Mexico's Savings Protection Bank Fund And the Financial Crisis

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The Savings Protection Bank Fund (Fobaproa) will be subject to debate for a long time, not only because the enormous resources needed to solve the financial crisis it caused will come out of taxpayers' pockets for many years, but also because the financial and fiscal reform still has a long way to go to prove its merits in a climate of skepticism and distrust.

Mexico's Bank Savings Protection Fund (Fobaproa), a federal trust to guarantee savings accounts deposited in the national banking system, has become the main factor in the financial crisis facing our country today. In addition to the sizeable sum of Fobaproa's liabilities, the generalized rejection of the government proposal to converting them into public debt is well founded.

The much debated financial bailout that the government has effected over the last four years by exchanging coupon-bonds for overdue loan portfolio has polarized the debate in the Chamber of Deputies. Adding fuel to the fire is the fact that these discussions coincided with the executive's introduction of its proposal for the government earnings part of the annual 1999 budget. The bill includes both tax hikes and increased prices in government goods and services (including utilities), giving the impression that the executive, not satisfied with cutting social spending, is eagerly seeking to bolster Mexico's stagnating economy by channeling funds to bankers.

The central point in the discussions have been very large loans granted without sufficient collateral, currently being audited to determine which bank and governmental officials are responsible for what.

Fobaproa and the Financial Crisis

Undoubtedly the Savings Protection Bank Fund (Fobaproa) will be subject to debate for a long time, not only because the enormous resources needed to solve the financial crisis it caused will come out of taxpayers' pockets for many years, but also because the financial and fiscal reform still has a long way to go to prove its merits in a climate of skepticism and distrust.

The agreement to come to the negotiating table to solve political and financial difficulties has put Mexico's entire political system in its new democratic mode to the test. Tensions could be felt throughout society and sharpened discrepancies not only among political parties, but also among the different currents inside them.

Today's rarified political atmosphere has made it difficult to appreciate the scope of a financial reform that would prevent Fobaproa's becoming a recurrent problem.

With bleak prospects, 1999 is beginning with a tax hike on top of the already heavy fiscal burden borne by the economy's ever shrinking formal sector, an increase in the prices of government goods and services and the struggle over the presidential succession in a still unconsolidated democracy.

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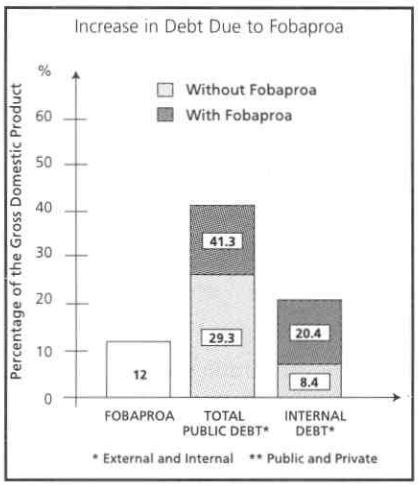
Mexico's official Institutional Revolutionary Party (PRI) will have to bear the brunt of the political cost of a difficult negotiation, including establishing alliances with the opposition, to reach an agreement to reform the country's entire financial system. The economy is in difficult straits since the prospects for getting enough funds to transfer to Fobaproa are not what were expected, and the audits may indeed link well known figures in the financial and political world to illegal operations.

The executive's initial proposal to Congress of converting Fobaproa's liabilities into public debt had to be changed because the amount involved was much larger that the government could possibly deal with. Apparently, President Zedillo's government never considered the possibility of having a minority in the Chamber of Deputies (the PRI holds only 47 percent of the seats). The publicity campaign arguing that the bank bailout was to protect savers' money was countered with the scandal sparked by bankers' misdirecting funds and underwriting loans without collateral. These same bankers —men like Jorge Lankenau, Carlos Cabal Peniche and Angel Isidoro Rodríguez (nicknamed "The Divine"), once touted as models of "successful businessmen"— were first linked with high government officials, and above all to the PRI, and then exposed as common criminals who watched as their financial empires came down like houses of cards. But the most important thing is that every negotiation related to the financial sector has been held in the shadow of the suspicion surrounding even those bankers who have not been named in connection with illegal operations.

THE MAGNITUDE OF FOBAPROA

In November 1998, official figures put Fobaproa's liabilities at 609 billion pesos (12 percent of Mexico's gross domestic product, that is almost one-eighth of all the goods and services that Mexicans produce in a year). This sum eliminates any possibility of it being dealt with in a single fiscal year. Getting enough government funds to cover it would require several fiscal years and congressional approval.

At one time, Fobaproa was a life raft for Mexico's financial system. But the transformation of liabilities into public debt unleashed a great polemic since the executive branch can only acquire debt with the approval of the Chamber of Deputies. However, Finance Ministry officials argued that it was a contingency debt that should be taken on as such, since it was the only way to guarantee the deposits in the national banking system. Fobaproa liabilities raise the total public debt from 29.3 percent to 41.3 percent of the gross domestic product (GDP) and the internal debt from 8.4 percent to 20.4 percent of GDP.



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Fobaproa requires 30 percent of all bank funds, affecting access to credit, but this figure is growing and, clearly, the domestic private sector will no longer have access to credit. On the other hand, the cost of servicing Fobaproa's debt hovers around 100 billion pesos, which could temporarily drop to 25 or 30 billion pesos due to the rewriting of zero-coupon bonds that pay only real interest and postpone payment of liabilities until they mature.

AN INEFFICIENT BANKING SYSTEM

This process is only the beginning of the restructuring of the national financial system. However, the banking system continues to suffer from high costs and long-standing vices and inefficiency, making it expensive and untrustworthy. The 20-point spread between lending and savings interest rates, the government's constant stepping in at moments of crisis, as in the case of Fobaproa, and privileges in charging for services have not been enough to create a banking system that can play the economic and social role that the nation needs.

Mexico, a country with almost 100 million inhabitants and a work force 35 million strong, has only 13 million bank customers. More than 7,000 bank branches service them, an average of fewer than 2,000 clients per branch. Each branch consumes 70 percent of its earnings in operating costs, while the recently established Chase Manhattan Bank of Mexico consumes 55 percent, according to General Director John Donnelly. System-wide data indicates that 26 of every 100 pesos that come in are used to cover administrative expenses (payroll, current account, systems, maintenance, etc.). At the same time, 79 out of every 100 pesos are needed to cover financial expenses (reserves and bankruptcies because of bad loans, interest payments, etc.). Clearly, if we do the addition, the result is a considerable deficit, which the banks went to Fobaproa to cover. They have also made commissions on services rendered and on the sale and purchase of securities their main source of income.

The financial sector's crisis involves many factors and, today, inefficiency is more and more evident. It is rooted in the absence of a clear definition of the model of banking system being followed, a glaring absence even before reprivatization of the banks. In general, the social function of the banking system has always taken a back seat to making a profit; resource management has also been inappropriate, so much so that today it has reached dimensions that affect the taxpayers.

The Gestation of the Financial Crisis

Mexico's economic development required active state participation. For many years the government banking system and development trust funds played a leading role in fostering industry. Monetary regulation was an economic policy tool for guaranteeing stability through the legal reserve, setting different interest rates according to the objectives of the loan, establishing general interest rates, etc. The theory that gave rise to the reprivatization of the banks meant an abrupt suppression of monetary controls and the country went from what was called "financial repression" to a "libertine financial policy." The immediate effect was unchecked growth in credit: between 1988 and 1994 alone, the overall loan portfolio rose from 49 percent to 72 percent of GDP. Loans were given —irresponsibly in most cases— to individuals who could not guarantee payment and, in some cases, equally irresponsibly, members of the boards of directors of the banks themselves were granted large loans without the necessary collateral. This was the case of Lankenau, Cabal Peniche and Angel Isidoro Rodríguez, today all under criminal indictment. While this explains Fobaproa's high level of liabilities, to understand how the financial crisis developed, we must look at other factors such as the following:

* Channeling of bank funds to non-productive activities, favoring speculation and the creation of consumers, not producers.

* The lack of an industrial policy that could protect small and medium-sized industries and agriculture from an extremely rapid economic opening, which led to many producers' insolvency.

* The sudden obsolescence of regulatory systems which, added to bankers' lack of experience, spurred inappropriate or illegal bank management.

Photos by Antonio Nava/AVE

Guillermo Ortiz, president of the Banco de México, and José Angel Gurría, Finance Minister.

* The elimination of most functions of the development banking system, after which no new mechanisms were established to replace them and nor was a transitional plan implemented to adapt to the new situation.

* A lagging exchange rate. Between 1988 and 1994 particularly, the setting of the exchange rate became the main anti-inflationary instrument. Toward the end of that period, the pressure for devaluation and capital flight accelerated the financial breakdown.

* Interest rate hikes. After the December 1994 peso devaluation, high floating

interest rates made most loans unpayable. Payments on credits originally designed to be covered by a fifth or sixth of the borrower's monthly income skyrocketed, and even the most careful and responsible loan holders defaulted when their entire monthly income was not enough to cover the new premiums demanded by the banks using the rising interest rates.

Members of *El Barzón*, the most active debtor organization, demonstrating against Fobaproa.

The refinancing mechanism using what were called Investment Units (UDIs), indexing the amount of the loan to increases in the minimum wage and turning whatever the borrower does not cover in monthly payments into capital, made paying off the loans impossible, particularly in the case of mortgages. Today, the original loan plus the capitalized interest comes to three times the market value of the property.

* The expansion of the bad loan portfolio. This has recently become more severe, but it actually dates from several years ago. By December 1994, bad debts already amounted to 8 percent or 9 percent of all loans, about three times the maximum recommended by international norms. New 1997 accounting criteria have an impact here: basically they consider the entire loan is in default when more than two monthly payments have been missed.

In conclusion, we could say that the financial crisis has been made more severe by over-borrowing by both companies and individuals, exchange rate adjustments, the economic slowdown and the government's ending protectionism for an economy whose major gains had been based on state tutelage.

A Partisan Solution

During the difficult negotiations to find a solution to the financial crisis, it became popular to say, "We don't know what's worse: having Fobaproa or not having it." What is certain is that the main political parties, the PRI, the National Action Party (PAN) and the Party of the Democratic Revolution (PRD), do agree on the need to find an immediate solution to the problem rather than running the risk of leaving it to a new administration that any of the three of them could head up.

Therefore, despite the urgency of finding a viable solution in financial, political and social terms, the discussions have been bogged down by the political situation typical of a period prior to a presidential campaign. The PRI's relative weakness in the Chamber of Deputies is augmented by having to defend points of view that, strictly speaking, are those of the bankers. The most coherent proposals were presented only at the last minute and the general impression is that they were achievements of the opposition parties.

The negotiations on Fobaproa liabilities came on top of those around the 1999 budget, and under "miscellaneous items," it was proposed they be turned into public debt. This further complicated approval of the 1999 budget: in addition to the drop in international oil prices (oil supplies 40 percent of federal earnings), which prompted a tax hike and mounting prices in government goods and services, the servicing of the public debt would be augmented by Fobaproa liabilities.

The official party has to bear most of the political cost; even though toward the end of the discussions the alternatives were only slightly different, the partisan climate made them more noticeable and spurred each of the political players to try to capture media attention and look like defenders of the people's cause, regardless of the viability of their proposals. At a time when the "protest" vote might become decisive in the 2000 elections, the opposition parties will try to make the PRI pay a heavy price for the errors and illegal activities that have an impact on the financial crisis.

The PAN is trying to convince the public that the PRI supports its proposal and that thanks to its valuable intervention the break-up of the banking system has been averted, as well as the resulting loss of the savings of millions of Mexicans. To capture the protest and "penalty" votes, the PAN is presenting itself as a responsible organization capable even from the opposition of negotiating and supporting the decisions the country needs.

For its part, the PRD will continue with its strategy of denouncing the PAN/PRI alliance for championing the bankers' cause and of insisting that it distanced itself from the Fobaproa discussions because of the mandate received in the public consultation it carried out on the question, which expressed the "public's opposition" to the fund's liabilities being taken over as government debt. Therefore, the PRD will declare itself the only true opposition party.

Circumstances will force the PRI to seek to benefit from the comprehensive financial reform which until now has been paid scant attention, but which is actually the best result of this entire difficult process.

THE REFORM OF THE FINANCIAL SYSTEM

Underpinning the restructuring of the financial system are two premises: across-the-board punishment of all lawbreakers and the principle that whoever has enough money to pay must do so.

The main discrepancy lies in the illegally granted loans since they concentrate large sums in a small number of transactions. They are said to come to 600, currently being audited. In addition, the value of Fobaproa's physical assets must be realized; as of now they are in warehouses or, in the case of real estate, in the hands of the debtors.

In order for society to incur the least possible cost, accounts must be scrutinized and different criteria applied according to the original object of the loan. Deputy Santiago Creel Miranda (PAN) suggests that this financial dilemma be divided in two parts: the capitalization program that came out of bank investments and other Fobaproa expenditures, which come to 360 billion pesos, and the purchase of loan portfolio, which comes to approximately 160 billion pesos.

The capitalization program should be carefully investigated because, in addition to inappropriate management, discretionary decisions by authorities to transfer resources to the banks are also questionable.

Figures taken from the October 1998 issue of the magazine *Mundo Ejecutivo* (Executive World) indicate that the interventions in the banks came to 59.472 billion pesos, of which Banco Unión and Banpaís received the largest sums.

Banco Unión received a total of 16.275 billion pesos to bail out 158 loans; Banpaís collected 11.375 billion for 112 loans; Banca Cremi secured 5.6 billion for 33; Banco del Centro needed 5.419 billion pesos for 33 loans; Banco Capital obtained 2.96 billion to save 12 loans; Banco de Oriente employed 2.262 billion pesos for 12 loans; Banco Obrero got 1.9 billion pesos for the 20 most important loans that it bailed out; Banco Interestatal received 338 million pesos for its 5 largest loans; Banco del Sureste was given 62 million for one loan; and Banco Promotor also saved one loan with 66 million pesos it got from Fobaproa.


The financial bailout proposed by the executive polarized the Chamber of Deputies.

The current proposal that any loan over 5 million pesos be excluded from Fobaproa seems the most reasonable because it returns to the banks the responsibility for recovering loans granted without the necessary guarantees, particularly since the majority were given to individuals or companies which were either part of or close to the investment groups those same banks represent. We should mention here that these are well known companies and groups that enjoy financial solidity and extensive investments and therefore are more likely to be able to repay them.

Debtor support programs should be implemented: measures would include a reduction in the total owed, accessible interest rates and mechanisms for refinancing that would allow borrowers to pay according to their incomes. Mortgage holders should be considered the most likely to repay if realistic criteria are applied in terms of the market value of their real estate, since today its market value is approximately half or one-third of their debt.[1]

Mortgage holders, as well as many agricultural, industrial and merchant entrepreneurs deserve the most possible support and are the most objective possibility of making good on the bad loan portfolio.[2] It should be mentioned that this kind of support would not necessarily mean losses for the banks. They would simply be applying lower interest rates and setting up realistic conditions for payment. They would earn less, but they would still make a profit.

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THE FINANCIAL PACKAGE

Different emergency measures have been implemented during the financial crisis, but both the financial sector and the public at large have called for actions that today are the basis for the so-called financial reform:

* Updating legislation to subject white collar criminals to exemplary punishment and to protect savings account holders through strict regulations.[3]

* Liberalizing restrictions on foreign investments aimed at acquiring and controlling the commercial banking system. This would have two purposes: on the one hand, it would professionalize banking and on the other, it would avert a further drop in the banks' value and their having to sell off their stock at a huge discount, like Banco Probursa, which got 20 cents on the peso from Banco Bilbao Vizcaya, or Banco Confía, which only received 5 cents on the peso for its net capital.

* Creating a deposit guarantee fund for up to the equivalent of half a million UDIs, which would be worth 1.1 million of today's pesos.[4] Ninety-eight percent of depositors have accounts totaling under 250,000 pesos.

* Strengthening the autonomy of the central bank, the Banco de México, so it can effectively take complete responsibility for managing the exchange rate and supervising the banking system.

* Canceling the license of the Fobaproa and Fameval Trusts (Fameval is the Stock Market Support Fund). The liabilities they now hold would be handed over to another body which would sell the corresponding goods left as collateral.

The financial reform is only the beginning of the recomposition of the entire economic system. The economy's successful functioning requires a socially responsible banking system that supports production, checks speculation as much as possible and inflicts exemplary punishment on illegal practices. VM

NOTES

[1] For example, 43-year-old José Antonio Castellanos, a prosperous lawyer and university professor, says, "In 1994 I was given a 550,000 peso loan which I was paying off at 7,000 pesos a month, about 20 percent of my income. I used the loan to buy a larger, more comfortable apartment. But after January 1995, it became a nightmare: first the monthly payments grew so much that my entire income combined with my wife's was not enough to pay the bank. When I refinanced in investment units (UDIs), my debt grew so much that now I owe three times what the property is worth, notwithstanding the fact that I paid part of my debt for the last four years and I included the money obtained from the sale of my previous apartment. When the property is auctioned off, I will still be in debt to the bank and I won't get a cent."

[2] On the last day of the regular congressional session, December 15, 1998, a PRI/PAN majority in the Chamber of Deputies approved a bill cancelling the Fobaproa and creating the Institute for the Protection of Bank Savings (IPROAP). This new institution will have the same general function as its predecessor in that it validates the bank bailout, although a significant change is that it will only guarantee deposits of up to 400,000 UDIs (about U.S.$85,000). Also, a debtor-support plan was approved that will allow for cancellation of between 45 percent and 60 percent of what is owed on mortgages and loans to small and medium industries and agricultural producers. [Editor's Note.]

[3] Also on the last day of the 1998 regular session, the Chamber of Deputies amended the penal code to raise sentences for white collar crime, putting financial offenses in the category of "serious crimes," thus making suspects ineligible for bail. [Editor's Note.]