Competition and consolidation in the Mexican banking industry after the 1995 crisis

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1. Introduction

The Mexican banking system has gone through major changes during the last two decades as a result of its nationalisation in 1982, the financial liberalisation and privatisation of the late 1980s and early 1990s, and finally the banking crisis of 1995. The second section of this paper mentions the main factors that originated the fragile situation of the Mexican banking sector when the 1995 crisis erupted, the third points out the principal causes behind the consolidation process, and the fourth describes the main characteristics of the sector's present structure. Finally, competition issues and the policies implemented to bring about a healthy development of the banking industry are also considered.

2. The onset of the crisis

After a long period of growth and relative stability, commercial banks were nationalised by a presidential decree in 1982 in the context of a major macroeconomic crisis. Nationalised banks were subject to strict government controls: deposit and lending rates were regulated and high reserve requirements prevailed. High fiscal deficits and difficulties in accessing foreign financing forced banks to concentrate their business in lending to the public sector. As a result, credit granted to the private sector by commercial banks decreased during most of the 1980s (Graph 1).

In the late 1980s the government embarked on an ambitious financial liberalisation and deregulation process: deposits and lending rates were freed, liquidity requirements of 30% of total liabilities were eliminated, and credit allocation directives were abolished. In the early 1990s new laws on the formation and operation of commercial banks and financial holding companies were introduced and banks were sold to the private sector. Banks' privatisation strategy was governed by two unquestionable principles: transparency and revenue maximisation. However, no foreign capital was allowed at that time.

As part of far-reaching economic reforms, the size of the public sector was substantially reduced through privatisation of many public enterprises. Consequently, public sector borrowing requirements decreased significantly, freeing a large amount of resources for lending to the private sector. Additionally, the foreign liabilities of Mexican banks increased rapidly (Graph 2).

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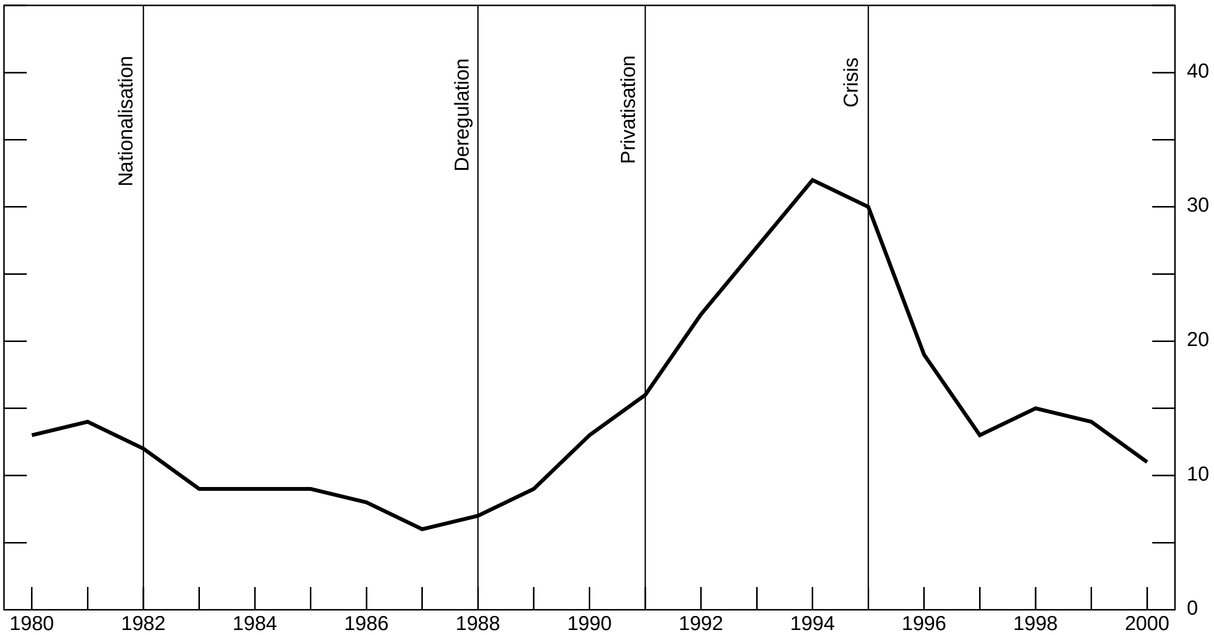
[1] The views expressed in the paper are the author's and do not necessarily represent those of the Central Bank of Mexico.

Graph 1

Bank credit to the private sector

as a percentage of GDP



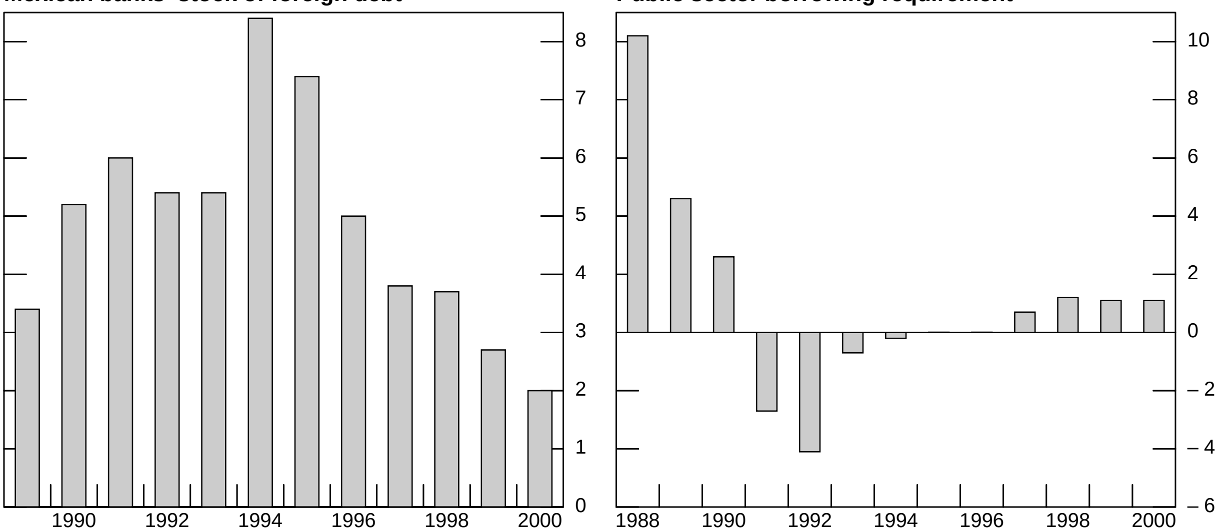
Note: Data for 2000 are end-September.

Graph 2

Mexican banks' stock of foreign debt and public sector borrowing requirement

as a percentage of GDP

Mexican banks' stock of foreign debt[1] **Public sector borrowing requirement**[2]



[1] Data for 2000 are end-September. [2] A positive (negative) value indicates a deficit (surplus).

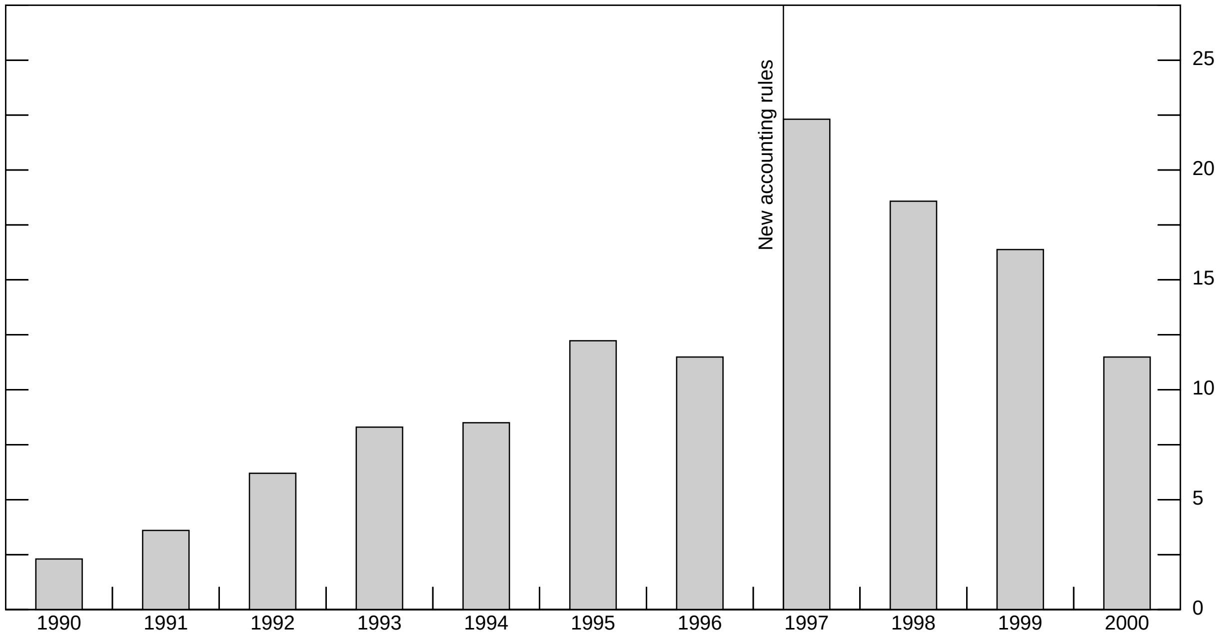
Source: Ministry of Finance.

The combination of financial deregulation and years of government-run banks, which left the sector without experienced bank managers and supervisors, but with an unprecedented availability of resources for lending to the private sector, proved to be a dangerous mixture that resulted in mounting problems in the banking system. Between 1989 and 1994, the total loan portfolio grew at an average annual rate in excess of 30% in real terms. Furthermore, private sector loans increased from 10% of GDP to slightly less than 40% during the period (Graph 1). At the same time, the ratio of past due loans to total loans jumped from 2% to 8% (Graph 3).

Graph 3

Mexican banks' past due loans

as a percentage of total loans



Note: Data for 2000 are end-September.

The devaluation of the peso in December 1994, the high interest rates that prevailed during the first months of 1995 and the fall of real disposable income sharply reduced borrowers' capacity to service their debts and thus the banks' balance sheets. To contain the crisis and prevent a systemic run on the banks, the authorities implemented several measures and programmes to support debtors and strengthen banks' balances. Among the measures taken were liquidity support in foreign currency, temporary capitalisation programmes, loan repurchases and debtor relief programmes.[2]

3. The aftermath of the crisis

As a result of the 1995 crisis, the authorities took over 15 banks. Of those 15 banks, four have already been sold back to the private sector, five have been dismembered and their branches and part of their liabilities sold to different entities, one will be sold at the beginning of next year and the rest will be liquidated. Another three banks[3] were not formally taken over but were offered under administration to potential purchasers, which acquired the institutions after bilateral negotiations with the authorities. Of

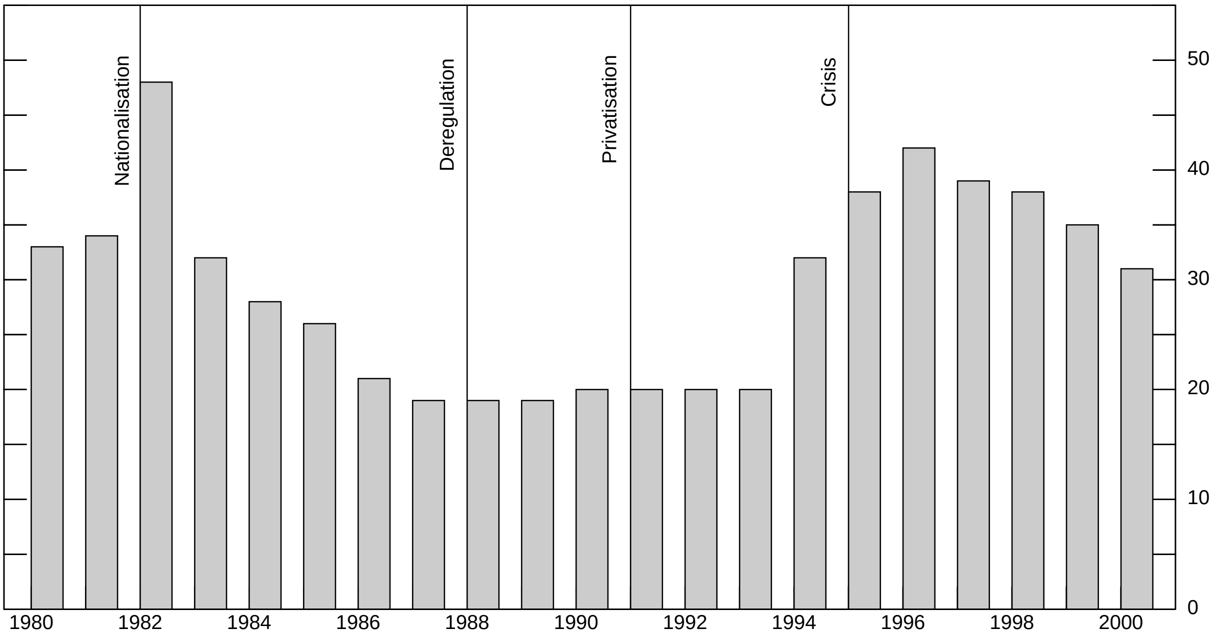
[2] See Graf (1999) for an extensive discussion of these programmes.

[3] In total four banks were handed to other private banks which had the ultimate objective of acquiring them, but only one had previously been taken by the authorities.

the 32 banks existing before the onset of the crisis, only 22 survived. However, after 1995 many banks were merged or acquired by other financial groups and new institutions entered the market. Today the banking system comprises 31 institutions.[4]

Graph 4

Number of commercial banks



Despite the measures taken, the crisis left the banking system undercapitalised and oversized. The consolidation process that has followed is the result of banks' efforts to remain competitive and financial authorities' measures to both strengthen the capital base of the banks and provide the right incentives to shareholders to aim for more prudent management of their institutions.

In this respect, the implicit full coverage of deposits by the deposit insurance agency is being substituted by a more limited scheme and new and more stringent capitalisation rules have been adopted. To facilitate the recapitalisation of banks, legislation was amended to eliminate any restriction on foreign investors' participation in the banking industry. Mexican banks had been protected from foreign competition for a long time. With the signing of the North American Free Trade Agreement with the United States and Canada, some restrictions were relaxed and a timetable was set to gradually open up the banking industry. However, the government accelerated the easing of restrictions and removed them completely at the end of 1998. At present, Mexican law authorises foreign banks to operate within the domestic market as either domestic banks, affiliates of foreign financial institutions or offshore branches. They can also open representative offices (Appendix 1).

The immediate and beneficial effect of the entry of foreign banks has been their contribution to the recapitalisation of the Mexican banking industry. In addition, a recent study has shown that the growth of credit granted by foreign banks in Mexico between 1995 and 1998 appears to have been more stable, or less sensitive to macroeconomic shocks, than that of domestic banks. The same study found, however, that the behaviour of credit was determined more by the extent of non-performing loans in banks' portfolios than by the nationality of their owners.[5]

4 Banks owned by the same financial holding company but operating under different franchises are considered as a single entity.

5 Goldberg et al (2000).

4. The current structure of the banking industry

The crisis, restructuring of distressed banks and incentives created by the new regulatory scaffolding have led to a radical transformation of the Mexican banking industry in just a few years. Table 1 shows the number of Mexican banks according to their ownership, amount of capital and their share of total assets.

Table 1

Structure of the Mexican banking system (September 2000)

	Number of institutions[1]	Capital (US$ bn)	% of assets
Mexican-controlled banks[2]	14	6.9	51.6
Large foreign affiliates and foreign-controlled large banks[3]	4	5.6	46.7
Small foreign affiliates[4]	13	0.7	1.7

[1] Banks owned by the same financial holding company but operating under different franchises are considered as one entity. If they were considered as different entities, there would be 35 banks. [2] Banks controlled by Mexican residents. [3] Foreign majority-owned banks and Mexican majority-owned banks in which foreigners have control of the management. [4] Foreign majority-owned banks without significant presence in the retail market.

Foreign banks have acquired a significant share of the Mexican market in the last few years. Nowadays, besides controlling the largest and third largest financial groups, they manage 48% of the assets of the banking system, 46% of outstanding loans, and hold 48% of the banking system capital. However, the role and participation of foreign banks in different markets differ according to their size. Small affiliates entered Mexico just before the onset of the crisis and play a major role in lending to the corporate sector, and in the derivatives, government securities and money markets. Not being engaged in retail banking, most of these affiliates operate from a single office located in Mexico City.

On the other hand, some foreign bank affiliates have significantly increased their participation in the retail market. Citibank, Canada's Bank of Nova Scotia and Spain's BBVA and BSCH, after having operated in the country with a relatively small presence, recently acquired control of Mexican banks with sizeable participation in retail banking. Spanish banks now have a majority ownership in Mexico's third largest financial group (Santander) and control the largest one (BBVA-Bancomer). Bank of Nova Scotia owns the seventh and Citibank the eighth largest.

Table 2

Participation in the Mexican banking system (September 2000,in percentages)

	Loans	Retail deposits	Derivatives
Mexican-controlled banks[1]	53.8	45.0	13.1
Large foreign affiliates and foreign-controlled large banks[2]	44.4	54.9	36.2
Small foreign affiliates[3]	1.8	0.1	50.7

[1] Banks controlled by Mexican residents. [2] Foreign majority-owned banks and Mexican majority-owned banks in which foreigners have control of the management. [3] Foreign majority-owned banks without significant presence in the retail market.

Some studies suggest that the strategy followed by these four foreign banks does not seem to be particular to the Mexican case. According to IMF (2000), the same behaviour has also been observed in other emerging market countries. Before deciding to get involved in the business of retail banking, foreign banks prefer to establish small subsidiaries to participate in the local money and capital markets. Some of them go further and take minority participation in domestic retail banks. The last step is to establish fully owned subsidiaries to enter retail banking markets. In the case of Mexico, they did so by buying established banks affected by the crisis and recapitalised by the government.

Table 3

Mexico's largest banks: total assets (September 2000)

	US$ billion	% share of market
BBVA-Bancomer	40	24
Banamex	34	21
Santander-Serfin	23	14
BITAL	19	11
Bancrecer	12	7
Banorte	11	7
Inverlat	6	4
Citibank	6	4

5. Preserving competition and efficiency

In the last few years many Mexican banks have merged or been acquired by stronger banks and financial groups. This consolidation process was driven initially by the authorities' efforts to remedy the financial situation of some banks either by facilitating their absorption by solvent banks or by liquidating them. The former strategy was followed when it was considered less costly for the government than liquidation.

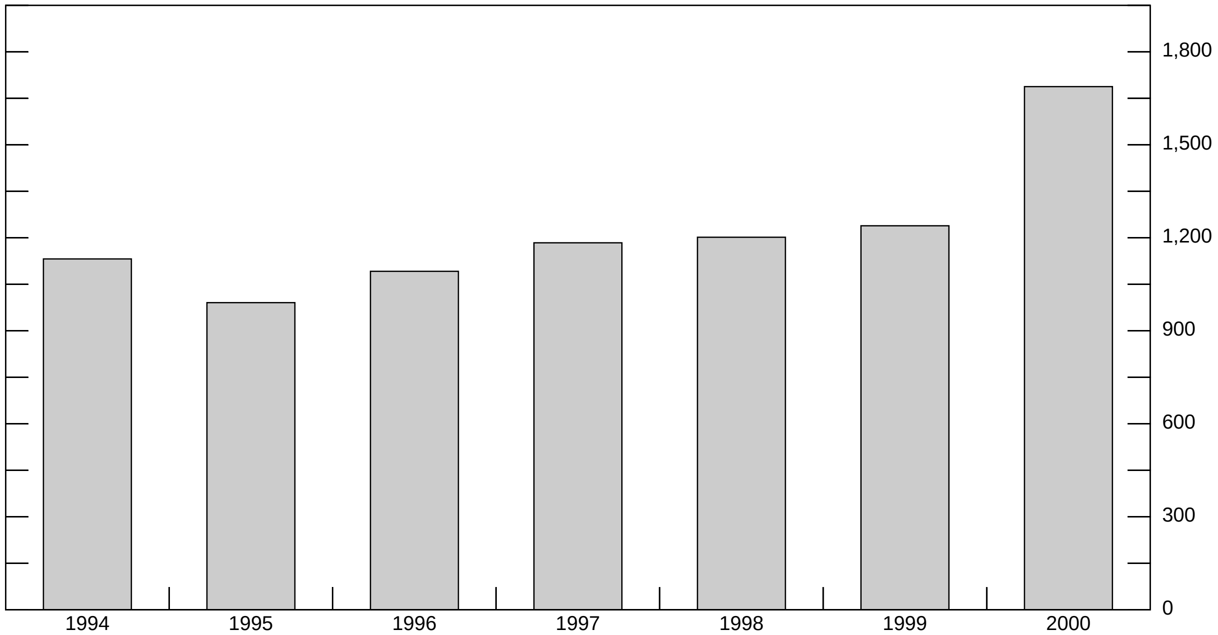
However, in a second phase, the consolidation of the system has been accelerated by the ongoing reduction of deposit insurance coverage and the publication of new and more stringent capitalisation rules, raising concerns about competition and efficiency in the Mexican banking system. These competitive issues emerged recently during the attempted merger of Mexico's two largest financial groups. The unsolicited attempt by Grupo Financiero Banamex-Accival to acquire control of Grupo Financiero Bancomer was closely analysed by financial authorities. In the end, the targeted group preferred to merge with Spanish BBVA, which had a relatively small presence in Mexico before the merger.

Mergers and acquisitions in Mexico have to be authorised by the Ministry of Finance after considering the opinions of the central bank and the Banking Commission. The Federal Competition Bureau (CFC) can object to any merger if it judges that it could prevent fair competition. According to antitrust laws, "monopolies" are forbidden,[6] as well as practices that diminish or impede competition and free concurrence in the production, distribution and commercialisation of goods and services.

[6] The only monopolies permitted are those indicated in the federal constitution that are operated by the federal government.

Graph 5

Concentration in the Mexican banking industry[1]



[1] As measured by the Herfindahl-Hirschman index.

The CFC can object to or impose restrictions such as divestitures on any merger if it considers that the level of concentration is harmful. In order to evaluate a merger or acquisition, the CFC applies, among other criteria, some quantitative measures. Thus, it could be considered that a merger will not alter the competition structure of a market when at least one of the following results is observed: the Herfindahl-Hirschman index (HHI) is less than 2,000 points; the increase in the HHI is less than 75 points; the Dominance index[7] decreases or its value is less than 2,500 points.

In assessing a merger, financial authorities focus on its potential impact on three broad areas: soundness of the institutions, structure of the industry, and authorities' ability to effectively perform their functions.

To evaluate the potential impact of a merger on the soundness of the institutions involved, the authorities should consider all factors that have any effect on the solvency of the resulting entity and its economic viability such as business strategies, capacity to generate adequate returns and its capital adequacy.

To assess the effects on the structure of the industry, it is essential to identify the relevant markets that could be impaired by the merger in question. A relevant market is defined as a geographic area where a specific product is commercialised and where certain entry barriers exist. Authorities should evaluate the potential impact of a merger on the competitiveness of each relevant market.

Finally, financial authorities should carefully consider how a merger could hinder their ability to conduct monetary policy, guarantee the integrity of payment systems and regulate and supervise the financial system. In relation to the latter, an issue that should draw particular attention is the potential of

7 The Dominance index is calculated as $DI = \sum_{i=1}^{n} \frac{\alpha_i^4}{(\mathrm{HHI})^2}$ where α_i is the market share of the i[th] bank in the industry and HHI is the Herfindahl-Hirschman index calculated as $\mathrm{HHI} = \sum_{i=1}^{n} \alpha_i^2$.

mergers to generate moral hazard behaviour on the part of institutions becoming "too big to fail or be unwound" or "too big to discipline adequately".[8]

6. Maintaining systemic stability

The crisis of 1995 reminded us of the importance of preserving financial stability to achieve and maintain healthy rates of economic growth. To uphold the safety and soundness of financial systems, it is essential to have in place a regulatory framework which provides adequate incentives for shareholders to exercise prudence in the management of their institutions and enough capital and reserves to absorb the losses of today's global and volatile financial markets.

It is also crucial to have an environment where banking can be a good and efficient business. For this purpose it is essential to have a legal system that protects and enforces not only the rights of those who hold claims against banks but also those of creditors. The legal system should provide the means for creditors to expeditiously collect their loans or speedily dispose of their collateral. The bankruptcy and foreclosure laws recently approved by the Mexican Congress work in that direction by setting specific time limits for resolution of disputes and by limiting judicial discretion in the resolution of insolvent firms.

Having sound and well managed individual institutions is only the first task for maintaining systemic stability. The other pillar of stability is the capacity of institutions to withstand common disturbances. In emerging market economies one source of such disturbances is the risk of contagion from crises occurring anywhere in the world. This is more likely nowadays since capital markets are globally integrated. The most recent crises in Asia, Russia and Brazil demonstrated that investors show certain herd behaviour, particularly when they face distress situations. Emerging market economies are particularly vulnerable to this type of collective response on the part of investors given the relatively small size of their capital markets and the sharp decrease in liquidity that takes place during financial crises.

Banks located in emerging economies are especially exposed because they usually have a significant part of their balance sheet denominated in foreign currency. The maturity mismatches and fractional reserve that characterise the business of banking make banks vulnerable to distress situations that lead foreign creditors to stop rolling over their loans. Under these circumstances, central banks may be forced to step in as lenders of last resort in foreign currency to prevent systemic runs in the banking system as happened in Mexico during the 1995 crisis.

To force banks to internalise the risk faced by the central bank of having to step in as lender of last resort in foreign currency, the Bank of Mexico implemented compulsory liquidity coefficients in foreign currency according to each bank's foreign currency liabilities and their remaining maturity. Mexican banks nowadays hold more than $10 billion of foreign currency denominated liquid assets. Additionally, Mexico's central bank established ceilings on banks' foreign currency liabilities and holdings of foreign currency denominated securities according to their capital.

7. Challenges ahead

Increasing competition and the development of new technologies are forcing banks to look for innovative ways to maintain their margins and profitability. Banks can obtain large economies of scope by cross-selling products, diversifying their income sources and taking advantage of economies of scale in processing customers' information. As a result, banks and financial holding companies are merging among themselves and expanding their business to include insurance, securities and even telecommunication products and services. These developments are exposing banks and financial

[8] Kane (2000).

holding companies to new and more complex risks as the borders between financial, commercial and technological firms become increasingly blurred.

Mexico's banking system comprises 31 banks, 17 of which belong to financial holding companies.[9] Thirteen of these financial holdings own brokerage houses, nine own insurance companies, nine participate in pension funds, and two in telephone companies. The increasing involvement of banks and financial holding companies in financial and non-financial businesses is forcing policymakers to evaluate how to update regulatory frameworks to enable their banks to compete in this new global reality.

The speed of technological and financial innovation is challenging traditional arguments in favour of the separation of banking and commerce. However, conventional limits to the transfer of risks from financial holding affiliates to banks will remain a crucial part of any regulatory framework as long as banks are considered special and thus deserving of the protection of safety nets.

There is almost common agreement that regulation should and will move towards greater reliance on corporate governance, internal risk models and market discipline. However, for these to work properly, safety nets have to be substantially reduced and transparency and disclosure procedures enhanced. In this respect, banks will become less special and hence less deserving of special protection, as depositors and investors gain access to more information about the soundness of financial institutions and banks' competitors in the credit business have access to more data on borrowers' expected behaviour. New technologies will contribute in this process by helping to collect, analyse and disseminate enormous amounts of data, reducing some of the information asymmetries that characterise the business of banking.

8. Final remarks

The crisis of 1995 was lengthy, costly and involved the restructuring of the Mexican banking industry. Even today, almost six years after the onset of the crisis, bank credit has not recovered. The current ratio of banks' assets to GDP is less than 40% in Mexico, compared to 50%, 60% and 70% for Argentina, Brazil and Chile, respectively. The ratio of banks' equity to GDP is also lower in Mexico. We believe that macroeconomic stability and the policies implemented to strengthen the banking system will make possible a considerable deepening of intermediation in the years ahead.

However, as the opportunities for banking business expand, additional capital will be needed. If profitability is to be the main source of capital, Mexican banks will face considerable challenges. Reductions of interest margins and increased competition will force banks to reduce further their operational costs, increase non-interest income and expand their income base. One way of achieving this is through further consolidation of the system and more capital injections from abroad.

9 Banks owned by the same financial holding company but operating under different franchises are considered as one entity. This figure does not include banks under government intervention, which no longer operate with the public and which will be closed.

Appendix 1

Mexican law contemplates four different forms of foreign investment in the banking industry:

Domestic banks: Mexican law establishes limits to individual participation in the capital of domestic banks. Individual shareholders can control up to 5% of the representative shares of the capital of domestic banks. However, exemptions from this rule can be authorised by the Ministry of Finance. In this sense, foreigners or foreign banks can own a participation of 5% or more (with prior authorisation).

Affiliates of foreign financial institutions: When foreign ownership of a domestic bank is higher than 51% of the capital, the bank is considered an affiliate of a foreign financial institution. However, to hold more than 51% of a domestic bank, the shareholder has to belong to a country that has a free trade agreement with Mexico that permits the establishment of affiliates from that country.

Offshore branches of foreign financial institutions: Mexican law permits the establishment of offshore branches of foreign financial institutions on Mexican territory only for the purpose of providing financial services to non-residents. Nevertheless, not a single authorisation has been granted for the establishment of a branch of a foreign financial institution on Mexican territory.

Representative offices: Foreign financial institutions can open representative offices on Mexican territory, with the sole purpose of representing their head office. In this respect, these offices are not legally permitted to take deposits, give credits or perform any type of financial operation within Mexico's borders other than receiving and providing information and negotiating the terms of the contracts between residents and the head office.

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