

## **The Political Economy of Bank Restructuring in Mexico \***

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### **Introduction**

Banks play a crucial role in the allocation of capital resources. Banks, among other financial institutions, facilitate the intermediation of capital flows by collecting funds from surplus agents and deciding among which targets to finance. During the time of economic crisis, however, severe distortion may arise in the functioning of the financial system. Financial crises lead to diminished levels of financial intermediation and hence to low economic growth.

When countries face economic crisis and pursue economic reform, restructuring the fragile banking system is chosen as the number one priority among many reform agendas. The stability of the financial system is considered as one of the most crucial institutional conditions for the smooth operation of the market economy and for economic recovery. Yet bank restructuring is a daunting task to accomplish. The resolution of

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a systemic banking crisis is not an event, but a long and complex process. The resolution of a banking crisis requires major changes in the financial as well as business practices of a country. Yet strong economic and political interests may impede required reforms. The weak institutional capacity of the government may be a hindrance to choosing the proper policies to resolve a crisis. In addition, government intervention into the banking sector may cause a moral hazard so that taxpayer's money could be wasted without resulting in a solvent and efficient banking system.

The main aim of this paper is to examine the process of bank restructuring in Mexico. The Mexican banking sector faced a serious insolvency crisis as the sudden devaluation of the peso triggered capital outflows, a high interest rate, an economic downturn, and an increasing ratio of non-performing loans (NPLs). The Mexican government implemented various measures to resolve the banking crisis. The Bank Savings Protection Fund, known by FOBAPROA (Fondo Bancario de Proteccion al Ahorro) was the main agency of the Mexican bank restructuring. Yet FOBAPROA pursued the bailout program without a transparent framework that had explicit criteria and procedures for decision making. In addition, there were pervasive mismanagement and favoritism in the operation of FOBAPROA. As a consequence, the liabilities of FOBAPROA rapidly increased and reached 67 billion US \$ by the end of 1998, and it became clear that FOBAPROA could not pay back these liabilities with its own resources. In April 1998, the Zedillo government sent Congress a package of banking reforms. The major component of the reform package was to convert all the FOBAPROA liabilities into public debts. Yet opposition parties and public criticized the Zedillo government for trying to rescue bank's shareholders at the expense of taxpayers.

Therefore, the bank bailout program became a hot political issue.

There have been two contrasting views regarding the bank bailout. One view, suggested by the Zedillo government and the PRI, argues that the bank bailout is a necessary and inevitable policy response to prevent the meltdown of the financial system. This view recognizes that there have been a lack of transparency and mismanagement in the operation of FOBAPROA. Yet this perspective also insists that proper institutional mechanisms for bank reform were provided by 1998 bank reform bills, and since then the Mexican banking system has been substantially improved.<sup>1</sup>

The other view, which has been supported by opposition parties and critical intellectuals, provides a contrasting account on the bank bailout program pursued by the Zedillo government. This perspective argues that the bank bailout program has been pursued without a clear vision and transparency, and there have been pervasive mismanagement and favoritism in the operation of FOBAPROA. As a consequence, after injecting huge public money into the banking sector, the resolution of the crisis was not complete and Mexican taxpayers should bear the burden of huge fiscal costs incurred from the bank rescue program for a long period of time.<sup>2</sup>

In this paper, I will address the following four issues. First, I will discuss the causes of the banking crisis in Mexico. A lending boom, lack of a legal framework and prudent regulation, and the peso crisis will be suggested as major causes of the Mexican banking crisis. Secondly, I will examine the various measures for bank restructuring implemented by the

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<sup>1</sup> The most important study reflecting this perspective is a book published by the Mexican Ministry of Finance in 1998. Secretaría de Hacienda y Crédito Público (1998), *FOBAPROA: La Verdadera Historia*. Mexico: SHCP.

<sup>2</sup> Major studies reflecting this perspective are as follows: Fárber(1998), Lopez(1999), and Huerta(1998).

Mexican government. In particular, I will discuss in detail the problem of the operation of FOBAPROA. Thirdly, I will explain why and how the bank bailout became a crucial political agenda in 1998 and discuss the differing positions of the political parties concerning the bank rescue. Fourthly, the economic as well as political impact of bank bailout policy will be discussed. I will analyze the fiscal costs of bank restructuring and the distribution of the fiscal costs. Finally, I will briefly compare the bank restructuring in Mexico and Korea, and discuss the lessons which can be drawn from the Mexican experiences.

## The Causes of the Banking Crisis in Mexico

### *Lending Boom and Lack of Risk Management*

After a decade of government ownership since the nationalization of banks in 1982, the Mexican banking system was privatized in 1992 by the Salinas administration to strengthen the banking sector. It was expected that the privatization of banks would give banks autonomy of management, that it would create an increase of savings and that banks would lead the drive toward better productivity and competitiveness of Mexican companies. However, the privatization was performed carelessly and without preparation. During the privatization process, financial authorities sold banks to the highest bidders, often without paying attention to closely held ownership, or banking expertise in choosing owners (Gruben, 1997). The new owners who paid high prices, in order to recoup their large investments, expanded lending with unprecedented high loan rates. With the optimism surrounding the economic reforms of the early Salinas administration, the bankers were eager lenders. Banks competitively rushed to give loans to the private sector only to increase their size of

business without consideration of risk and without the ability to measure it.

The lending boom of this period was made possible by abundant international capital flows to Mexico, resulting from capital liberalization carried out in the years before the crisis. In addition, the dynamic investment process of firms and growing consumption levels of households, coupled with high real lending rates, fueled the expansion of the banking loan portfolio between 1988 and 1994. Bank lending rose from 16.9 percent in 1988 to 43.3 percent of GDP in 1994 as shown in Table 1.

**Table 1: Bank Lending as a Percentage of GDP, by Sector, 1988-1997**

Year	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
	16.9	20.0	22.1	24.7	30.7	34.7	43.3	43.2	35.4	28.8

Source: Mohar (1998)

### *Lack of Adequate Legal Framework and Prudential Regulations*

Before financial liberalization, and even in the early 1990s, adequate risk management and a credit-rating system were notoriously absent from Mexico. Bank managers lacked the experience to operate in a deregulated environment. Banks did not adequately assess borrowers' payment capacity. In addition, financial information disclosed by banks was not prepared in accordance with international accounting standards, and it was difficult to assess the soundness of banks.

In addition, antiquated bankruptcy laws and an inefficient judicial system made it virtually impossible to collect collateral from nonpaying

debtors. In Mexico, for example, the recovery of a loan through the legal process could take between three and seven years. Finally, supervision and prudent regulation did not develop at the pace required in a liberalized financial market.

As a consequence of the lending boom and lack of risk management capacity of the banks, increased non-performing loans became one of the main problems of the banking system. By the end of 1994 and prior to the peso crisis, the Mexican banks reported 9.0 % of NPL among total loan portfolio. During the same period, the Mexican banks showed a decreasing level in the capitalization. The average BIS capital ratio of Mexican commercial banks decreased from 9.03% in 1992 to 8.0% at the end of 1994 (De Luna-Martinez, 2000).

### *The Peso Crisis in 1994*

The peso crisis which occurred in December 1994, hit the fragile Mexican banking sector hard. In spite of the euphoria and optimistic mood of the final year of the Salinas administration, the Mexican economy and political system began to show its structural limitations from the beginning of 1994. Rising current account deficits and an overvalued peso, along with political instability and social cleavage as manifested in the Chiapas peasant uprising, the assassination of the PRI presidential candidate Luis Colosio and the ensuing killing of the PRI managing director, Francisco Ruiz Massiu, caused the outflow of the foreign capital throughout 1994. Foreign reserves fell sharply from 29 billion US dollars in February to \$6 billion US dollars in December (Blaine, 1998, Lee, 1998).

In spite of the bad signs of the economy, the Salinas government delayed the devaluation of the peso, being worried about the negative

repercussions on the presidential election in September and his candidacy for WTO director general. Because of the massive exodus of foreign capital out of Mexico, the new Zedillo government finally gave up defending the peso on December 22, 1994 and let the peso float. As a consequence, the value of the peso plummeted and foreign reserves fell from \$6 billion by the end of December to \$4 billion by the end of January 1995. The devaluation triggered capital outflows, high inflation, and an economic downturn. The GDP growth fell from 4.4% in 1994 to -6.2% in 1995, which resulted in the bankruptcy of many corporate as well as individual borrowers (Casteñeda, 1995).

The crisis was harsh on individuals, and firms, and banks. The devaluation followed by a sudden interest hike and an economic downturn aggravated loan payments. Banks raised interest rates from about 18 percent to as much as 120 percent, they made loan repayments impossible for most borrowers. Banks stopped lending in the wake of the crisis.

Because of imprudent lending practices, the proportion of non-performing loans (NPLs) was high even before the peso crisis. It was aggravated by the peso crisis. In 1993, NPLs accounted for 7.3 percent of total loans, and rose to 9 percent by the end of 1994. Over one third of all Mexican loans were non-performing by the beginning of 1996.

### The Bank Rescue Program

When the financial system was on the verge of collapse, the Mexican government began to implement a series of recapitalization and debtor rescue programs to shore up the fragile banking sector. The Mexican government had to act promptly to provide liquidity and maintain the integrity of the banking system. Otherwise the banking crisis could have

spread quickly to the business sector. The Mexican government implemented various measures to curtail the transmission of the banking crisis to the business sector, to restore depositors' confidence, and to foster the restructuring and capitalization of troubled banks.

Various measures were implemented to relieve pressures on debtors' capacity to pay due to the drastic contraction of debtors' disposal income. The first agreement for immediate support of bank debtors (Agreement of Immediate Support to Bank Debtors, or ADE) was implemented in September 1995. The reduction of interest rates and a package of benefits for small and medium-size borrowers were the two main components of ADE. In addition, the government offered hundreds of thousands of debtors relief by converting their debts into a new, inflation-indexed financial instrument called the Unidad de Inversion (Investment Unit or UDI). Results from loan restructuring within UDI and ADE programs showed a substantial improvement in asset quality. The amount of restructured loans totaled 274 billion pesos in October 1997 (Adams, 1997).

A second round of support measures for debtors were implemented in 1996. In September 1996, FINAPE (the Financial Support Program for the Agricultural Sector) was put into effect to assist debtors in the agriculture and fishing sectors. This program reduced up to 40 percent of debtors' total payments or monthly installments and makes available up to twelve billion pesos for financing profitable projects. In October 1996, FOPYME (Support Program for Small and Medium Enterprises) was implemented. This program benefited 98 percent of the small and medium-size firms with outstanding bank loans under six million pesos. Under this program, partial prepayments allowed reduction of the principal, as well as of interest for a specified time, and banks were committed to providing up to thirteen billion pesos in new financing



(Mohar, 1998).

In addition, some measures were implemented to rescue troubled bank by strengthening the solvency and liquidity of those banks. One of the two main bailout programs was PROCAPTE, the temporary capitalization program, which was carried out to help banks increase the asset side of the balance sheet in the face of rising NPLs. The goal of PROCAPTE was to assist banks to increase their capital-to-asset ratio above 8 percent. PROCAPTE allowed banks needing additional capital to issue five-year convertible bonds, which were purchased by FOBAPROA.

The second and most important bailout program mainly relied on emergency aid from the Mexican equivalent of the Federal Depository Insurance Fund (FDIC) of the United States. FOBAPROA was initially set up during the Salinas Administration. FOBAPROA discretely began to absorb private bank debt in 1995. FOBAPROA was designed to clean up bank balance sheets and improve asset quality at no immediate costs to the government. FOBAPROA bought non-performing loans from the banks at a discount. For FOBAPROA to take a non-performing loan off the books, a bank had to agree to write off 25 percent of its value. In exchange, it received ten-year promissory bonds, backed by the government for 75 percent of the asset's value.<sup>3</sup> Not surprisingly, virtually every bank participated in the FOBAPROA program. Although the FOBAPROA loan purchase program gave the banks some breathing space, their regulatory capital requirements were hiked to 8 percent of assets, from 6 percent, to make Mexico compliant with international capital standard.

Though the banks could write off their bad loans, they could not forget

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<sup>3</sup> These promissory bonds cannot be bought or sold on any market, and cannot be used as collateral in financial transactions. Interest was payable but accrued over the term and was payable only at maturity.

them. If FOBAPROA sells a loan, as it was planned to do, the bank had to record the sale, and take 25 percent of the loss. Inevitably it meant that banks would have to take a substantial hit, because these loans could be sold only at steep discounts.

Concomitant to the support measures, the government initiated a profound regulatory reform to enhance the transparency and efficiency of the financial system. The government tried to improve supervisory practice, and enhance risk management. The government required that financial institutions value their securities portfolio at market price. In addition, the government tried to establish accounting criteria consistent with international standard.

The various emergency measures implemented by the government prevented the collapse of the banking system, and helped to strengthen the solvency and liquidity of the banks. The private sector injected new capital into the banks. The ratio of reserves to non-performing loans for the banking system increased substantially, and the banking system's capitalization index climbed from 8 percent to 16.3 percent between February 1995 and November 1997. The ratio of non-performing loans decreased in 1997. This trend enabled banks to resume granting new loans and reduced the potential fiscal cost of the programs.

In spite of the positive contribution of bank rescue measures, many criticisms and suspicions have been raised about the operation of FOBAPROA. There is much evidence about mismanagement and favoritism in the operation of FOBAPROA. Thus, FOBAPROA has become a major political scandal since 1998.

### *Mismanagement of FOBAPROA*

One of the reasons why the bank bailout became a political scandal was

that FOBAPROA lacked a transparent framework with explicit criteria and procedures for decision making. Important decisions such as the viability of banks, the recapitalization of weak banks with government resources, or the amount of NPLs purchased from troubled banks were made on a case by case.

In addition, FOBAPROA was very generous to banks in the recapitalization and loan purchasing program. Practically all non-intervened banks were allowed to sell a part of their NPLs to the FOBAPROA. In South Korea, by contrast, only banks that absorbed weak banks and merged with other bank were eligible to sell their NPLs to the government. Moreover, FOBAPROA purchased NPLs from the banks at a relatively high price. The purchase price of NPLs by FOBAPROA was 75% of the face value. In Korea, the Korea Asset Management Corporation (KAMCO) purchased NPLs from the bank at only 45% of their face value for secured loans and only 3% for insecured loans (De Luna-Martinez, 2000). Another serious shortcoming of the FOBAPROA operation was limited information. The agency lacked essential data about the loans for which it had willingly taken responsibility.

A serious result of mismanagement and favoritism in the operation of FOBAPROA was that a substantial portion of the NPLs that FOBAPROA purchased from the banks were irregular or illegal loans. Table 2 shows the types and amounts of irregular loans in FOBAPROA portfolio, which was published in Mackey report.<sup>4</sup>

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<sup>4</sup> On July 19, 1999, Canadian auditor Michael Mackey delivered a 300-page report which was the outcome of six months of work requested by Mexican Congress. This report revealed that FOBAPROA's purchase of NPLs from the banks frequently violated the original criteria of the loan purchase program and even Bank Laws and Regulations. The Mackey report also shows that a few wealthy businessmen whose NPLs formed the bulk of the debt absorbed by FOBAPROA, were the chief beneficiaries of the bailout program.

**Table 2: Irregular Loans of FOBAPROA Portfolio***(Billion Peso)*

	a) Loans violating the original criteria of Capitali-zation and Loans Purchase Program	b) Self-Loan and Cross-Loan among Banks or Loans to related or affiliated firms	c) Loans judged Illegal and/or in Violation of Bank Laws and Regulations	Total (a+b+c)
<b>TOTAL</b>	<b>24.7</b>	<b>42.0</b>	<b>6.0</b>	<b>72.7</b>

Source: Mackey (1999).

The total amount of irregular loans is 72.7 billion pesos, which is about 14 percent of the total loan portfolio. There are three types of irregular loans. The first type of irregular loan violated the original criteria of Capitalization and the Loan Purchase Program of FOBAPROA. The second type of irregular loan is a self-loan and cross-loan among banks or a loan to related or affiliated groups. The final type of irregular loan is an illegal loan because it violated bank laws.

The major result of insufficient information on borrowers and the purchase of irregular loans from the banks was the inability to sell off acquired assets. FOBAPROA had the task to orderly dispose of the assets acquired from the capitalization and loan purchase program, as well as those of intervened banks. Yet FOBAPROA could only sell a tiny portion of the assets obtained from the banks. It was known that assets sold as of June, 1999 represented only 4.6% of the total acquired assets. In the Korean case, by contrast, the Korean Asset Management Corporation (KAMCO) could sell about 36 percent of total acquired assets. In addition, only 20% of the face value of the FOBAPROA's assets are

expected to be recovered in Mexico. In Korea, KAMCO has recovered on average 53% of the face value of the loans it acquired through these sales and dispositions (De Luna-Martinez, 2000).

Due to inexperience and lack of documents about the borrowers, the first auction of FOBAPROA loans was not held until 1996. When it was sold, usually the steep discounts (30 percents on the dollars) were given to purchasers, and the discount rate tended to rise as the recoverability of loans was low. Often files contained little or no financial data about the borrower. Unable to obtain proper credit histories of the debtors, potential purchasers wanted to pay only a small fraction of the face value of the assets.

Moreover, the bailout mechanism had a deep and fundamental flaw. The banks really did not want those loans sold. They had no incentive to move quickly to gather the necessary paperwork and data that would enable FOBAPROA to find buyers. As mentioned before, the FOBAPROA bought the assets at a high price and assumed the large part of the losses derived from the recovery of loans. In addition, as recovery of loans could take many years under the weak bankruptcy law, there was no incentive for banks to recover defaulted loans.

### *Favoritism and Cronyism*

Even more serious and politically explosive than the poor management of FOBAPROA were accusations and evidence of favoritism and cronyism. Critics charged that the agency had assimilated debts of solvent borrowers to reward wealthy allies of the government. Congress gathered documentation indicating rich and well-connected businessmen had huge financial obligations erased by the loan purchasing program of

**FOBAPROA.**

The recapitalization program of 1995-1996 also came under suspicion. FOBAPROA tried to strengthen banks with insufficient capital reserves, by contributing two pesos for every one peso that shareholders added. In reality, the ratio of bank assistance depended on the judgement of the Finance Ministry. The ratio went from three to one, to five to one. In this way, some banks benefited a lot.

The PAN and the PRD legislators joined forces to demand the names of the borrowers whose debts appeared in FOBAPROA's portfolio. Preliminary documents obtained by the opposition parties in late July from FOBAPROA suggested that just 604 loans made to some of Mexico's wealthiest entrepreneurs represented almost half of the agency's total liabilities (Kessler, 1999).

In particular, there has been an allegation that wealthy businessmen and bankers who donated huge political money to the ruling party and Zedillo campaign in the 1994 presidential election benefited from the loan purchase program of FOBAPROA. The most publicized example was the Carlos Cabal case. Carlos Cabal, the former owner of Banco Union and Banca Cremi, has been accused of illegally lending \$700 million pesos to himself. Cabal was a friend of Carlos Salinas and was known to have donated millions to the presidential campaign of Ernest Zedillo. He fled Mexico and hide in foreign countries. On November 11, 1998, he was arrested in Australia and indicted by the Mexican government (Kessler, 1999).

**Table 3:** Liabilities of FOBAPROA*(Million Peso)*

	28-Feb-98	% of GDP 98	20-June-99	% of GDP 99
Direct liabilities	447,500.0	11.57	616,800.0	13.27
Indirect liabilities	104,800.0	2.71	143,300.0	3.08
Total Liabilities	552,300.0	14.27	760,100.0	16.35
Realized payment in present value	83,266.3	2.15	168,758.3	3.63
<b>Total</b>	<b>635,566.3</b>	<b>16.43</b>	<b>928,858.3</b>	<b>19.98</b>

Source: Rosales(2000)

As a consequence of mismanagement and favoritism, along with a poor record of disposition and sales of acquired assets, FOBAPROA's liabilities increased rapidly by 1998. Table 3 shows the liabilities of FOBAPROA. In Feb. 1998, total liabilities of FOBAPROA were 635 billion pesos which was 16.4% of GDP of that year. In June 1999, FOBAPROA liabilities rose to 929 billion pesos, 19.9 percent of GDP. This amount was equal to almost one-third of the total assets of the banking system and far more than the bank's total capital.

### Mexican Bank Rescue and Party Politics

As FOBAPROA failed to recover or sell its acquired assets, the liabilities of FOBAPROA increased every year and FOBAPROA did not have

resources to handle the liabilities. In April 1998, President Zedillo sent Congress a package of banking reforms to guide Mexico out of its financial meltdown. The legislation actually consisted of several different reforms. The most crucial and controversial component of the reform bills was to convert all FOBAPROA liabilities into public debt. This would free the banks from bad loan portfolios. The government insisted that converting FOBAPROA liabilities into public debts was crucial to avoiding further financial chaos. Yet the payment of this debt plus interest will require about 8 percent of GDP for a minimum of 10 years. President Zedillo suggested to pay the debt through increase in the value added tax and cuts in social programs.

By the middle of 1998, however, the bank rescue had been transformed from a highly technical issue of bureaucratic management to the most blistering political attack ever staged by Mexico's political opposition. The opposition parties denounced Zedillo's reform packages as handing out public money to the rich. The government and the PRI argued that the measure was needed to strengthen the banking system and protect innocent savers who held their deposits at troubled banks. The opposition parties, the PAN and the PRD, accused the government of underwriting the debts of its wealthy and corrupt allies with taxpayers' money. In addition, opposition parties claimed that the operation of FOBAPROA violated the constitution because FOBAPROA's liabilities were never authorized by Congress (López, 1998; Székely, 1999).

The politicization of the bank bailout program was an unprecedented event in the Mexican political system. For most of century, the Institutional Revolutionary Party (PRI) was the exclusive arena for negotiation among diverse economic interests. Because the degree of institutionalization of the party system in Mexico has been very low, the political parties did not play a major role in the policy making process



(Mainwaring, 1995). Since the PRI as a hegemonic party had dominated Mexico for almost 70 years, crucial government policies tended to be determined by the executive and the PRI to the exclusion of opposition parties. In addition, because Mexico maintained the strong presidential system, called an imperial presidency, the legislature was not strong enough to be a governing partner to the executive or to check the power of the executive body. Moreover, since all of the recent presidents from de la Madrid to Zedillo were economic technocrats (*tecnico*), technocrats began to have the upper hand over the professional politicians of the PRI (*politico*). The role and influence of the PRI in the governing coalition declined since the mid-1980s (Centeno, 1994).

Considering the insignificance of party politics in Mexico, it was very interesting to note that the politics of the bank bailout under President Zedillo was driven by the parties themselves. There were a few reasons why the bank bailout became a highly political issue in 1998. First, as the bank bailout program incurred huge fiscal costs, the distribution of the costs was a crucial political issue. Second, as there were many scandals about mismanagement, favoritism, and even fraud in the operation of FOBAPROA, anger and suspicion by the public was intensified. The opposition parties tried to politicize the FOBAPROA scandal in order to undermine the Zedillo government and the PRI. Finally, the opposition parties won the majority of Congress in the 1997 election and could have an upper hand over the PRI in dealing with the FOBAPROA case. On July 6, 1997, the PRI lost control of Congress for the first time. Opposition parties won 261 of 500 seats of *cámara de diputados* (the lower house of Congress). Although the opposition was split ideologically, it united to form a solid majority to take away the PRI's control of the Congress. The PAN and the PRD appointed leaders to key committees and installed

themselves as the new leaders of the legislature. This event fundamentally reshaped Mexican politics (Dresser, 1998). The loss of a majority removed the PRI's ability to quash formal congressional inquiries. The politicization of the banking policy accelerated the process of democratization in Mexico.

The Zedillo government and the PRI insisted that converting FOBAPROA liabilities into public debts was inevitable to prevent the collapse of the banking system and that the costs should be shared by taxpayers. The government and the PRI admitted that there were mismanagement and favoritism in the operation of FOBAPROA. Yet they insisted that the government and the PRI did not violate the existing laws and they are not legally responsible. As a result of relentless attacks from both the Left and the Right, the PRI became concerned over the possibility that the bank rescue could sink the party at the polls. The PRI centered its efforts on forging a compromise.

A left-center opposition party, the PRD, took the uncompromising position and tried to politicize this issue as much as possible. The PRD strongly opposed the government proposal of converting FOBAPROA liabilities into public debts. The PRD insisted that wealthy businesses and bankers should share substantial portion of the costs. Initially there was a division between radical and moderate factions within the PRD. The moderate faction insisted that the PRD should avoid the uncompromising position. Because the radical position of the PRD may antagonize the business sector, and narrow the support base, the moderate faction argued that the PRD should find a realistic alternative to the government proposal, by participating in the negotiation process. Yet the national committee of the PRD (*consulta nacional*) controlled by the radical faction decided to take a critical position toward the bank bailout issue. On August 13, 1998 the PRD leaders proposed a thorough congressional investigation of bank

records. In late August, the party conducted a national referendum on the bailout in which over two million people participated. The PRD announced that 94 percent opposed the conversion of bad banks loans into public debt. The PRD publicly announced its exit from the ongoing negotiations and dedicated itself to attacking any progress toward a resolution as antidemocratic and unconstitutional.<sup>5</sup>

The PAN, conservative opposition party, found itself in a difficult position. On the one hand, its core business constituency demanded some resolution to the financial crisis. On the other hand, cooperation with the PRI endangered the PAN's ability to broaden its appeal among the popular sectors. The PAN recognized the need to approve the government reform bill, but did not want to pay a hefty political price for doing so.

The PAN took a compromising position. The PAN recognized that converting liabilities of FOBAPROA into public debts was inevitable to avoid the collapse of the banking sector. Yet the PAN insisted that a thorough investigation of the bailout program needed to be conducted and irregular loans among FOBAPROA portfolio should be returned to the banks. In addition, the PAN demanded the political as well as legal punishment of government authorities and bankers who were responsible for mismanagement and fraud in the operation of FOBAPROA.

The PAN initially tried to build an alliance with the PRD in dealing with Zedillo's bank reform package. Yet the two parties failed to reach a consensus due to ideological gaps and different support groups. In particular, the uncompromising position of the radical faction of the PRD made impossible the alliance between the two parties. As the alliance with the PRD failed, the PAN began to cooperate with the PRI in crafting

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<sup>5</sup> Regarding the differing positions of political parties and the process of political debate, see Fárber(1998) and González (1998).

an alternative proposal as a substitute for Zedillo's financial reform package.

After the nine months of extremely difficult negotiations, the government finally managed to enlist the support of the PAN in Congress and succeeded in passing a bank reform package on December 12. The final bill was radically different from the one originally proposed by the government. Instead of being converted into permanent public debt, as the government had originally intended, it was decided that FOBAPROA liabilities were absorbed by a newly-created Institute de Protection al Ahorro Bancario (IPAB). This new body is allocated public funds by the Chamber of Deputies on an annual basis as part of budget. .

The new legislation creating the IPAB allowed the reform of Mexico's banking system to continue, given that the government was able to purchase non-performing loans from commercial banks. This permitted a new capitalization of these institutions by domestic and foreign investors and also allowed for an easier and swifter sale of the assets that were purchased by FOBAPROA, thus leading to a reduction in the fiscal cost of IPAB liabilities.

In spite of substantial progress of bank restructuring, the resolution of the Mexican banking crisis has not concluded yet. It is not clear whether IPAB can complete bank reforms unfinished by FOBAPROA without increasing the cost to the taxpayers. The Mexican banks are still undercapitalized and in a fragile state. In July 1999, the government took over Serfin, the nation's third largest bank. There are many pending tasks to restore the soundness and solvency of the Mexican banking system. First, Mexican banks needs to recover the function of bank lending. Bank lending in Mexico has declined by more than 60% in real terms since 1994. This has reduced the banks' main source of income, and the rapid decline of bank lending has become a hindrance to economic growth. Secondly,

Mexico needs to make progress in the sale and disposition of assets acquired from troubled banks.

### The Economic and Political Impacts of Bank Rescue

The bank rescue program and subsequent political scandal had a significant economic as well as political impact on Mexico. In the economic aspect, there is no doubt that the bank bailout program contributed to preventing the collapse of the banking sector, and improving the solvency and efficiency of the banks. Yet mismanagement and favoritism in the operation of FOBAPROA undermined the credibility of the Mexican government and increased fiscal costs required for the bank rescue. As the bank bailout program became a hot political issue, and opposition parties and the public criticized fraudulent lending and cronyism, the legitimacy of neo-liberal economic reform pursued by the Salinas government and the following Zedillo government was severely damaged. Before the peso crisis, Mexico has been considered one of the most successful cases of economic reform among Latin American countries. Yet the peso crisis and bank bailout scandal was an embarrassment for the PRI and the Zedillo government.

Because liabilities of FOBAPROA were transferred to public debt, substantial fiscal costs are inevitable. The exact fiscal cost of the bank rescue is difficult to calculate because it depends on various factors. The future interest rate and the recovery or sale of the acquired assets affects the fiscal costs of bank rescues. Table 4 shows the distribution of bank rescue costs estimated by Mackey report. Among the total liabilities, the Mackey report estimated that only 33% of liabilities are recoverable and the remaining 67 percent of liabilities should be taken either by banks or

taxpayers as a loss. It is expected that the 67% will be split with banks taking 5.2% of the losses and the taxpayers taking 61.9% of the losses.

**Table 4:** Distribution of Bank Recovery Costs

*(Billion Peso)*

	Amount of Liabilities	Recoverable	Distribution of Loss	
			Banks	Taxpayers
Total	659.8	217.50	34.1	408.2
Proportion of Liabilities	100%	33.0%	5.2%	61.9%

Source: Mackey (1999).

Due to huge amount of public debts, the Mexican government is forced to pursue a tight fiscal policy and will be constrained in future economic management. The government should spend a substantial portion of its budget to pay the real interests of liabilities of IPAB every year. For example, in the year 2000, the total liabilities of IPAB are expected to reach 750 billion pesos as shown in Table 5. Assuming the interest rate of finance of IPAB is 8.00%, the government should pay 60 billion pesos for the real interests of liabilities. The IPAB plans to defray these real interests with 10-20 billion pesos obtained from asset sales and 4.5 billion pesos of bank quotas. The remaining 35-45 billion pesos should be transferred from government budget.

**Table 5:** Real Component of the Interests on the Liabilities of IPAB, 2000*(Billion Peso)*

I. Total liabilities of IPAB at the end of 1999	750.0
II. Real interests rate ( Cetes 28 days)	7.0%
III. Real interests rate of finance of IPAB	8.0%
IV. Real interests (IxIII)	60.0
Defray with the following resources	
1. Recovery (asset sales)	Betw. 10.0&20.0
2. Quotas from Banks	4.5
3. Rests (Fiscal transfers)	Betw. 45.5 &35.5

Sources: Rosales (2000)

In the political aspect, the handling of the bank restructuring affects political parties differently. The politicization of the bank bailout undermined the legitimacy of the PRI and accelerated the cleavage of the Mexican ruling system. Scandals and pervasive favoritisms in bank lending practices damaged the PRI's popularity that had already been weakening for a long time. The FOBAPROA scandal and negative political repercussions on the PRI partially contributed to ending the hegemonic domination of the PRI in last June's presidential election.

The PRD successfully politicized the FOBAPROA issue, and fiercely attacked the government and ruling party. Yet the PRD showed its radical position by rejecting a compromise with the government. The uncompromising and radical position of the PRD in dealing with FOBAPROA signifies the dilemma and limitation of the PRD as a populist and center-left party. The PRD was a major and strong opposition party in 1988 when Cardenas ran against Salinas of the PRI. Many experts argued that Cardenas would be the president if there were no manipulation

of vote counting. Since then, however, the PRD has failed to consolidate its position as an alternative political party, and its political influence and support rate have declined. The populist policy orientation of the PRD excluded the business sector and middle class from the potential support base.

It seems to me that the PAN gained most from the bank bailout program by taking a position of compromise. By participating in negotiation with the government and revising the original proposal of the government, the PAN could obtain credit for preventing the collapse of the financial system and reducing the fiscal costs of the government from the business sector and middle class.

### A Brief Comparison of Bank Restructuring in Korea and Mexico, and Lessons from the Mexican Case

South Korea has experienced a banking crisis since November 1997. The banking crises of Korea and Mexico pose important similarities as well as differences. Both crises were commonly triggered by sudden currency devaluations and simultaneously unfolded with a major meltdown of their economies. Facing banking crises under similar circumstances, however, Mexico and Korea have adopted two different strategies for resolving their banking crises.<sup>6</sup> First, Mexico has relied on a market-based approach to recapitalize the banking system. The government encouraged bank's shareholders to recapitalize their institutions and to attract new capital from new domestic and foreign investor. In Korea, on the contrary, the main instrument for bank recapitalization has been the injection of government resources. Second, the two countries show difference on the

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<sup>6</sup> Discussion on different strategies for resolving banking crises in Mexico and South Korea heavily relied on the following study: De Luna-Martinez(2000).



use and recipients of government financial support. In Mexico, both banking institutions and debtors have benefited from direct fiscal support. In Korea, the use of public resources has been exclusively limited to injecting capital into banks and buy NPLs from troubled banks. Third, the speed of reforms also differs in the two cases. It is known that Korea has undoubtedly made progress more rapidly than Mexico.

In addition, the management of the banking crisis in Korea has been relatively transparent than in Mexico. Key decisions such as the viability of institutions, the amount of NPLs purchased from the troubled banks and the extent of fiscal support to banks have been made with clear criteria and procedures.

Even though the overall assessment of the Korean bank restructuring strategies is positive, bank restructuring has not been completed yet in Korea. Because of the collapse of the Daewoo Group in 1999, the amount of NPLs of the major banks suddenly increased. The expected sale of some banks for foreign capital has been delayed. Thus, currently the Korean government is pursuing the second round of financial restructuring and huge additional public funds are required to finish the bank restructuring.

For the effective resolution of the banking crisis, Korea can learn the following lessons from the Mexican bank bailout case. First, the Mexican experience shows that successful resolution of the banking crisis is a complex and difficult task. The management and resolution of a banking crisis depends on various financial, economic, political and social factors. The rapid resolution of a crisis can be determined by the prompt identification of insolvent banks, the amount of resources allocated by the government, the rapid disposition of non-performing assets, and the macroeconomic recovery of a country. In addition, the institutional

capacity of the government, the willingness to implement painful reform measures, and the degree of resistance from labor unions also affect the resolution of the crisis.

Secondly, the Mexican experience indicates that government intervention may cause serious moral hazard problems. Pervasive mismanagement and cronyism in FOBAPROA indicates that huge public money was used to save rich bankers and businessmen who were responsible for reckless lending practice or borrowed money illegally from banks and did not pay back. To avoid moral hazard, when public resources are injected into ailing banks, the government should demand the painful restructuring efforts by banks and ask bank managers to take responsibility for their poor management. Otherwise, even after spending huge public funds, the banking sector will not be able to restore long-term solvency and efficiency, and additional public resources will be required to rescue the banking sector.

Thirdly, the process of bank bailout should be carried out with transparency and clear criteria and procedures. In the Mexican case, since there were many evidences of mismanagement, fraud, and favoritism in the bailout process, the government plan for bank bailout faced steady and widespread resistance from opposition parties and social groups.

Finally, the bank restructuring experiences of Mexico show how the changing political balance between the ruling party and opposition parties affected the way in which the economic reform package was handled in the political arena. The politicization of FOBAPROA indicates that party politics can be a crucial hindrance to bank reform. Up until now, bank restructuring in Korea has remained a highly bureaucratic issue rather than a political issue. Strong resistance from labor unions has been a major constraint to bank reform in Korea. Yet there have not been constraints or major disagreements to the bank reform policies from opposition parties.

Since the major opposition party frequently has challenged other government policies such as policy toward North Korea, however, it is possible that the opposition party could take a different position toward bank reform. To avoid the politicization of bank reform, the government and ruling party need to make strong efforts in maintaining consensus and cooperation with the opposition parties concerning the bank restructuring.

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