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# Mexican Banks Shift Bad Debt to Government

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--John Chambers and Lacey Gallagher

This article is based on presentations made by John Chambers and Lacey Gallagher, both of whom are based in the New York office of Standard & Poor's.

Standard & Poor's believes that the measures Mexican bank authorities have taken to shore up their country's financial system have been effective in partially restoring investor confidence, attracting fresh capital to the system, and granting some rate relief to the real sector.

However, the authorities have achieved these results by explicitly assuming much of the contingent liability that Mexican banks had long posed to the government.

Although this added liability for Mexico is material at 12% of GDP, Standard & Poor's believes that it is manageable within the context of the government's current financial position and is consistent with the country's 'BB' long-term foreign currency rating. However, the rating's negative outlook includes the possibility of even higher costs to Mexico as more banks seek special assistance from the government.

PROCAPTE Program

The first measure pertains to capital. The government's Deposit Guaranty Fund (Fondo Bancario de Proteccion al Ahorro, or Fobaproa) has established a temporary capitalization program known as Procapte (Programa de Capitalizacion Temporal). Banks whose capital levels fall below 8% of risk -adjusted assets will be required to issue five-year callable, mandatory convertible subordinated debentures to Procapte. The debentures will convert into common shares sufficient to restore the bank's capital to a 9% level. If, before five years, the bank's capitalization falls below 2% for tier I capital or if it is 25% less than the average of the banks participating in the program, the debentures convert into shares immediately. Once the shares convert, the government will sell the shares on the market. To ensure that this scheme will not boost the country's money supply, banks participating in the program are required to deposit the proceeds at the central bank.

On March 31, the Comision Nacional Bancaria y de Valores (CNBV) announced that six banks would participate in Procapte. The six are:

* Banca Serfin for N$3.2 billion;

* Banco Inverlat for N$1.4 billion;

* Banco Internacional for N$700 million;

* Banco del Centro for N$452 million;

* Banca Confia for N$425 million; and

* Banco de Oriente for N$311 million.

In terms of potential dilution for shareholders, Banco de Oriente subscribed for an amount that is 130% of its equity, Banca Serfin for 73% of its equity, and Banco Inverlat for half of its equity.

In Standard & Poor's view, the Procapte program helped restore investor confidence during the difficult spring months and provided an incentive for shareholders, over the course of five years, to restore their banks' capital to adequate levels or face dilution. The disadvantages of this program are that it provides no cash to the banks, and a five-year period to restore capital to minimum levels could be viewed as generous.

Unidades de Inversion

A second key program the banking authorities initiated pertains to liquidity support for Mexican borrowers. This program, announced at the end of April allows banks to reschedule up to N$165 billion of loans, a quarter of the system's total, and creates a new unit of account, unidades de inversion, or UDIs.

Eligible loans will be placed in a trust and their terms renegotiated, lengthening their maturity to up to 12 years and changing the denomination of the loan to UDIs, which are peso units of account linked to the government's consumer price index. The trust will be funded by loan loss reserves from the banks in the amount of 15% of the loans and from government funds bearing interest at UDI plus the margin on pension

funds, known as SAR (Sistema del Ahorro para el Retiro).

The banks, in turn, will be required to hold on their balance sheets non -negotiable government bonds equal in amount to the trust's funding. These zero coupon notes will accrete interest at the rate on Mexican bills (cetes). As the loans in the trust are repaid, the government funding will be retired and the non-negotiable bonds on the banks' balance sheet redeemed.

The economic effect of this plan, from the banks' point of view, is that it provides them long-dated UDI funding for the trust's assets. It is like an asset swap, in which the bank exchanges loans to be "udiized" for a zero coupon government note.

The trusts will cover the UDI payments to the government with interest from the restructured loans. At the bank level, so long as its average cost of funds is below the cetes rate, it will have a positive carry on the nonnegotiable cetes-pay instruments, although they will be a cash flow drain.

From the government's point of view, it is inflating its balance sheet with a liability equal to 85% of N$165 billion and with an asset backed by restructured loans with recourse to Mexico's troubled banks.

Potential Negative Effects of the UDI Program

The burden of this program is hard to evaluate. First, there is the basis risk, which has to weigh either on the government or on the banks. Second, the government's asset--the receivable from the trusts--is backed by assets that are weak loans of weak banks. The Chilean experience of the 1980s argues that a lot of the loans will never be repaid and that some banks will not be able to make up the difference. By indexing the problem, it is only compounded. Third, the scheme introduces backward-looking indexation, which is already showing signs of spreading to the nonfinancial sector. This problem is mitigated partly by having the index calculated with only a 10-day lag.

Moreover, the scheme grants only partial relief to borrowers. Its main benefit is that it provides them

long-term funds. However, the rate relief is minimal.

The mechanism has the effect of transferring high interest payments now for high principal payments later.

Borrowers who have weak pricing power may remain liquid under this scheme, but their solvency will be impaired. If they enjoy liberal grace periods, however, their eventual liquidation will be postponed.

More worrisome is that the scheme allows the banks to mask their problems. The trust will require no initial capital and 15% reserves (40% for mortgages). This level is less than all loan categories except A and B loans.

Although the government securities that will replace the transferred loans will be 100% risk weighted, the act of transferring loans will free up loan loss reserves (beyond the 15%) for allocation to loans remaining on the bank's core balance sheet.

All loans in Mexico are graded on a scale of 'A' to 'E.' Loans graded 'E' will not be eligible for the trust. Going forward, loan grading will take place at the bank and at the trust simultaneously, although the latter will not begin until 1996. Standard & Poor's believes that Mexican banks could make their loan grading more rigorous, and does not expect the act of downloading loans to a trust will, in itself, improve this process.

 

Although the stronger banks will not grant grace periods to borrowers transferred to the trust and although Standard & Poor's expects that the CNBV will be vigilant in monitoring banks that may try to abuse the UDI program, Standard & Poor's still expects some faltering borrowers to obtain grace periods of up to seven years. In nominal terms, a UDI loan with a seven-year grace period is equivalent to capitalizing interest for seven years. Even a bankrupt company can make interest payments on a (steadily increasing) principal amount; thus, the true state of the portfolio will not emerge until the first installment is due.

Any analysis of Mexican banks, therefore, must examine both the bank and its trust, as the bank is still liable for the trust's solvency. At the bank level, loan quality will improve to the extent the teetering loans, except the 'E' loans, are transferred to the trust. On the other hand, margins may fall, as high-yielding assets are replaced with non-negotiable securities paying the cetes rate. At the bank level, capitalization and reserve levels will seem to improve.

Economically, however, asset quality will improve only if the long-dated funds stave off what would have otherwise been the liquidation of solvent, yet illiquid, firms. In the longer term, asset quality will improve only if inflation is contained and the country's economy begins to grow again.

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