Portugal, [Spain, Italy?] 2012
“Some countries view a sovereign debt restructuring as shameful; others have done it so often it’s a national pastime” [Dec 9-Legal Business-Greece-Lee Buchheit.]

THE 1994-1995 MEXICO DEBT CRISIS

Origins of the Crisis

- Although the peso devaluation proved to be the catalyst that triggered the crisis, it was widespread instability in the banking sector that fostered the environment necessary for a crisis to occur. Arguably, this instability transformed what should have been an economic adjustment into a full-blown, severe financial crisis. [See Thomas W. Slover, J.D. (Southern Methodist University), 5 NAFTA-Tequila Sunrise: Has Mexico Emerged From The Darkness Of Financial Crisis?]

- “Moral hazard”- Lack of incentives to act prudently and supervise managers. “Moral hazard” might be defined as actions taken by economic agents to maximize their own utility to the detriment of others in situations where agents do not bear the full consequences of their actions. [See William P. Osterberg, The Hidden Costs of Mexican Banking Reform, FED. RESERVE BANK OF CLEV., Jan. 1, 1997, at note 10.]
● General problems:
  - Weak financial institutions
  - Lack of proper internal controls
  - Related-party lending
  - Insider dealing
  - Fraud
  - Poor asset quality
  - Weak corporate governance

● Inadequate legal framework:
  - Regulatory shortcomings
  - Supervisory forbearance
  - Lack of adequate loan classification and provisioning requirements
  - Difficulty in collection of collateral
  - Poor bankruptcy regime
The terms of the $20 billion U.S. package were formalized in the “U.S.-Mexico Framework Agreement for Mexican Economic Stabilization” (Framework Agreement) signed on February 21, 1995, which governs the U.S. loan and loan guarantees package for Mexico.

Under the Framework Agreement, Mexico committed itself to comply with the IMF program and additional requirements set by the U.S. Treasury. In particular, the Mexican government agreed to (1) refrain from intervening in the foreign exchange market using international reserves, but rather to stabilize the peso using indirect fiscal and monetary policy; and (2) disclose information regularly on a number of variables and policy decisions in a systematic and transparent way and proceed with structural reforms.

Mexico adopted several new fiscal policy measures in accordance with IMF guidelines. These measures included: (1) an increase in the value-added tax; (2) a reduction in budgetary outlays equal to 1.6% of GDP for fiscal year 1995; (3) an immediate tax increase on gasoline, diesel fuel and electricity prices; and (4) an increase in the fiscal surplus of 2.1% of GDP.
DOMESTIC PROGRAMS AND SOLUTIONS IMPLEMENTED AS PART OF THE INTERNATIONAL AGREEMENTS

- **The Central Bank**

  Greater autonomy and enhanced authority to conduct monetary policy and supervision of the payments system and foreign exchange markets.

- **Temporary Capitalization Program (Programa de Capitalización Temporal) (PROCAPTE)**

  Introduced to solve the full of the capital-asset ratios of many Mexican banks caused by the drastic devaluation of the Mexican peso.

- **Banking Fund for Savings Support (Fondo Bancario para Protección de Ahorro) (FOBAPROA)**

  Deposit insurance. Purchased subordinated convertible debentures from participating banks in amounts sufficient to raise the banks’ ratio of net capital-to-risk-weighted assets to 9%.
Domestic Programs and Solutions Implemented as Part of the International Agreements (... continued)

- **Debtor Relief Program (Acuerdo de Apoyo Inmediato a Deudores de la Banca) (ADE)**

  Provided relief to the debt burden of consumers and mortgage loan debtors created by high interest rates and the substantial decrease in economic activity.

- **Asset Valuation and Sale Agency (Valuación y Venta de Activos) (VVA)**

  In charge of appraising and selling the assets that FOBAPROA acquired from the banks. Later replaced by FOBAPROA.

- **Long-Term Structural Reforms**

  Gradual increase of foreign investment in banks and financial groups permitted by Mexican law. NAFTA, a big boost to this effort.
Domestic Programs and Solutions Implemented as Part of the International Agreements

- **Establishment of Futures Markets**

  Banco de Mexico facilitated the development of a mechanism to manage risks and determine prices and exchange rates. The Chicago Mercantile Exchange (CME) followed suit.

- **Pension System Privatization**

  Radical political and economic move. To alleviate the bankruptcy of the public pension system, Mexican workers were required to choose by the year 2001 which private pension fund administrator (called an AFORE) they wished to look after their pension contributions.
REGULATORY AND SUPERVISORY REFORMS

- **Amended Loan Loss Reserve Requirements**
  
  Stringent loan loss provisions required.

- **Stricter Bank Lending Standards**
  
  Implemented to combat related lending, insider dealing and fraud.

- **Enhanced Supervision**
  
  Included the merger of two regulators in one agency.

- **Adoption of GAAP Accounting Standards**
  
  To create reliable accounting standards and practices.

- **Participation in SDDS**
  
  Sought to bring uniformity and transparency to information provided by IMF members.
Regulatory and Supervisory Reforms (… continued)

- **Revised Capital Adequacy Valuations**
  
  Adopted to reflect market risk (changes in share prices, interest rates, exchange rates and inflation) as well as credit risk.

- **Encouragement of a Credit Bureau System**
  
  Only created in February 1995.
ASSESSMENT OF MEXICO’S REFORMS

- **Negative: Conflicts of Interest by the Regulator**
  
  Stemmed from the government regulators’ dual role as “watchdog” and supporter of financial institutions.

- **Positive: Impact of Reforms**
  
  Mexico regained access to international capital markets in the second quarter of 1995, only five months after the December 1994 devaluation.

- **Positive: A New Insolvency Regime**
  
  Adoption of the 2000 Commercial Insolvency Law (Ley de Concursos Mercantiles) (“LCM”).