

## **1998 FINANCIAL SYSTEM REFORMS**

This report contains the most important provisions issued by the Central Bank in 1998. In order to facilitate consultation of these provisions this document orders them chronologically based on the date they came into effect.

### **FOREIGN CURRENCY LIABILITY ADMISSION REGIME**

In July 1998, Banco de México decided to amend the foreign currency liability admission regime applicable to commercial banks.

Banco de México established that at the end of each day such banks must not have contracted liabilities either denominated in or referenced to foreign currency in excess of the amount that results from multiplying the factor of 1.83 by the bank's tier 1 capital calculated to the third month immediately prior to the month in question.

Likewise the Bank stated that this limit is applicable to all liabilities denominated in or referenced to the foreign currency of banks, their branches, agencies and affiliates as follows:

Liabilities falling due:

Equal to or less than 360 days	100%
Greater than 360 days but less than or equal to 720 days	20%
Greater than 720 days but less than or equal to 1,080 days	10%
Greater than 1,080 days <sup>1</sup>	5%

### **INVESTMENT REGIMES FOR FOREIGN-CURRENCY TRANSACTIONS AND APPLICABLE TERM CONDITION**

At the end of 1997 Banco de México announced the foreign currency investment regime applicable to commercial banks. This provision established a transitory regime that provides for banks' gradual compliance.

In view of problems encountered by commercial banks adjusting their operations to the referred regime, Banco de México resolved that provisions related to the levying of sanctions would become applicable as of January 1st, 1998.

On October 16<sup>th</sup>, 1998, Banco de México issued additional related regulations to discourage subsidiaries of commercial banks or brokerage firms that are part of financial groups comprising a bank from continuing to undertake unauthorized derivative transactions. As a result, the way in which such transactions are calculated was modified for the purpose of such regimes.<sup>2</sup>

## **MONETARY REGULATION DEPOSITS**

In order to reinforce Banco de México's monetary policy instruments, and given the fact that only the flexible and timely use of this policy can offset the effect of external shocks on the exchange rate, inflation expectations and medium and long-term interest rates, as of September 2nd, 1998, the obligation of commercial banks to create monetary regulation deposits with the Central Bank amounting to a combined total of \$25,000'000,000.00 (TWENTY-FIVE BILLION PESOS 00/100 M.N.) was established. These deposits were created by each bank, each bank working day for an amount resulting from distributing \$1,250'000,000.00 (ONE BILLION TWO HUNDRED AND FIFTY MILLION PESOS 00/100 M.N.) from commercial bank local currency and US dollar deposits pro rata.

These deposits are for an indefinite period of time and pay a 28-day interest rate equivalent to the arithmetic average of the Inter-bank Equilibrium Interest Rate (TIIE) obtained by Banco de México each bank working day during that period.<sup>3</sup>

## **CLEARING AND TRANSFER OF LOCAL CURRENCY FUNDS**

Given petitions from diverse banks, in January 1998, Banco de México, authorized banks' participation in clearing houses located in markets where they were not previously present and through the clearing houses themselves. Prior to this they were only able to participate through another bank.<sup>4</sup>

Likewise, in order to continue with the modernization of payment systems begun in 1994 and increase clearing house settlement based on inter-bank credit lines rather than on Central bank credit, at the beginning of March some amendments were made to the clearing and fund transfer regime including the following:<sup>5</sup>

Firstly, it was established that with respect to banks' local currency single account regime with Banco de México, overdrafts not backed by guarantees derived from clearing house documents would no longer be accepted.

The Clearing House System (SICAM) was created as a sub system of SIAC- BANXICO responsible for clearing documents and calculating loans required to settle clearing balances.

It was stipulated that in order to settle documents received through clearing houses throughout the country, banks could grant each other loans.

A limit was established on loan amounts banks may grant each other, which may not exceed the greater of the following two amounts: i) thirty percent of the lender bank's net capital, or ii) 2.4 percent of the average daily local currency liability balances in the month derived from the lender bank's deposits. In no case may the sum of all of the credit lines a bank grants other banks exceed a ceiling based on its net capital or average deposits.

It was determined that if the credit obtained from banks is not enough to settle balances resulting from the clearing process, Banco de México will undertake clearing based on a previously determined procedure by excluding from one or several clearing houses documents charged to the bank/s. Likewise, the areas in which Banco de México authorizes document clearance were updated and the regime applicable to documents known as remittances was revoked, as these were no longer presented to clearing houses.

In order to comply with requests from diverse banks as well as from Cecoban, S.A. de C.V., on August 18th 1998, some clearing houses dealing with documents that were notoriously low in number and amount stopped operating and the coverage of others was extended.<sup>6</sup>

## **DERIVATIVE TRANSACTIONS**

In order to enable commercial banks to undertake the same transactions in equity markets as those undertaken in OTC markets, and in order to broaden the range of contracts banks can enter into in the derivatives market, Banco de México deemed it appropriate to allow them to undertake future and option transactions on the following underlying assets in equity and OTC markets:<sup>7</sup>

- a) Precious metals;
- b) Local and foreign currencies;
- c) Government securities issued, backed or guaranteed d) by the Federal Government or Foreign Governments;
- e) Real or nominal interest rates;
- f) Stock market indexes, a group of stock, or g) share quoted on such exchanges;
- h) Investment units, and
- i) Exchange of money flows (Contracts known as "swaps").

In order to ensure that only banks with the necessary liquidity and infrastructure can undertake these transactions, Banco de México established that banks interested in undertaking them must obtain its authorization.

In order to obtain the aforementioned authorization, in their authorization request banks must include a report issued by a consulting company with experience in handling and controlling risk management systems approved by Banco de México which states they have the technical capacity to undertake the transactions in question and comply with management, operating and internal control requirements.

Likewise banks aiming to undertake such transactions should have tier 1 capital amounting to at least 90 percent of the capital required to cover their market and credit risks in accordance with the applicable Capitalization Requirements Rules.

First time authorizations last for six months as of when they are granted and are renewable for a further six.

Provisions enable banks whose authorization has been renewed to request permanent authorization. The request must be accompanied by a report issued by an external auditor certifying that the bank in question continues to comply with the aforementioned requirements.

Once the aforementioned authorization has been obtained, banks acquire the obligation to submit every four years as of the date on which the authorization was granted, a report issued by a consulting company with experience in the management and control of risk management systems and approved by Banco de Mexico stating they still have the technical capacity required to undertake each of the transactions the permanent authorization was granted for.

Furthermore, in order to deal with requests from certain customers who need to enter into contracts documenting debt transactions related to future and option transactions, a new financial instrument known as "structured notes" was provided for.

This instrument enables commercial banks with Banco de México authorization to enter into future and/or option transactions and reach agreements with clients that returns on fixed-term deposits and bank bonds can be determined based on variations in one or several of the underlying assets on which banks can undertake future and option transactions. In order to undertake such transactions banks should comply with the following rules:

1. The minimum amount of each transaction should be the local currency equivalent of 100,000 investment units at the time of the agreement or its renewal;
2. When the transactions mature, under no circumstances may clients receive settlement for an amount below the principal amount of the debt transaction in question;
3. Banks were banned from undertaking propaganda related to such transactions through massive media channels, and the transactions must be undertaken in places other than over branch counters;

4. Prior to entering into the respective agreement, banks must provide clients with documents describing the transaction and the associated risks and quantifying the returns likely to be generated under different scenarios; the file must contain written proof that clients are aware of the risks and possible returns from entering into the transactions, and
5. Banks must include a phrase stating that said investment instrument involves the celebration of derivatives and may not therefore generate any returns at all or returns below those existing in the market on the transaction date in question in their contracts and corresponding account statements.<sup>8</sup>

In view of the beginning of derivative market activities in our country through the MexDer Mercado Mexicano de Derivados, S.A. de C.V., in which standard futures and options contracts are negotiated, in the middle of December Banco de México modified its provisions so that banks that comply with the established requisites may participate in this market. Furthermore, commercial banks authorized to enter into financial transactions known as OTC market derivatives were allowed to pledge securities in their portfolios when entering into contracts with counterparties that are banks or foreign financial entities with a "P-1" grade from Moody's Investors Service, or "A-1" from Standard and Poor's, as long as such agreements are documented based on the contract known in international markets as International Foreign Exchange Master Agreement, approved by the International Swaps and Derivatives Association, Inc., or based on other standard contracts authorized by Banco de México.<sup>9</sup>

## **EQUITY AND DEBT INSTRUMENT MUTUAL FUNDS**

Given: a) the convenience of allowing equity mutual funds to enter into repurchase transactions through a regime in line with the one applicable to debt instrument mutual funds; b) the need to make investment funds more flexible when managing liquidity; and c) the appropriateness of eliminating limits applicable to mutual fund repurchase transactions, in September 1998 Banco de Mexico issued a new regime that debt and equity mutual funds must adhere to when conducting repurchase transactions.

The main changes to the regime establish that repurchase transactions entered into by mutual funds should be documented in framework contracts which in turn should stipulate the following:

- a) The mutual fund's obligation throughout the term of the repurchase transaction to maintain a proprietary position in the same kind of securities with a market value higher than cash plus the agreed premium, earned and uncollected;
- b) The mutual fund's obligation to request on a daily basis from the

repurchaser and throughout the term of the repurchase agreement, additional securities to the ones received when their market value decreases in relation to the cash delivered plus the agreed premium, earned and uncollected;

c) The obligation of the bank or the brokerage firm acting as repurchaser to transfer the securities or additional securities to those referred to in paragraph b) above to the mutual fund;

d) The investment fund's obligation to return the corresponding securities to the repurchaser on a daily basis and during the term of the repurchase agreement when their market value increases compared to the cash delivered plus the agreed premium, earned and uncollected without prejudicing compliance with the content of a) above.

The securities that are returned to the repurchaser in the terms set forth in the paragraph above will be deemed to have been delivered as part of the settlement of the repurchase agreement and will reduce the number of securities the repurchasee must transfer when the transaction expires; and

e) Conventional penalties for the repurchaser and the repurchasee in the event of non-compliance with the obligations mentioned in paragraphs c) and d) above.

It was also established that mutual funds must mark the securities acquired in the repurchase agreement to market on a daily basis.<sup>10</sup>

Finally it was established that this regime would come into effect on January 4th, 1999, and that mutual funds could use it prior to the said date. However, in view of operating problems encountered by mutual funds when complying with the new repurchase regulation as part of work being done to avoid Y2K issues, in December 1998 Banco de México opted to delay the coming into effect of the aforementioned regime indefinitely.<sup>11</sup>

## **US DOLLAR SALE AUCTIONS**

As will be recalled, in February 1997, the Foreign Exchange Commission agreed to implement a contingency dollar sales scheme in which the central bank offers up to 200 million dollars a day for auction, and banks submit bids using an exchange rate at least 2% above the previous working day's rate.

On August 24th, 1998, the Foreign Exchange Commission changed the timetable for submitting bids in the US dollar sale auctions that Banco de México undertakes to 13:00 to 13:15 hours from 12:00 to 12:15 hours previously.<sup>12</sup>

At the end of August of this year, the Foreign Exchange Commission opted to extend the hours during which banks can submit their bids in such auctions, and so as of August 27th, 1998 three auctions take place during

three different time slots: the first is between 9:00 and 9:15 hours; the second between 11:00 and 11:15 hours, and the third between 13:00 and 13:15 hours while the combined amount of dollars auctioned by Banco de México may not exceed two hundred million dollars; in other words, if the entire amount is auctioned during the first time slot, only one auction per day will take place.

To make the rest of the scheme congruent it was specified that the minimum price of the bids when the auction undertaken the previous bank working day has given rise to dollar sales by Banco de México, would be the result of multiplying by 1.02 the average price of sales undertaken in the auction/s on the previous bank working day weighted by the foreign currency amounts sold at each exchange rate.<sup>13</sup>

### **RIGHTS AUCTIONS FOR ENTERING INTO CONTRACTS TO EXCHANGE CASH FLOWS FROM THE COMPARISON OF INTEREST RATES**

In order to lower the risks that commercial banks could incur as a result of the interest rate structure of their lending and borrowing transactions, on August 31st and September 21st, 1998, Banco de México decided to enter into contracts to exchange cash flows from the comparison of interest rates (interest rate swaps).<sup>14</sup>

In the auctions held on August 31st, 1998, the maximum amount for both types of auctions was twenty-five billion pesos, ten billion of which corresponded to nominal interest rate swaps and fifteen billion to real interest rate swaps.

In the auctions held on September 21st, the maximum amount was fifteen billion pesos for nominal interest rate swaps and six billion investment units for real interest rate swaps.

Banco de México determined the minimum nominal or real interest rate it would be willing to receive according to whether it concerned nominal or real interest rate swaps.

The assignment process for auctions held on August 31st, 1998 was different for nominal interest rate swaps and real interest rate swaps. For both types of swaps the assignment took place in descending order beginning with bids with the highest rate. The difference in the assignment consisted of how the maximum amount assigned is established. With respect to nominal interest rate swaps, the maximum assignment amount was ten billion pesos irrespective of whether it concerned interest rate swaps with six or twelve settlement periods. With respect to real interest rate swaps, the maximum assignment amount was set at seven billion five hundred million pesos both for assignments of swaps with nineteen settlement periods and swaps with thirty-nine settlement periods. It was determined that banks would only have the right to submit combined bids per bank not exceeding 6.5 percent of the sum of their local currency deposits and US dollar deposits.

In the auctions held on September 21st, in the assignment process for both nominal and real interest rate swaps, different assignment amounts were established in accordance with the number of settlement periods in question. In these auctions Banks only had the right to submit combined bids per bank not exceeding 7.5 percent of the sum of their local currency deposits and US dollar deposits.

Commercial banks with bids assigned in the auctions were allowed to transfer the rights and obligations derived from such contracts to other commercial banks in full or in part.<sup>15</sup>

## **CENTRAL BANK CREDIT IN DIFFERENT PAYMENT SYSTEMS**

In August 1998, Banco de México resolved to take certain measures in relation to the credit it grants to banks in different payment systems.

As a result it was established that a SPEUA participant can send payment orders to Banco de México itself to credit its single account and the S.D. Indeval, S.A. de C.V. control account and instruct Banco de México to send payment orders that are debited to the referred accounts as long as the net balance does not exceed the limit established for determining the maximum amount of the sum of all the risk exposure limits determined by a SPEUA participant with respect to the others, which may not exceed the lower of the following amounts: 9 billion pesos or the amount resulting from a formula that takes into account the bank's net capital and the monthly average balance of daily local currency deposits.

The same limit was established for the credit lines a bank grants to others to settle documents received through Clearing Houses.<sup>16</sup>

## **SINGLE ACCOUNT REGIME**

In order to reinforce the instruments available to Banco de México for managing monetary policy, the decision was made to raise the rate charged to banks that register negative daily balances in their local currency single accounts that are below 300 million pesos or above: i) the equivalent of 0.25 percent of the monthly average balance of their daily local currency liabilities resulting from deposits, or ii) the equivalent of seven and a half percent of their net capital. In that event Banco de México will debit from the single account of the bank in question the amount resulting from applying to the excess amount the rate obtained from multiplying by three the annual rate of return, equivalent to the discount rate, of 28-day Federal Treasury Certificates, or the term substituting it in the case of non-working days, corresponding to the auction in which such securities have been placed on the working day immediately following the one on which such a situation occurs.

Likewise it was determined that in the event of a bank registering positive balances in excess of the amounts mentioned in the previous paragraph on a bank working or non-working day, Banco de México will debit from the Single Account in question, on the working day immediately following the one on which such an assumption occurs, the 28-day Cetes rate or term substituting it in the case of non-working days, corresponding to the auction in which such securities have been placed.<sup>17</sup>

Given the evolution of payment systems, on December 22nd it was established that as of January 1st, 1999 it will no longer be necessary for banks to maintain a minimum amount of guarantees in their single account.<sup>18</sup>

### **TRUSTS THAT MANAGE SUMS OF MONEY PERIODICALLY CONTRIBUTED BY INTEGRATED MARKETING CONSUMER GROUPS**

On September 28th provisions related to the regime applicable to trusts that manage sums of money periodically contributed by integrated marketing consumer groups known as "self-financing" were announced.

Barring some adaptations and the understanding that trusts set up for the acquisition of real estate are subject to the investment regime applicable to trusts that grant credit, the regime is similar to the communiqués that Banco de Mexico sent to the Ministry of Commerce and Industry on October 28, 1994 and February 24th, 1995, and which it informed banks of.

Regarding this it was stipulated that these trusts are not subject to the above-referred investment regime. Each trust may only manage the funds of a single group of consumers, the maximum number of participants per trust being the amount resulting from multiplying the number of months in the respective financing term by five.

Banco de México determined that the respective financing terms must not exceed 4 years, it being the obligation of the trustor to ensure congruence between the funding term and the useful life of the asset being financed taking into account depreciation over time. Likewise, the asset that is the object of sale must be part of the trust's assets until the loan is fully covered.

It was determined that when for any reason the fund in question is fully or partially terminated, or the transaction is terminated, the existing funds must be delivered exclusively to the corresponding trustees, or their beneficiaries, in proportion to the contributions amount plus other financial dues in accordance with the contract.

It was established that consumers that participate in these trusts be free to withdraw from them at any time, and have the right to receive any returns agreed on in relation to payment of the corresponding contributions and deduction of any penalties agreed thereto.

With respect to the relationship between the fiduciary institutions and marketing companies, it was stipulated that they must enter into a contract other than the trust contract in which they must agree to: refrain from mentioning in any type of advertising the name of the fiduciary institution or include any sign that could be a source of error or confusion among participants in such systems with respect to the legal personality the corresponding transaction is being entered into with; refrain from including in advertising that the transaction in question has been the subject of authorization or approval from a financial authority; include a clause in client contracts indicating that obligations associated with the delivery of the new property and/or rendering of the services covered by the transactions will be assumed by the marketing company.

Finally, it was established that funds that are temporarily liquid must be converted into instruments registered in the National Registry of Securities and Intermediaries with a maturity no greater than 90 days and that no investments can be made in commercial paper without a bank guarantee.<sup>19</sup>

### **CLEARING OF CHECKS AND MONEY ORDERS IN US DOLLARS**

Bearing in mind that banks adopted mechanisms for clearing checks and money orders in US dollars without Banco de México's intervention, as of March 2nd, 1998, the Bank revoked the transitory regime preventing the application of provisions authorizing such clearance in those terms.<sup>20</sup>

### **SETTLEMENT OF TRANSACTIONS INVOLVING SECURITIES DEPOSITED IN S.D. INDEVAL, S.A. DE C.V., INSTITUTION FOR SECURITIES DEPOSITS (INDEVAL)**

In order to make the mechanism for assigning credit lines to settle transactions involving securities deposited in Indeval more expedite, as of April 1st, 1998, Banco de México modified provisions establishing the transaction limit applicable to Indeval institutions for settling such transactions.<sup>21</sup>

It should be recalled that every working day Banco de México establishes the maximum capacity of the overdraft banks may incur in their single accounts in relation to the settlement of transactions involving securities deposited in Indeval, known as maximum capacity. This maximum capacity determines the operating limit of the bank in Indeval for the settlement of such transactions, known as maximum capacity. This maximum capacity determines the bank's operating limit in Indeval for the settlement of such transactions.

It was established that Banco de México would announce both to the bank and to Indeval, the transaction limit on the bank working day immediately prior to its applicability.

Likewise it was stipulated that Banco de México would inform banks and

Indeval of the amount of the credit lines that banks must grant one or more brokerage firms on each bank working day derived from the increase in their maximum capacity, which after requested by the bank is authorized by Banco de México. Banks themselves will inform Indeval of the credit lines they are willing to grant to brokerage firms each bank working day using funds other than those granted by Banco de México.

## **MEXICAN GOVERNMENT SECURITIES PLACED ABROAD**

Given that securities known as Global Bonds due 2008 were registered in the Securities and Special Sections of the National Securities and Intermediaries Registry, Banco de México considered it appropriate to permit such securities to be traded in the country by both commercial banks and brokerage firms.<sup>22</sup>

## **ASSET AND LIABILITY POSITIONS RELATED TO THE NATIONAL CONSUMER PRICE INDEX**

Bearing in mind that commercial bank capitalization rules published in the Official Federal Gazette on July 15, 1996 contemplate risks incurred as a result of lending and borrowing transactions related to the level of the Consumer Price Index, the assets and liabilities position related to the level of the National Consumer Prices Index regime ceased to be effective.<sup>23</sup>

## **ELECTRONIC FUND TRANSFERS**

In order to prevent electronic fund transfers from being returned on account of errors in the beneficiary's account number, Banco de México decided that as of July 1998, on the back of each account statement sent to accountholders banks should include a legend indicating that if the client wants to receive payments through SPEUA and the Inter-bank Payment he or she should notify the person that will send the payment/s of the account number indicated in the legend as well as the name of the bank where the account is held.<sup>24</sup>

At the end of December it was envisaged that the formula for calculating the maximum amount of the sum of all of the risk exposure limits determined by a bank with respect to others in SPEUA, would be obtained based on a procedure that takes inflation levels into account.<sup>25</sup>

## **VERIFICATION OF THE ECONOMIC SITUATION AND MORAL STANDING OF CLIENTS TO AVOID THE CONCLUSION OF IRREGULAR TRANSACTIONS**

Given the importance of equipping banks with controls to verify the economic and moral standing of their clients in order to prevent the conclusion of irregular transactions, at the beginning of July 1988, Banco de México made it compulsory for them to ascertain this situation based

on reports obtained from a credit information company prior to entering into transactions. It was also determined that banks should take the necessary steps to verify this for previous clients.<sup>26</sup>

### **EARLY PAYMENT OF BANK BONDS AND SUBORDINATED NOTES**

In order to procure funds from banks on terms more appropriate to the market situation and banking system, on September 14th, 1998, Banco de México allowed banks to pay bank bonds and subordinated notes in advance.<sup>27</sup>

This was subject to banks stating the following in titles and indentures documenting the respective debt transaction:

- a) That it has authorization from the Central Bank to make the corresponding early payment;
- b) The price or procedure used to determine it in the event of the issuer opting for early payment; and
- c) Banco de México will not establish any procedure for the early payment of such securities.

Banks were allowed to pay bonds and subordinated notes issued prior to September 14th, 1998 early on the understanding that Banco de México will not establish any procedure for such payment.

### **MODIFICATION OF THE RULES FOR THE PLACEMENT OF GOVERNMENT SECURITIES**

In order for primary market auction notifications and results to be released through electronic means or telecommunication other than Banco de México's Accountholders' Attention System, on November 26th, 1998 some modifications were made to these rules.<sup>28</sup>

### **RECIPROCAL PAYMENTS AND CREDIT AGREEMENT SIGNED BY BANCO DE MEXICO AND THE CENTRAL BANKS OF OTHER MEMBER STATES OF THE LATIN AMERICAN INTEGRATION ASSOCIATION (LAIA) AND THE DOMINICAN REPUBLIC**

As a result of the amendment of the ALADI Reciprocal Payments and Credit Agreement regarding the interest rate applicable to banks for incorrect transaction execution or when the central bank of member countries of this Association or the Dominican Republic fails to pay the balance due, and the interest rate applicable to banks once the central bank in question has paid the balance in full or in part, on December 28th, 1998, the Operating Rules of the Reciprocal Payments and Credit Agreement signed by Banco de México and other Central Banks of ALADI member countries and the Dominican Republic were modified to establish that the reference rate will be equivalent to the simple arithmetic average

of daily quotations for the first three months and fifteen days of the compensation period in question of the 4-month LIBOR interest rate determined by the British Bankers Association plus one percentage point.

### **FEDERAL GOVERNMENT DEVELOPMENT BONDS SWAP**

As financial agent of the Federal Government, Banco de México established the procedure for swapping Federal Government Development Bonds with an interest rate referenced to 28-Day Treasury Certificates for Federal Government Development Bonds with a quarterly coupon, an inflation hedge and an interest rate referenced to 91-day Treasury Certificates. The notification was given on March 24<sup>th</sup>, 1998.<sup>29</sup>

### **AMENDMENTS TO DIVERSE CREDIT SUPPORT PROGRAMS**

In June Banco de México informed the country's banks that the Ministry of Finance and Public Credit amended procedures previously established in National Production Credit Support Programs; Additional Benefits for Mortgage Borrowers and Fovi Housing Borrowers under the Immediate Support for Bank Debtors Agreement and Agreements for Agriculture and Fishing Sector Financing and Micro, Small and Medium-sized Company Financing and Development so that capitalization and/or payments related to support would be made under the new mechanism.<sup>30</sup>

At the end of August banks were informed of the Ministry of Finance and Public Credit procedure applicable to mortgage borrower support programs for reversing the Investment Unit amounts banks recorded as excesses as a result of the non-formalization by debtors of notarial deed restructuring.<sup>31</sup>

At the end of September the terms established by the Ministry of Finance and Public Credit for fiduciary institutions to exercise credit lines granted under the Programs National Production Credit Support, National Production Support through Tier One Loan Restructuring and National Production Support through the Restructuring of Rediscount Transactions of Commercial Banks with Development Banks were released. The Ministry authorized Banco de México as financial agent of the Federal Government to enable banks to exercise credit lines determined by the National Banking and Securities Commission granted to date on the understanding that amounts exercised and charged to them could only be related to the acquisition of loans granted to micro, small and medium-sized companies whose debtors had initiated loan restructuring procedures by July 31<sup>st</sup>, at the latest.

Furthermore, the Ministry of Finance and Public Credit determined that by September 30<sup>th</sup>, 1998 at the latest, fiduciary institutions could allocate funds obtained from credit lines opened by the Federal Government under the Programs for the acquisition of loans granted to micro, small and medium-sized companies whose debtors had begun loan restructuring

procedures by July 31, 1998 at the latest.<sup>32</sup>

On October 2nd, Banco de México released the Ministry of Finance and Public Credit document establishing the procedure to be used by banks for the early settlement of loans granted by the Federal Government in relation to diverse loans restructured in investment units referred to as "flow" originators in trusts in which the Bank Savings Protection Fund is the Trustee.<sup>33</sup>

In mid-November banks were informed of the Ministry of Finance and Public Credit's decision to modify the interest rate paid by Special Federal Treasury Certificates issued by the Federal Government in relation to diverse credit support programs.<sup>34</sup>

### **OTHER RELEVANT FINANCIAL SYSTEM PROVISIONS AND CRITERIA**

In view of the fact that the Ministry of Finance and Public Credit amended the guidelines for the sale of government securities to Retirement Mutual Funds using funds from Transfers undertaken under Circular CONSAR 24-1, at the end of April Banco de México amended the "Procedure for the Sale of Government Securities to Retirement Mutual Funds" establishing that these funds could present weekly government securities purchase requests for up to the total balance of their investment in Federal Government loans, on the date such a request is submitted, as long as the balance is no greater than fifty million UDIS, or thirty percent of the investment balance in Federal Government loans at the start of the month in question.<sup>35</sup>

In the month of July modifications to interest rates on local currency loans that the Commercial Development Fund (FIDEC) charges banks were released.

Such modifications established that with respect to loans of up to 500 thousand pesos, the interest rate will be equivalent to the 28-day Interbank Equilibrium Interest Rate published by Banco de México in the Official Federal Gazette on the first bank working day of the period in which the corresponding interest (TIIE) is earned, less one and a half percentage points; with respect to loans above that amount, the interest rate will be TIIE less half a percentage point; for loans of up to 100,000 pesos which are the first financing that the end borrower, be it a corporation or an individual with a business activity, has received from a bank, the interest rate will be TIIE less two percentage points, and for quarterly interest loans, the interest rate will be equivalent to TIIE less a quarter of a percentage point, regardless of the loan amount.<sup>36</sup>

On August 12th, the Ministry of Finance and Public Credit published in the Official Federal Gazette the Rules that mutual funds referred to in article 28 Bis-15 of the Securities Market Act should adhere to. These funds manage securities portfolios, a service that includes offering consulting and supervision and making investment decisions about securities and

documents issued as part of a series or en masse on behalf of third parties. The rules refer to these funds as affiliates and they must be corporations whose capital stock is majority or wholly owned by a foreign financial institution which undertakes the same kind of activities in the country where it is incorporated.

Any foreign bank that wishes to establish a subsidiary must notify the Ministry of Finance and Public Credit as well as the National Banking and Securities Commission of its investment in the subsidiary within ten working days following the date of its incorporation. It may also acquire shares representing the capital stock of a company offering these services that is already incorporated as long as it acquires at least 51% of the shares representing the capital stock, modifies its bylaws and if the foreign bank already has a share interest in another subsidiary merges both companies.

The subsidiary's transactions must be documented in the name of the respective client and must be undertaken through brokerage firms, brokerage specialists, mutual fund operators or banks; brokerage activities may not be performed either directly or indirectly.

Furthermore, on December 15th MexDer, Mercado Mexicano de Derivados, S.A. de C.V., (derivatives market) headquartered in Mexico City began operating.

On August 12th and December 30th, 1998, the Rules applicable Companies and Trusts involved in the establishment and operation of a listed futures and options market were modified. The changes included, among others: a) the inclusion of the "Market Maker" concept as a participant that will assist adequate price formation; b) the involvement of individuals with the character of operating companies was permitted to provide greater flexibility in line with international experience; c) the settlement regime applicable to operating partners created by financial entities that are settlors of a settlement partner and are engaged exclusively in transactions on behalf of such entities was adjusted; and d) it was stipulated that operating partners may not be settlors in trusts whose aim is to operate as settlement partners.

Finally, with respect to the contradictory thesis related to the agreement about adding interest due to the capital on which it has been earned, in order to calculate the most recent returns on the new unpaid balance, known in law as anatocism or interest capitalization, the High Court of Justice ruled that provisions regulating anatocism or interest capitalization are valid when new credit agreements are entered into with clients, as special legal rules governing this agreement do not distract from the power of the parties to agree on interest capitalization.

## **MAIN LEGAL REFORMS TO THE FINANCIAL SYSTEM**

On December 13th, 1998, Congress approved Decrees issuing the Bank Savings Protection Law, and diverse provisions of laws regulating Banco de México, Banks, the Securities Market and Financial Groups and the Law on

the Protection and Defense of Financial Service Users were amended, added to and repealed as follows:

### **Bank Savings Protection Law**

The aim of this legislation is to establish a bank savings protection system, regulate financial support granted to commercial banks (the institutions) to protect the interests of public savers, and lay the foundations for the organization and operation of the Bank Savings Protection Institute (IPAB).

The IPAB is a decentralized body of the Federal Public Administration that guarantees bank deposits as well as loans and credit granted by banks. However, bank liabilities are excluded from this protection as are liabilities in favor of any company that is part of a financial group to which a commercial bank belongs; liabilities in the form of negotiable instruments and securities made out to the bearer; liabilities or deposits in favor of shareholders, members of the board and senior officers of the institution in question as well as general attorneys with administrative powers and general managers; and transactions that failed to adhere to legal, regulatory or administrative provisions or to sound banking practices and uses, in which there is bad faith as well as those related to money laundering operations.

Regarding this, IPAB will pay the balance of the above-referred guaranteed liabilities for up to an amount equivalent to 400,000 Investment Units (UDIs) per person, whatever the number and type of the liabilities in their favor and owed by the same bank, subrogating the respective collection rights.

Banks must pay to IPAB the ordinary and extraordinary quotas that its Board establishes based on risk exposure; ordinary quotas may not be less than 4 thousandths and extraordinary quotas may not, in the space of one year, exceed 3 thousandths of banks' liabilities. Furthermore, the sum of ordinary and extraordinary quotas may not exceed in the space of one year, 8 thousandths of the total amount of banks' debt.

The IPAB may grant financial aid to provide liquidity or clean up a bank. Such support may be granted in the form of share or subordinated note subscription, assumption of debt, granting loans or the acquisition of assets owned by banks and will only proceed when:

- a. There is a technical study that justifies the bank's viability and suitability of the support;
- b. It is judged appropriate for the bank to continue to operate because that option is less costly than paying guaranteed obligations;
- c. There is a clean-up program for the bank that will receive the support;
- d. Guarantees are provided or IPAB takes necessary steps for shareholders of the problem bank to absorb the cost that would

have been incurred had support not been made available; and

e. The Governing Board authorizes the support.

The prompt and timely payment of IPAB support through loans will be guaranteed by shares with voting rights representing the ordinary capital stock of the problem bank.

Should IPAB conclude that conditions for the bank to meet its debt are not present, Congress will dictate the appropriate measures for ensuring payment of the guaranteed obligations and financing.

In the event of a situation of emergency that affects the solvency of a bank but IPAB does not have the funds to cover the secured debt or capitalization or financial clean-up plans, IPAB's Governing Board will inform the Federal Executive and may resort to financing for that purpose.

Congress will make a special provision for any funds that IPAB may require in the Expenditure section of the Budget.

It was also stipulated that only after IPAB has provided a bank with financial support can its Governing Board appoint the person who will exercise cautionary administration. This administration enables the IPAB to be the bank's sole administrator, replacing the general shareholders meeting and its board.

IPAB may determine the dissolution and liquidation of banks or request suspension of payments or declare their bankruptcy. It will also perform the functions of settlor or syndicate for banks that are in the process of liquidation, suspension of payments or bankruptcy.

Furthermore it can acquire, either directly or through trusts in which it is a trustee bank, assets that are subject to financial clean-up programs and must manage and sell the assets with a view to obtaining the maximum recovery value possible. These sales will take the form of a public auction.

A Governance Board and an Executive Secretary are responsible for IPAB's administration and governance. The Governing Board comprises: the Minister of Finance and Public Credit, the Governor of Banco de México, the Chairman of the National Banking and Securities Commission and four members of the board appointed by the Federal Executive and approved by two thirds of the Senate, and during recesses by the same amount of members of Congress's Standing Commission. The Governing Board will remove the Executive Secretary.

It should be pointed out that the transitory regime of the Law establishes that the Federal Executive and Congress will take pertinent measures to ensure that audits of the Bank Savers Protection Fund (FOBAPROA) are completed within a maximum period of 6 months as of when the Law comes into effect such that to the extent the transactions of such Fund

are audited, responsibilities will be defined in the event of irregularities, and once the audits have been completed, banks may opt to terminate the agreements and cancel transactions with FOBAPROA and return the debt instruments issued to it and in exchange the Fund must return to banks the collection rights to the respective portfolio. At the same time the IPAB will grant a guarantee or payment instrument covering the aforementioned collection rights under the Rules issued by the Governing Board.

With respect to acts undertaken by the Federal Government and Banco de México to end FOBAPROA and the Stock Market Support Fund (FAMEVAL), it is established that IPAB will assume the loans Banco de México granted to the trusts and agree on the terms and conditions under which such financing will be discharged without charge to the IPAB, as far as Banco de México's results permit, without impacting the Bank's capital and reserves.

IPAB will proceed to evaluate, audit and complete the financial clean-up transactions begun by FOBAPROA corresponding to Banco del Atlántico, S.A., Banca Promex, S.A., and BanCreceer, S.A.

While articles 122 of the Law on Credit Institutions and 89 of the Stock Market Act were fundamental to the creation and functioning of FOBAPROA and FAMEVAL, respectively, the transitory regime stipulates that FOBAPROA will continue operating with the sole objective of managing program transactions known as capitalization and portfolio acquisition as well as undertake necessary acts to conclude the audits ordered by Congress.

It should be pointed out that the guaranteed debt regime provided for in the Law will come into effect on December 31st, 2005. Before this term expires IPAB will determine the guaranteed debt regime through a Board resolution that will be published in December each year.

### **Law on the Protection and Defense of Financial Service Users**

The aim of this law is the protection and defense of the rights and interests of public financial service users (users) and the regulation of the organization, procedures and working of the National Commission for the Protection and Defense of Financial Service Users (Commission).

The Commission's main powers include promoting, advising, protecting and defending the interests of users, acting as an arbitrator in disputes brought before it, and fostering fair relationships between users and banks; therefore, anyone who has a problem with banks will be able to submit a claim to the Commission.

In pursuit of its aim the Commission has full technical autonomy to dictate its resolutions and rulings and authority to levy the sanctions provided for in the Law. It should be mentioned that the Commission will not be privy to claims derived from variations in interest rates that users and banks agree on when these stem from adverse macroeconomic conditions as well

as matters deriving from banks' internal or contractual policies, and are not extremely burdensome or disproportionate for users.

The Governing Board and Chairman are responsible for managing the Commission. The Board is comprised of a representative of the Ministry of Finance and Public Credit, a representative of Banco de México, a representative of the National Banking and Securities Commission, a representative of the National Insurance and Surety Commission, a representative of the National System for Retirement Savings, and three representatives of the National Consultative Board and Chairman.

The Chairman will be responsible for the legal representation of the Commission and will be appointed by the Ministry of Finance and Public Credit.

Likewise, the Law provides that the Consultative Boards will assist the Commission and can be national or regional. These Boards provide an opinion and prepare proposals to ensure that the Commission's functions are carried out as best as possible.

Responsibility for the Registration of Financial Service Borrowers also lies with the Commission. Civil servants who provide authorization for the working and operation of banks must notify the Commission of this so they can be registered.

In order to create and foster an adequate financial service and transactions culture the Commission must disseminate information related to the diverse services banks offer among users.

Finally the Law regulates conciliation and arbitration procedures as well as reviews motions to challenge sanctions imposed by the Commission. It also indicates the requirements users must comply with in order to obtain free legal aid.

### **Amendments to the Laws on Credit Institutions, the Securities Market Act and Regulation of Financial Groups**

The main amendments to these laws include those related to the shareholder regimes of commercial banks, brokerage firms and brokerage specialists, and controlling companies; ordinary capital will be comprised of series "O" shares and along with series "L" shares will be freely subscribed so as to ensure greater foreign investment in the capital of such financial entities.

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<sup>1</sup> Circular-Telefax 24/98 directed at commercial banks.

<sup>2</sup> Circular-Telefax 52/98 directed at commercial banks.

<sup>3</sup> Circular-Telefax 32/98 directed at commercial banks.

<sup>4</sup> Circular-Telefax 4/98 directed at commercial banks 5/98 directed at development banks, both dated January 30<sup>th</sup>, 1998.

<sup>5</sup> Circular-Telefax 8/98 directed at commercial banks, Circular-Telefax 9/98 directed at development

- banks, dated March 9th, 1998.
- <sup>6</sup> Circulars-Telefax 27/98 and 28/98 directed at commercial banks and development banks, respectively.
  - <sup>7</sup> Circular-Telefax 10/98 directed at commercial banks.
  - <sup>8</sup> This provision was complemented by Circular-Telefax 20/98, directed at commercial banks.
  - <sup>9</sup> Circular-Telefax 57/98 directed at commercial banks
  - <sup>10</sup> Circular 1/98 directed at debt and equity mutual funds.
  - <sup>11</sup> Circular 1/98 BIS directed at debt and equity mutual funds.
  - <sup>12</sup> Circular-Telefax 30/98 directed at the country's banks.
  - <sup>13</sup> Circular-Telefax 31/98 directed at the country's banks.
  - <sup>14</sup> Circulars-Telefax 33/98, 34/98, 45/98 and 46/98 directed at commercial banks.
  - <sup>15</sup> Circulars-Telefax 37/98, 45/98 and 46/98 directed at commercial banks.
  - <sup>16</sup> Circulars-Telefax 35/98 and 36/98 directed at commercial banks and development banks, respectively.
  - <sup>17</sup> Circular-Telefax 38/98 and 40/98 directed at commercial banks and Circulars-Telefax 39/98 and 41/98 directed at development banks.
  - <sup>18</sup> Circulars-Telefax 58/98 and 59/98 directed at commercial and development banks, respectively.
  - <sup>19</sup> Circulars-Telefax 49/98 and 50/98 directed at commercial and development banks, respectively.
  - <sup>20</sup> Circular-Telefax 6/98 directed at commercial banks and Circular-Telefax 7/98 directed at development banks. Circular-Telefax 12/98 directed at commercial banks.
  - <sup>21</sup> Circular-Telefax 12/98 directed at multiple banks.
  - <sup>22</sup> Circular-Telefax 19/98 directed at multiple banks and Circular 69/94 Bis 5 directed at brokerage firms.
  - <sup>23</sup> Circular-Telefax 21/98 directed at commercial banks.
  - <sup>24</sup> Circular-Telefax 22/98 directed at banks.
  - <sup>25</sup> Circular-Telefax 58/98 directed at commercial banks and Circular-Telefax 59/98 directed at development banks.
  - <sup>26</sup> Circular-Telefax 25/98 directed at commercial banks.
  - <sup>27</sup> Circulars-Telefax 43/98 and 44/98 directed at commercial banks and development banks, respectively.
  - <sup>28</sup> Circulars-Telefax 55/98 and 56/98 directed at commercial and development banks, respectively and Circular 66/94 BIS 5 directed at brokerage firms.
  - <sup>29</sup> Circulars-Telefax 11/98, 13/98 and 14/98 directed at the country's banks and Circulars 93/98, 94/98 and 94/98 Bis directed at brokerage firms.
  - <sup>30</sup> Banks were informed of these procedures through Circular-Telefax 23/98.
  - <sup>31</sup> Banks were informed of these procedures through Circular-Telefax 29/98.
  - <sup>32</sup> Circular-Telefax 48/98 directed at the country's banks.
  - <sup>33</sup> Circular-Telefax 51/98 directed at the country's banks.
  - <sup>34</sup> Circular-Telefax 54/98 directed at the country's banks.
  - <sup>35</sup> Communication S11/039-98 directed at the Mexican Association of Retirement Fund Managers.
  - <sup>36</sup> Letter-Circular dated July 16, 1998 directed at the country's banks.