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Abstract

On December 22, 1994, the Mexican government allowed the peso to float freely against the US dollar, aggravating the run on peso deposits, leading to the rapid devaluation of the peso, and sparking the peso crisis. The following week, the Bank of Mexico announced that the Mexican deposit insurer would fully guarantee all commercial bank deposits and liabilities except subordinated debt. The announcement of the blanket guarantee appeared effective at reassuring foreign investors, as the central bank was soon able to ease the liquidity support that it had been providing to banks during the crisis. The government created a deposit insurer, the Bank Fund for Savings Protection (Fondo Bancario de Protección al Ahorro, or FOBAPROA), in 1990. Over the next two years the government privatized government-owned banks. Every December, the Bank of Mexico was responsible for announcing which bank liabilities FOBAPROA would cover and the coverage limit for the following year. In its 1993 statement, under financial and political pressure, the Bank of Mexico announced a similar blanket guarantee of bank deposits and liabilities as a preemptive measure to reassure market participants about the soundness of the newly privatized banking system. The Mexican government took a number of other actions to protect the banking system as the financial crisis deepened in 1994 and 1995. The central bank opened a US dollar credit window for commercial banks; the government also charged FOBAPROA with bank recapitalization and the purchase of nonperforming loans from troubled banks. In December 1998, the Mexican Congress replaced FOBAPROA with the Institute for the Protection of Bank Savings. This move corresponded with a gradual transition from FOBAPROA's blanket guarantee to a more limited guarantee. The gradual reduction of the guarantee began in 1999 and ended in 2005.

Keywords: banking crisis, bank resolution, blanket guarantee, FOBAPROA, Mexico

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[1] This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering blanket guarantee programs. Cases are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/.

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Overview

On December 22, 1994, the Mexican government allowed the peso to float freely against the US dollar, aggravating the run on peso deposits. Prior to this announcement there was significant political turmoil, which, combined with weakened demand for peso assets and the government's issuing short-term dollar-indexed notes, left the Mexican government vulnerable in the event of a peso devaluation. Ultimately, the government decision to let the peso float led to the rapid devaluation of the peso and sparked the Mexican peso crisis. The following week, the Bank of Mexico announced that the Mexican deposit insurer would cover all commercial bank deposits and liabilities except subordinated debt. The announcement appeared effective at reassuring foreign investors, as the central bank was able to ease the liquidity support that it had been providing to banks before the announcement (Laeven and Valencia 2008).

Key Terms

Purpose: "[T]o protect investors from any loss in case of insolvency of Credit Institutions" (Haber 2005, 2333).

Launch Date(s)	Announcement: December 30, 1993, and December 29, 1994
End Date(s)	Gradually removed from 1999 to 2005
Eligible Institutions	All commercial banks
Eligible Liabilities	All unsubordinated liabilities
Fees	Monthly contributions from commercial banks, calculated annually based on the amount of protected liabilities
Coverage	Unknown
Outcomes	The total cost of Mexico's crisis policy was about 15% of its GDP in 1998
Notable Features	FOBAPROA purchased nonperforming loans and recapitalized banks

The government had created a deposit insurer, the Bank Fund for Savings Protection (Fondo Bancario de Protección al Ahorro, or FOBAPROA), in 1990. Over the next two years the government privatized government-owned banks through auctions that ended in July 1992. (La Porta, Lopez-de-Silanes, and Zamarripa 2002). Between 1991 and 1994, the proportion of nonperforming loans (NPLs) in Mexican banks rose from 4.1% to 7.3%, gross past-due loans tripled, and total real bank lending doubled, outpacing growth in deposits (Haber 2008; Hernandez-Murillo 2007).

Every December, the Bank of Mexico was responsible for announcing FOBAPROA's coverage limit for the next year (Bank of Mexico 1993; 1994). In 1993 and 1994, when Mexico began experiencing a financial crisis, instead of setting a specific coverage limit, the Bank of Mexico's statements established a guarantee on all liabilities of commercial banks except subordinated debt (Haber 2005; World Bank 1998). The 1993 announcement was preemptive, to protect the recently privatized banking system, and the 1994 announcement followed the Mexican peso crisis. Similar announcements were made every year through 1997 (Mackey 1999).

Political turmoil during 1994 and 1995 and authorities' allowing the peso to float in December 1994 added further pressure (Laeven and Valencia 2008). The crisis of 1994 and 1995 led to a more than 90% depreciation of the peso, an increase in interest rates, inflation greater than 50%, and a decline in GDP by 6.2% by the end of 1995 (Sánchez 2009). The rapid rise of interest rates led performing, risky loans into default, creating a growing share of NPLs and a shrinking deposit base. The National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, or CNBV) took over banks that were in serious distress—replacing management, suspending shareholder rights, removing NPLs and injecting capital through FOBAPROA, and arranging for the bank to be sold to another institution. In total, the CNBV took over 12 banks between 1994 and 1997 (Graf 1999; Haber 2008). The total cost of Mexico's crisis policy was about 15% of its GDP in 1998.

At the beginning of the blanket guarantee, the Mexican government announced that it was a temporary measure and ultimately would be replaced by limited deposit protection (IADI 2005). In December 1998, Congress replaced FOBAPROA with the Institute for the Protection of Bank Savings (Instituto para la Protección al Ahorro Bancario, or IPAB). This move corresponded with a transition from FOBAPROA's blanket guarantee to a limited guarantee (Hernandez-Murillo 2007). The government gradually reduced IPAB's deposit guarantee between 1999 and 2005 to avoid disrupting banks (Sánchez 2009).

Summary Evaluation

In a 1998 report, the World Bank commends Mexico's bank support programs for restoring "a degree of confidence in the Mexican banking system," stating that the blanket guarantee was "an underpinning of this confidence" (World Bank 1998, 16). In 2008, Laeven and Valencia, two International Monetary Fund (IMF) economists, note that following the 1994 announcement, the central bank's liquidity support to banks declined, suggesting that depositor withdrawals had eased. The IMF paper points to this as evidence that the blanket guarantee was initially successful in improving public confidence (Laeven and Valencia 2008).

Another issue the World Bank brings up is that the guarantee distorted banks' incentives and was an obstacle to adequate supervision. Mexico had only recently privatized its banks and, as noted by the World Bank, there was a long-standing implicit guarantee because of the government's relationship with the banking system. This implicit guarantee was an obstacle to market-based supervision of banks. The World Bank also notes that the broad guarantee made bank resolutions more costly than if the government had forced large depositors and bond holders to share in the losses from bank failures (World Bank 1998). The guarantee covered all banks regardless of creditworthiness, and some analysts observe this as having given banks with lower capital an incentive to take on more risk (Hernandez-Murillo 2007).

During this period, some bankers took advantage of the guarantee by making large loans to themselves and then defaulting on the loans. From 1995 to 1998, 20% of large loans went to bank directors—these loans had a 4% lower rate of interest, 33% higher probability of default, and 30% lower collateral recovery rate than arm's-length loans (Haber 2008).

One of the reasons the party in power at the time lost control of Congress in 1997 was that the actions of the CNBV and FOBAPROA were perceived by many as a bailout of wealthy stockholders financed by taxpayers. The new Congress carried out a nine-month investigation into FOBAPROA and the bailout and ultimately disbanded FOBAPROA and replaced it with IPAB (Haber 2008).

Context: Mexico 1993–1994		
GDP (SAAR, nominal GDP in LCU converted to USD)		$500.7 billion in 1993
		$527.8 billion in 1994
GDP per capita (SAAR, nominal GDP in LCU converted to USD)		$5,650 in 1993
		$5,854 in 1994
Sovereign credit rating (five-year senior debt)	1993	Moody's: Baa1
		S&P: AA-
		Fitch: Data not available
	1994	Moody's: Baa1
		S&P: A+
		Fitch: Data not available
Size of banking system		$152.3 billion in 1993
		$203.9 billion in 1994
Size of banking system as a % of GDP		30.4% in 1993
		38.6% in 1994
Size of banking system as a % of financial system		Data not available in 1993
		Data not available in 1994
Five-bank concentration of banking system		Data not available in 1993
		Data not available in 1994
Foreign involvement in banking system		Data not available in 1993
		Data not available in 1994
Existence of deposit insurance		Yes in 1993
		Yes in 1994
Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset.		

Key Design Decisions

1. **Purpose: The 1993 and 1994 announcements indicate that the purpose of the blanket guarantee was "to protect investors from any loss in case of insolvency of Credit Institutions."**

In 1990, Mexico created FOBAPROA, a deposit insurance system. Then, in 1991 and 1992, the government privatized the Mexican banking system (La Porta, Lopez-de-Silanes, and Zamarripa 2002). In December 1992, the Bank of Mexico announced FOBAPROA's coverage limit for 1993. Then in December 1993, to preemptively protect the newly privatized banking system, the Bank of Mexico announced its intention to protect all liabilities the next year. A similar statement was made in December 1994 following a run on the peso (Haber 2008). The Bank of Mexico's announcement in both years noted that there was an established "tradition that the Mexican financial authorities try to protect investors from any loss in case of insolvency of Credit Institutions" (Mackey 1999, 53). The historically close relationship between the Mexican government and the banking system adds context to why the Bank of Mexico was so quick to express its intent to guarantee all unsubordinated liabilities in 1993, before the crisis was in full force.

2. **Part of a Package: The Mexican government adopted the blanket guarantee as part of a larger bailout of the country's banking system that included establishing a US dollar credit window for commercial banks, recapitalization, and restructuring.**

During the Mexican financial crisis, the Mexican government used several measures to stabilize the financial system in addition to the blanket guarantee. The central bank opened a US dollar credit window for commercial banks; the government also charged FOBAPROA with recapitalizing banks and buying NPLs from troubled banks (Haber 2008; Sánchez 2009). When needed, the CNBV resolved failing banks. In total, the CNBV took over 12 failing banks—suspending shareholder rights, replacing management, buying NPLs and injecting capital through FOBAPROA, and facilitating the sale of the bank. The CNBV did not resolve the two largest banks but did replace their management and find merger partners. Notably, several of Mexico's banks were considered too big to fail, specifically the two largest banks, which were not completely resolved. FOBAPROA's purchases of NPLs lasted through 1998.

The Mexican government also received funding from the IMF to address the liquidity problem caused by short-term obligations maturing. The IMF funding intended to convert short-term debt and reverse the depreciation of the peso (IMF 1996). The United States' Exchange Stabilization Fund also allowed the US to assist Mexico via swap lines, starting in 1994 (GAO 1996). These swap lines from the Federal Reserve for USD 30 billion lasted until October 2009 (Sánchez 2009).

3. Legal Authority: In 1990 the Mexican government established a deposit insurance agency, FOBAPROA, which the Mexican congress disbanded in 1998.

On July 18, 1990, the Mexican government adopted the Credit Institutions Law to establish a framework for banking in the private sector (World Bank 1995). The same year, the administration created a deposit insurance agency, FOBAPROA (Hernandez-Murillo 2007). FOBAPROA was governed under the principal statute governing the activities of commercial banks, Article 122 of the Credit Institutions Law. This article established the goal of FOBAPROA, to "provide preventative support to commercial banks and protect savings" (World Bank 1995, 96–97). This article also required the Bank of Mexico to, each December, announce the maximum amount that would be covered by FOBAPROA the next year.

In 1993 and 1994, FOBAPROA did not announce a deposit insurance limit, instead making a statement establishing an intention to cover all liabilities except for subordinated debt (Laeven and Valencia 2008).

FOBAPROA was also used for other banking policy. In 1995, FOBAPROA was used by the Bank of Mexico to offer short-term dollar-denominated credit to banks (Hernandez-Murillo 2007). As part of the banking system bailout, FOBAPROA held government funds to be used to help banks, and the government used FOBAPROA to purchase NPLs from troubled banks (Haber 2008).

In 1998, Congress disbanded FOBAPROA and replaced it with IPAB.

4. Administration: The Bank of Mexico managed FOBAPROA.

The Bank of Mexico was responsible for FOBAPROA's day-to-day operations (World Bank 1995).

5. Governance: FOBAPROA's policy decisions were made by a Technical Committee with representatives from the Bank of Mexico, Ministry of Finance and Public Credit, and the National Banking and Securities Commission.

The Technical Committee had nine members, four named by the minister of finance and public credit, one being the minister, three members appointed by the Bank of Mexico, one being the governor, and two members appointed by the CNBV, one being the president of the commission (World Bank 1995).

In 1998, after the bailout, a different party gained control of Congress and conducted a nine-month investigation into the bailout. Ultimately, Congress disbanded FOBAPROA and replaced it with IPAB (Haber 2008). IPAB was required to periodically publish its financial statements and report regularly to Congress (IMF 1999). FOBAPROA had never made its financial statements publicly available as of 1995 (World Bank 1995).

6. Communication: The blanket guarantee was introduced through announcements in 1993 and 1994 that expressed an intent to protect investors in case of insolvency.

The Bank of Mexico was responsible for announcing FOBAPROA's deposit coverage amount every December; in December 1993 and 1994, it did not announce a limit and instead announced a guarantee of all liabilities except subordinated debt. The announcement of a blanket guarantee in 1994 appeared to promote market confidence, as the Bank of Mexico was able to quickly reduce the liquidity support it provided to banks (Laeven and Valencia 2008). The Mexican government also announced that the blanket guarantee was a temporary measure and ultimately would be replaced by limited deposit protection (IADI 2005).

7. Source(s) and Size of Funding: Funds came from commercial banks and the Bank of Mexico.

FOBAPROA's funding came from contributions from commercial banks and loans from the Bank of Mexico. The banks' contributions were based on the amount of liabilities protected by FOBAPROA. The central bank and the Ministry of Finance and Public Credit were authorized to fund FOBAPROA. Article 122 of the Credit Institutions Law stated that the minister could establish contributions to be paid by the commercial banks to fund FOBAPROA (World Bank 1995).

The Bank of Mexico was supposed to be fully reimbursed for loans to FOBAPROA through contributions from the banking community and the liquidation of assets.

8. Eligible Institutions: All commercial banks established in Mexico were eligible.

The blanket guarantee covered all commercial banks (World Bank 1998).

9. Eligible Liabilities: All unsubordinated liabilities were eligible.

The blanket guarantee covered all unsubordinated liabilities, including interbank deposits as of the 1995 announcement (Laeven and Valencia 2008; World Bank 1998). The guarantee covered all deposits equally, regardless of the creditworthiness of a bank or the amount of its deposits (Hernandez-Murillo 2007; La Porta, Lopez-de-Silanes, and Zamarripa 2002). The guarantee excluded liabilities resulting from "illicit, irregular, or bad faith operations" (Mackey 1999, 53).

10. Fees: Contributions from commercial banks were made to FOBAPROA every month and calculated annually based on the amount of covered liabilities.

Commercial banks funded FOBAPROA through contributions calculated annually and paid monthly. Banks' contributions consisted of ordinary and extraordinary contributions collected by the Bank of Mexico—ordinary contributions could be up to 0.5% of protected liabilities and extraordinary[3] contributions could be up to 0.7% of protected liabilities (World Bank 1995).

11. Process for Exercising Guarantee: The process associated with exercising the guarantee is not clear.

Research did not reveal the process for exercising the guarantee.

12. Other Restrictions: Article 122 of the Credit Institutions Law provided FOBAPROA could require a guarantee from banks receiving preventative support.

Article 122 of the Credit Institutions Law, which governed FOBAPROA, provided that if a troubled bank received preventive support, FOBAPROA could require a guarantee from that bank. This guarantee could be in the form of a lien over the shares of the bank. Later amendments to the Credit Institutions Law specified that FOBAPROA's lien was preferential over preexisting encumbrances and allowed FOBAPROA to exercise corporate rights associated with the shares without executing the lien over the shares (World Bank 1995).

13. Duration: The blanket guarantee was announced in December 1993 as a temporary measure, though there was no specified end date at the time.

In December 1993, the Bank of Mexico did not announce a limit to FOBAPROA's deposit insurance coverage for the following year, creating a preemptive blanket guarantee for the next year. A year later, in 1994, the Bank of Mexico made a similar announcement instead of setting a limit for FOBAPROA, this time following the peso crisis (Laeven and Valencia 2008). Mexican authorities said that the guarantee would be a temporary measure when the measure was put in place, and it was gradually removed starting in 1999 and ending in 2005 (IADI 2005; Sánchez 2009).

[3] The circumstances under which extraordinary contributions would be collected are unknown.

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