CHAPTER 5

International Business Risks

By 1982, a decade after the first steps with foreign finance and the Euromarkets were given, Mexican banks had considerably expanded abroad and developed a strong international presence. Through their agencies and branches in the main world financial centers, the six largest banks of the country were managing assets for US$7.7 billion, an amount representing about one quarter of their balance sheets. The international activities of the foreign banking offices included some trade finance and the provision of financial services to Mexican clients abroad, but the lion's share of the business was sovereign lending. As of end-1982, about 60% of the assets of the foreign agencies and branches consisted of international loans, of which as much as 91.2% was owed by Mexican borrowers. To finance these loans, the agencies relied almost entirely on the funds they could raise in the US wholesale money markets or through international Eurocurrency interbank transactions.

This chapter analyzes the risks and vulnerabilities of the international business model of Mexican banks and the severe financial problems that they confronted in the wake of the crisis. The use of wholesale liquidity, which consisted essentially of short-term fundraising instruments with maturity ranging from overnight up to six months, to finance long-term sovereign loans was not a very prudent strategy. It was also careless to grant most of the credits at predetermined fixed interest rates, while the interbank lines used to fund such lending were arranged at variables or floating rates. Another worrisome practice behind the

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intermediating activities of the overseas agencies and branches related to foreign exchange, since their liabilities were in dollars, but the bulk of the loans were granted to Mexican borrowers that operated mainly in pesos. Although not currency mismatched in their cross-border operations, their borrowers were and, consequently, the agencies were still exposed to foreign exchange risk and the balance sheet effects associated with a potential devaluation.

The dangers of the international activities of Mexican banks and their network of agencies and branches overseas came into sharp focus during the wake of the crisis. With the moratorium declaration of the Mexican government in August 1982, the fundraising activities that Mexican banks were undertaking in the international wholesale markets came under severe strains. As the perception of risk increased, international banks became reluctant to operate with their Mexican counterparts and they started to retrench the credit lines with them. Interbank funding became more expensive and available at shorter term, which aggravated the interest rate and maturity mismatches that the agencies had accumulated in their books. The drain of interbank funding created significant liquidity pressures on Mexican foreign agencies and compromised the external position of their parent banks, leading to the intervention of Banco de Mexico as well as the financial authorities of the host countries, namely the US Federal Reserve and the Bank of England, to secure their financial situation.

The liquidity problems encountered by the Mexican banks abroad revealed the existence of important loopholes in international financial regulation and misunderstandings about lending of last resort policies in the Euromarkets. In a context in which Banco de Mexico's international reserves were largely insufficient to meet the foreign exchange needs of Mexican banks, the possibility that they failed to reimburse their interbank obligations went beyond national borders and became a matter of international concern. The repercussions of a payment disruption in the international money markets and the possibility of a liquidity crisis were major worries for developed countries financial authorities, and it was not clear who, if anybody, was to assist foreign banking institutions in the case financial support from their home countries was not to come. Significant differences and conflicting positions existed between the US Fed and the Bank of England, the institutions behind the two largest money markets in the world, as to their lender of last resort responsibilities.

Mexican International Banking Network

In the early 1980s, the Mexican banking sector reached the peak of international presence and culminated the process of foreign expansion initiated during the previous decade. By 1982, the network of foreign banking offices of Mexican banks operating overseas—without considering representative offices—was made up of 21 agencies and 6 branches in six different cities: Banamex, Bancomer and Banca Serfin with 4 each, Multibanco Comermex with 5 and Banco Mexicano Somex and Banco Internacional with two each.[1] In addition, Banamex was leading the consortium bank Intermex, which counted also with Nafinsa and Banco Nacional del Comercio Exterior among its shareholders since 1979, and Bancomer and Banca Serfin had participation in the ownership of the Libra Bank and Eulabank respectively. It was, however, through their network of foreign agencies and branches rather than the affiliated consortium banks, as described in previous chapters, that Mexican banks got a direct involvement with, and exposure to, the international capital markets.

Table 5.1 shows the volume of activity of the foreign agencies and branches of the six large Mexican banks operating in the world capital markets. As of June 1982, their consolidated balance sheets totaled about US$7.7 billion, of which Banamex and Bancomer accounted for US$4.2 billion or 54.5%. These two largest Mexican banks, which were also among the major ten Latin American banking institutions, had been the first to start their international expansion process and to operate in the Euromarkets. Multibanco Comermex and Banco International were at the third and fourth place with about US$1.1 billion in assets and liabilities each, followed by Banca Serfin and Banco Mexicano Somex with US$772.7 and 480.4 million respectively. Except for Banca Serfin, the other three banks, and especially Banco Mexicano Somex, opened their foreign offices much later during the early 1980s, and thereby by 1982 the volume of their operations was relatively less developed.

The USA, which was the main destination for Mexican banks, was also the place where the bulk of their foreign balance sheets were concentrated. By 1982, the six Mexican international banks had agencies in New York and, with the exception of Banco Internacional and Somex,

[1] CIEN-A13/E-68/Agosto de 1982, 18–20.

Table 5.1 Asset and liabilities of Mexican foreign agencies and branches (US$ million in June 1982)

	Foreign agencies and branches					
	New York	*Los Angeles*	*London*	*Cayman Islands*	*Nassau*	*Total*
Banamex	580.0	159.2	887.7	0.0	420.1	2047.0
Bancomer	1004.6	376.6	523.3	260.7	0.0	2165.2
Banca Serfin	33.1	228.2	310.0	0.0	201.3	772.7
Multibanco Comermex	204.9	215.6	400.9	280.0	25.0	1126.4
Banco Mexicano Somex	1.1	0.0	0.0	479.3	0.0	480.4
Banco Internacional	105.8	0.0	0.0	1015.4	0.0	1121.2
Total	**1929.6**	**979.5**	**2122.0**	**2035.4**	**646.4**	**7712.9**

Source FFIEC 002 Report and Bank of England, Task Force, 13A195/2

there was also strong presence in Los Angeles, which were the two major money market centers in the USA. In June of that year, the ten US agencies of Mexican banks accounted for US$2.9 billion or 37.7% of the consolidated balance sheets of the network of foreign banking offices in major international financial centers, with two-thirds located in New York and the remaining third in Los Angeles. London was the other major destination of the banks with four banking offices—Banamex, Bancomer, Serfin and Comermex—and US$2.1 billion of assets and liabilities. The Cayman Island offshore financial center had also four agencies with a similar aggregate volume of business, half of which belong to Banco International, which had 90% of their operations there and only 10% in New York. Finally, Banamex, Banca Serfin and Comermex had US$646.4 million booked in Nassau, an amount representing 8.3% of the balance sheet of all foreign agencies and branches.

To operate in the USA, Mexican banking institutions had to adopt a legal form as established in US regulation. At that time, there were three main organization structures available to foreign banking corporations willing to engage in the US banking market, and agencies and branches were the two most common ones.[2] According to US banking legislation,

[2] See Betsy B. White, 'Foreign Banking in the United States: A Regulatory and Supervisory Perspective', *FRBNY Quarterly Review* 7 (1982), 48–58.

agency banks were extensions of the parent banks in the country of origin and integral part of its capital base. They were allowed to lend and transfer funds and accept credit balances incidental to their customers' banking transactions—essentially clearing and compensating balances, but not to take domestic deposits. Their main activity, therefore, consisted on wholesale banking, trade financing and money market operations. Branches, on the other hand, were virtually identical to agencies, but they could offer a larger range of banking services that included the accepting of deposits from domestic and foreign residents. The fact that all ten offices of Mexican banks in the USA were legally licensed as agencies and not branches reveals the interest in accessing the money markets rather than conducting retail banking businesses. In the case of the UK, legislation did not contemplate a figure directly equivalent to the US agency, and the four London banking offices of Mexican banks adopted the statute of full service branches with authorization to develop both wholesale and retail banking activities.

A third organizational structure used by foreign banks to conduct businesses in both the USA and the UK—apart from consortium banks—were the subsidiaries. Unlike agencies and branches, which acted essentially as wholesale banking offices, subsidiaries were separately capitalized banking entities subject to the same regulation than any other local bank. Thus, foreign banks willing to develop full consumer business activities, which often required having a bank with its own branch network and local identity, could directly charter a subsidiary or, as it was usually the case, buy an existing one with a retail branch network already established. In the case of Mexican banks, Banamex and Bancomer acquired two US subsidiary banks. Between 1979 and 1980, as part of its internationalization program, Banamex bought the Community Bank of San José and the Mexican-American National Bank of San Diego and merged them into the California Commerce Bank, which had seven branches in total. Likewise, in the spring of 1982 Bancomer purchased Grossmont Bank of San Diego, which had five branches in the state of California.

The balance sheet structure of these two Mexican subsidiary banks illustrates the different type of business that they developed when compared to agencies. As of June 1982, the total assets of the California Commerce and Grossmont Bank reached US$307 and 141 million, and their equity US$12 and 21 million respectively. Data compiled by the Federal Reserve Bank of New York (FRBNY) at the time of the

Mexican crisis show that these subsidiary banks were largely focused on local retail banking. In both cases, the loan portfolio represented about 60% of their assets, 40–45% of which had been granted to commercial and industrial corporations, between a fourth and a third was real estate credit, and the remainder were loans to individuals for household, family and other personal expenditures (basically consumer-oriented advances).[3] On the liability side, deposits were their main fundraising instrument. In the case of the California Commerce Bank, for instance, deposits accounted for about 93% of the funding base, 14% of which were demand deposits and the balance of 86% were time deposits. There were no substantial transactions with federal funds or borrowing from other financial institutions in the money or interbank markets. Through these banks, Banamex and Bancomer looked to participate in the financing of the rapid growth of trade between the USA and Mexico and the provision of banking services to the Mexican clientele in California.

These subsidiary banks were the first incursion of Mexican banks into retail banking in the USA and they represented only a small part of their businesses there. In mid-1982, for instance, the assets of the California Commerce Bank represented about 15% of the balance sheet of the Banamex's US agencies, and the Grossmont Bank only 6.5% of Bancomer's. While the US subsidiaries were small banks conducting retail activities at a regional level, the agencies were involved in wholesale banking and sovereign lending, and thereby the scale and scope of the operations were substantially different. By that time, the US agencies along with the branches in London and the Caribbean offshore financial centers had become important extensions of Banamex and Bancomer overseas and they were at the heart of their international businesses. At an aggregated level for the six Mexican banks operating abroad, the assets managed by their international branches and agencies accounted for as much as one-fourth of the consolidated balance sheets in Mexico.

An Interbank-Based Business Model

The business model of the foreign agencies and branches of Mexican banks and the role that they had in the international activities of parent banks can be depicted through a balance sheet analysis. In this

[3]FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

regard, the most systematic and complete source of information available on Mexican banking offices abroad is the *Report of Assets and Liabilities of US Branches and Agencies of Foreign Banks* of the Federal Financial Institution Examination Council (FFIEC 002), available online in the historical commercial bank database of the Federal Reserve Bank of Chicago. With the approval of the International Banking Act (IBA) by the US Congress in 1978, which resulted from a rising controversy about the increasing expansion in the number and assets of foreign banks in the USA and the lack of federal regulation and supervision of their activities, Mexican banks as well as other foreign banking offices operating in the USA had to complete a detailed regulatory form and submit it to supervisory agencies quarterly, with the first report on condition filed in June 1980.[4]

An examination of the asset and liability structure of the US agencies serves to illustrate the business pattern behind the international activities of Mexican banks. As shown in the previous section, the USA was the only country where all Mexican banks involved with foreign finance had direct presence and the US agencies represented over a third of the volume of business of all the banking offices abroad. Figure 5.1 represents the liability composition of the six Mexican banking agencies in New York and the four in Los Angeles at a consolidated level as of end-June 1982. Borrowed money, which consisted of funding lines from other banking institutions in the form of interbank certificates of deposits or due bills, was their main fundraising instrument and accounted for about US$1.1 billion or 36.7% of the US$2.9 billion liabilities of the agencies. Excluding Banco Internacional and Banco Mexicano Somex, which opened their US agencies very late in the period and thereby had not a well-developed balance sheet structure as of mid-1982, the share of borrowed money as source of funding ranged between 30.7% for Bancomer and 57.4% for Banca Serfin.

Federal funds along with deposits and credit balances were the second largest sources of funding of the agencies. The federal funds, which consisted of overnight borrowing or purchases between banks and other entities in managing their reserves, accounted for 22.1% of agencies' liabilities on average, ranging from 10.6% for Banca Serfin and 26.1% for Bancomer. On the other hand, deposits and credit balances had a similar

[4] White, 'Foreign Banking in the United States', 52–56.

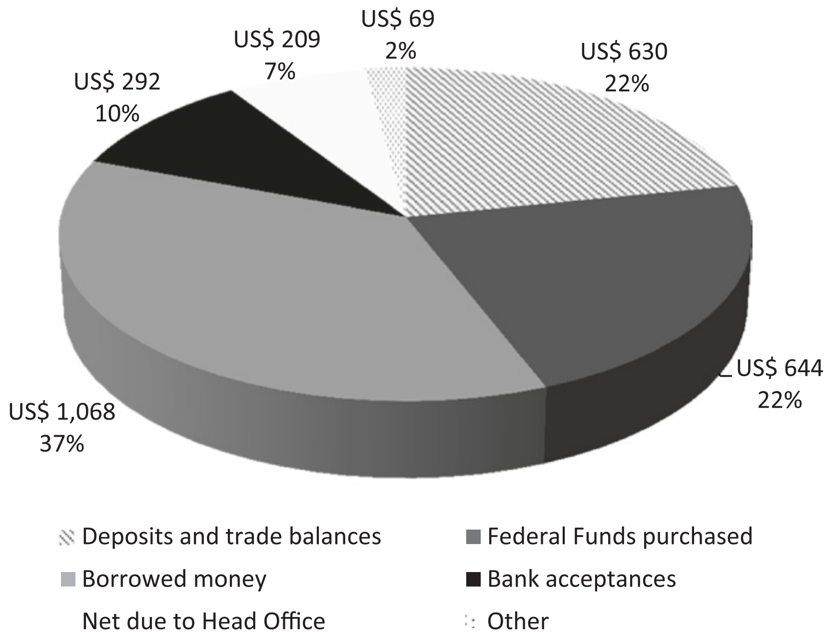

Fig. 5.1 Liability composition of the US agencies of Mexican banks (June 1982 in US$ million and %) (*Source* FFIEC 002 Call Report)

share of 21.9%, of which 65.5 and 32.3% were deposits from banks in foreign countries and commercial banks in the USA respectively, while the remaining 2.2% consisted of credit balances or deposits from individuals, partnerships or corporations. Finally, bank acceptances represented 10% of the total liabilities of the agencies, obligations to the head offices in Mexico 7.2%, and the remainder of 2% were miscellaneous liabilities.

The liability structure just described highlights the wholesale, interbank bias of the funding base of the agencies. The clear majority of the financial instruments that they used to raise funds were interbank transactions or money market facilities. In fact, at an aggregate level, only US$10.9 million or 0.5% of their liabilities was due to creditors other than banks, which shows the prominent role of financial institutions and wholesale liquidity as virtually the only source of funds for Mexican agencies. Through these agencies, parent banks had a direct line to access dollar funding in the US money markets, but also

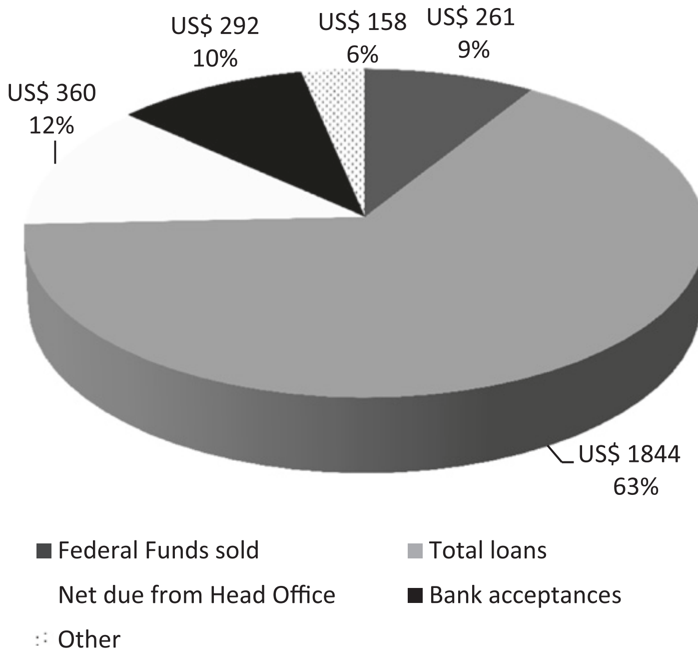

Fig. 5.2 Asset composition of the US agencies of Mexican banks (June 1982 in US$ million and %) (*Source* FFIEC 002 Call Report)

Eurocurrency wholesale liquidity because they could undertake cross-border transactions with banks in London. In fact, from the USA, the agencies could engage in operations with banks and other financial institutions not only there but also in other countries or international financial centers. Thus, interbank borrowing from the domestic and Eurodollar markets provided the US agencies of Mexican banks with a major source of the funding that they could use to conduct businesses in and outside the USA.

Figure 5.2 exhibits the asset structure of the agencies, which shows where they had been allocating these funds. As much as US$1.9 billion or 65.4% of the assets at a consolidated level were loans, of which 73.9% were commercial and industrial credits, 15.4% was lending to financial institutions and the balance has been mainly granted to foreign governments and official institutions. With a value of 81.7%, Banca Serfin was

the bank with the higher ratio of loan portfolio to total assets, while Bancomer was on the opposite extreme with a share of 66.9% and in all cases commercial and industrial credits accounted for over two-thirds of the agencies' loan portfolio. Lending was the main activity of the agencies and they were using the money raised in the international wholesale interbank markets to fund their credits. The asset and liability composition of the agencies makes clear a business model that essentially consisted in borrowing from banks operating in major international financial centers to relend these funds, notably to the industry and commercial sector, but also to foreign governments and other financial institutions.

This business model based on international wholesale funding and foreign lending was a salient feature of Mexican and developing countries banks participating in the Euromarkets. In a study on the development of the interbank market commissioned by the Institute of International Finance in 1985, the former French Executive Director of the International Monetary Fund (IMF) and Work Bank Paul Mentré makes direct reference to this pattern. Unlike the conventional use of interbank transactions to adjust the volume of assets and liabilities and to manage interest and exchange risk, "LDC commercial banks typically borrowed on the US domestic market or on the London dollar market to relend directly, or through offshore centers, to final borrowers." Moreover, as he adds, "during the years immediately preceding 1982, excess short-term borrowing by LDC banks, using their subsidiaries in industrial countries to channel long-term funds to their domestic borrowers, has been one of the catalysts of the 1982 crisis."[5] In the case of Mexican banks, it was not through the subsidiaries but rather the international network of agencies and branches in main financial centers that they were managing to do that.

The strategy employed by Mexican banks to raise funds in the international money markets is explicitly outlined in the minutes of Banamex's Executive Committee. During a meeting in May 1976, after highlighting the importance of the bank's agencies in New York and Los Angeles to support its corporate banking clients through the funds in dollars they were capturing abroad, Medina Mora asked the Committee for an authorization to make deposits with main international banks. As he explained to his colleagues, for these agencies to be able to raise funds

[5] FRBNY archive, Box 108403, The International Interbank Market and International Banking Lending, June 28, 1985.

"it was necessary a permanent presence in the international money markets, which impl[ied] (…) an active participation as buyers and sellers in the money market through the mechanics of interbank deposits." These interbank transactions were, in his words, "about a coming and going of money in which movement results a favorable [net] balance more or less permanent that [they] derive[d] to [their] clients, or that [they] used to buy money market instruments such as bank acceptances, certificates of deposits, commercial papers, etc."[6]

Thus, to access wholesale funding Mexican banks needed to participate on both sides of the money markets. This meant that "at the same time that [Banamex] receive[d] deposits from banks [Banamex] ha[d] to make [deposits] with them, otherwise [they] would be considered only as money takers, losing no only [their] image but also the possibility of continuing to operate."[7] From an operational perspective, the mechanism consisted in, as Director José Manuel Rivero would point up, "making placements with [lending banks], for example, placing $10 million with an institution that is providing $20 million to Banamex."[8] The relationship between federal funds purchased and sold by the US agencies of the Mexican banks illustrates this pattern at a money market financial instrument level. As of June 1982, their federal funds liabilities totaled US$645 million while the correspondent claims were US$261 million, leaving a favorable balance of US$378 million. By purchasing more than what they sold, Mexican agencies had a net borrowing position or were net takers of funds in that market.

It is also important to highlight the relationship between the assets and liabilities of the US agencies with their head offices represented in Figs. 5.2 and 5.1 respectively. These accounts capture the internal capital market transactions or transfer of funds between the US agencies and their parent banks in Mexico and thereby show the extent to which they lent to and borrowed from each other. The charts show that in June 1982, the US agencies had outstanding claims with the head offices in Mexico for US$360 million or 12.3% of their assets, while the corresponding obligations were US$210 or 7.2% of total liabilities. The

[6] Banamex archive, Libro No. 8 de Actas de la Comisión Ejecutiva, May 26, 1976 Meeting.

[7] Ibid.

[8] FRBNY archive, Central Records, BAC 1983: Office Memorandum, November 22, 1983.

US agencies had, therefore, a net creditor position *vis-à-vis* their head offices, meaning that they were channeling liquidity to their parent banks and providing them with part of the dollars that they raised in the international interbank market. Banamex was the only case in which the US agencies were net debtors to the head office, but during the previous quarters the situation was the other way around as it was also the case for the other Mexican banks. The higher proportion of inter-office claims relative to obligation illustrates the role assumed by the agencies in supplying foreign exchange and arbitraging domestic and international liquidity for their parent networks.

Although the Bank of England did not produce systematic information on the operations of Mexican branches in London as the FFIEC, data collected after the outbreak of the debt crisis by a Task Force show a similar asset and liability structure that their US counterparts. As of June 1982, as much as US$1.87 billion or 88.2% of the US$2.12 billion of total liabilities of the four Mexican branches in London were owed to banking institutions. 62.8% of this amount were due to banks operating in the UK, 21.5% to other banks overseas and the balance of 13.7% to own offices. In terms of assets, loans and advances to non-bank final borrowers accounted for US$984 million or 46.3%, while the remaining US$1.13 billion or 53.7% were claims on banking institutions. Like in the case of the US agencies, the London branches of Mexican banks were net debtors to banking institutions in the UK and abroad, and net creditors of their parent banks and own offices. Therefore, the same business pattern emerges with the branches borrowing in the UK and international interbank market to deploy these resources in extending loans to the non-financial sector as well as transferring liquidity to their homes offices in Mexico.[9]

Asset and Liabilities Imbalances

Financial intermediation by Mexican foreign agencies and branches generated some new risks and vulnerabilities associated with asset and liability management. The engagement in wholesale banking activities implied a number of financial transformations between the borrowing of funds in the interbank market and the provision of loans to non-banking final

[9] Bank of England archive, Task Force, File 13A195/1.

users. There was usually a geographic transformation, since funds were typically borrowed in a marketplace and lent in a different country, but also in terms of the maturity, currency and interest rate of the obligations and the corresponding claims. A prudent management of wholesale banking operations would have normally required liabilities to be reasonably balanced by claims in amount, period and currency as to ensure adequate funds available from maturing assets to repay obligations when they were to come due. Thus, to the extent that the balance sheet was not managed with enough regard for matching, banking institutions became exposed to changes on market conditions and thereby their financial position more fragile.

A first type of imbalance that arose in wholesale banking when providing loans financed through interbank borrowing concerned maturity. On the one hand, interbank funding was made up of short-term money market transactions, with maturities normally ranging between overnight and six months, although placements up to a year and over could be also arranged.[10] On the other hand, the credits that were granted with these funds had much longer term. Borrowing short and lending long is the typical maturity transformation performed in traditional banking by taking deposits that must be available on short notice and lending out the money that will not be available for a long time, which implies that banks take the risk of continuing to generate deposits to replace withdrawals. This risk is, however, considerably more important in the case of wholesale funding because interbank deposits or credit lines usually have shorter maturities than retail deposits and they are much more volatile.

Table 5.2 shows the share of short-term funding and loans in the balance sheet of the US agencies of Mexican banks. As of June 1982, 22% of the agencies' total combined liabilities consisted of federal funds and borrowed money of immediately available funds with one-day maturity and 19.1% were deposits or credit balances—essentially from banks—for 30 days ending with call date. Banamex and Comermex had the lowest and largest concentration of the funding base on these two financial instruments with a 20.6 and 64% respectively. On the asset side, 73% of the commercial and industrial credits, which were the major component of US agencies assets and their loan portfolio, as the previous section has shown, were due within the following year and the remaining 27% had a

[10] See BIS, 'The International Interbank Market: A Descriptive Study', BIS Economic Papers No. 8 (1982).

Table 5.2 Maturity balance sheet structure of the US agencies of Mexican banks (US$ million in June 1982)

		Assets			*Liabilities*		
		Loans due					
	Total Asset & Liability	*Within 1 year*	*Over a year*	*Other assets*	*Borrowings due in a day*[a]	*TD & CB for 30 days*[b]	*Other liabilities*
Bancomer	1385	554	134	697	361	350	674
Banamex	741	198	64	480	136	17	588
M. Comermex	421	154	97	170	199	71	151
Banca Serfin	261	98	57	106	58	69	135
Banco Internacional	106	22	31	53	50	52	4
B. Mexicano Somex	1	0	0	1	0	0	1
Total US agencies	**2915**	**1026**	**382**	**1507**	**644**	**558**	**1553**

Source FFIEC 002 Call Report
[a]Federal Funds and borrowed funds of immediately available funds with one day maturity
[b]Total deposits and credit balances for 30 days (or month) ending with call date

maturity of over one year. These figures make very clear the considerable extent to which the agencies relied on very short-term interbank liquidity to finance their loans.

A second type of mismatch that the agencies accumulated in their balance sheets concerned interest rates. At that time, interbank funding lines were typically arranged at LIBOR plus a premium, which would depend on the risk associated with the borrowing bank, meaning that virtually all the liabilities of the Mexican banks' agencies in the USA, as well as the branches in London and other financial centers that borrowed in the interbank market, had variable interest rates. In contrast, data from the memoranda of the FFIEC 002 reports show that in the case of the US agencies an important part of their portfolio consisted of claims arranged at predetermined or fixed interest rates. Figure 5.3 exhibits the breakdown of commercial and industrial loans of the US agencies of Mexican banks by interest rate type, showing the predominant part of credits with fixed rates. At a consolidated level, only US$416 million or 30% of the agencies' commercial and industrial loans had a floating interest rate, while the remaining US$992 million or 70% had been arranged at fixed rates. In the case of Banca Serfin and Banco Internacional, at

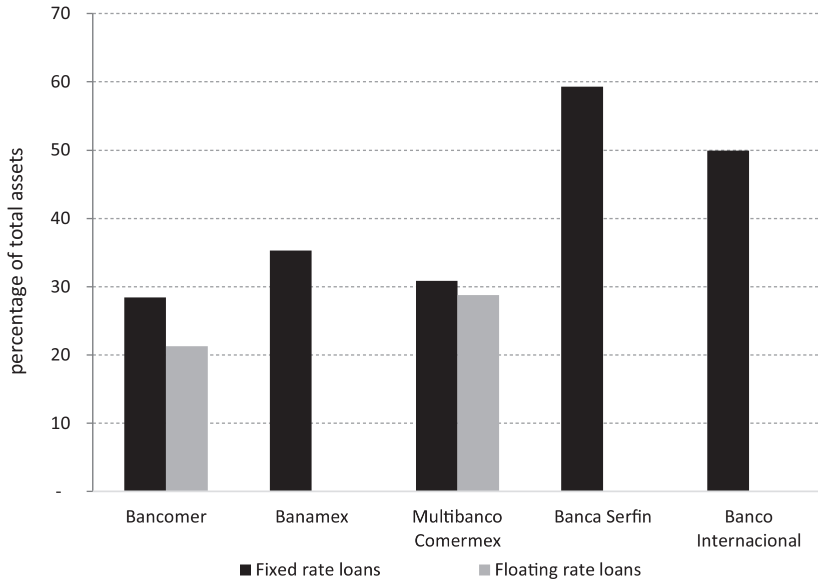

Fig. 5.3 Industrial and commercial loans of the US agencies of Mexican banks (June 1982) (*Source* FFIEC 002 Call Report)

least as much as 59.3 and 49.9% of their assets were loans with fixed rates respectively, while the correspondent shares for Bancomer, Banamex and Comermex stood between 28.4 and 35.3%. For its part, Banco Mexicano Somex, which had opened the New York agency in the early 1982, had not granted any loan by that time.

A final mismatch concerns the geographic scope of the foreign agencies and branches' activities. The data filed in the FFIEC 002 report distinguish between claims with and obligations to US addressees and non-US addressees, which allows to assess the extent of cross-border transactions and the pattern behind them. Table 5.3 shows the part of the assets and liabilities of the US agencies in and outside the USA. While average obligations to creditors domiciled in the USA accounted for 67.6% of the agencies' total liabilities, 73.3% of their claims were due to clients abroad. Apart from the new Somex agency, Banamex had the

Table 5.3 Cross-border balance sheet structure of the US agencies of Mexican banks (US$ million in June 1982)

	Assets				*Liabilities*			
	In the US		*Outside the US*		*In the US*		*Outside the US*	
	US$ m	*%*	*US$ m*	*%*	*US$ m*	*%*	*US$ m*	*%*
Bancomer	366	26.4	1019	73.6	975	70.4	410	29.6
Banamex	170	22.9	572	77.1	362	48.8	380	51.2
M. Comermex	129	30.6	292	69.4	341	81.1	80	18.9
Banca Serfin	88	33.5	174	66.5	206	78.7	56	21.3
Banco Internacional	26	24.6	80	75.4	89	83.9	17	16.1
Banco M. Somex	1	95.1	0	4.9	0	0.0	1	100.0
Total US Agencies	**779**	**26.7**	**2136**	**73.3**	**1972**	**67.6**	**943**	**32.4**

Source FFIEC 002 Call Report

lowest share of liabilities to US lenders, which represented about half of its funding base, but the bulk of the non-US borrowing that was not due to the head office but coming from London or another international financial center where the bank was operating. Such cross-border structure is in line with the business model analyzed in the previous section, meaning that the Mexican agencies funded themselves in the US money markets or from US bank lenders to make international loans outside the USA or to non-US borrowers.

The cross-border imbalance of the asset and liability structure of the agencies is important because it speaks about the implicit currency risks behind their operations. Although the FFIEC 002 report does not provide information on the location of non-US claims, an internal memorandum elaborated by the staff of the FRBNY estimated that of the US$2.9 billion in assets of the US agencies of Mexican banks in June 1982, about 80–90% represented dollar claims with Mexican borrowers, and 60% were owed by the Mexican government or public sector.[11] These agencies, as well as the ones in London and the Caribbean offshore centers, were the operating arm of parent banks in the Euromarkets and intermediated foreign capital with final borrowers in their homes countries. Lending was made in dollars, but to borrowers with businesses mainly in pesos and not necessarily

[11]FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

to exporting firms with access to dollars. This means that, while the agencies might not have been currency mismatched in their cross-border operations, their borrowers were. They were consequently exposed to currency risk and to the balance sheet effects associated with a potential devaluation of the Mexican peso.[12]

The dangers of the mismatches incurred by Mexican banks when conducting their international activities worsened during the run-up to the debt crisis of 1982. On the one hand, after the arrival of Paul Volcker to the US Fed in 1979 and its decision to fight inflation through restrictive monetary policy, international interest rates experienced a sharp increase. Federal funds and prime rates, which averaged 11.2 and 12.6% respectively in 1979, climbed to a historic peak of over 20% during 1981, and the LIBOR and Eurodollar rates in London followed the same path.[13] With most of their assets arranged at fixed rates, the rise of the cost of funding could not be matched with an equivalent increase in interest income, creating thereby some financial pressures for the agencies. On the other hand, the devaluation of February 1982 and the subsequent payment problems of some private external debtors translated into increasing difficulties for Mexican banks to raise dollars in Mexico and service their foreign creditors. However, it was the outbreak of the debt crisis in August 1982 what brought the imbalances and weak financial position of the agencies and branches into sharp focus, delivering indeed a final blow to the international activities of Mexican banks.

The Impact of the Moratorium

On August 20, 1982, the Mexican government approached the international financial community and announced a temporary suspension of principal payments on external debt. The moratorium declaration did not only bring Mexico into default, but it also unleashed sovereign debt payment problems at an international level. In the next few months, a

[12] On the balance sheet effects of devaluations, see Paul R. Krugman, 'Balance Sheets, the Transfer Problem, and Financial Crises', in Peter Isard, Assaf Razin, and Andrew K. Rose (Eds.), *International Finance and Financial Crises: Essays in Honor of Robert P. Flood* (Boston, 1999), 31–56.

[13] Timothy Q. Cook and Thomas A. Lawler, 'The Behavior of the Spread Between Treasury Bill Rates and Private Money Market Rates Since 1978', *Federal Reserve Bank of Richmond Economic Review* November/December (1983), 3–15.

number of other heavily indebted developing countries with similar economic and financial difficulties pursued the same path, spreading the crisis regionally and all over the world. This marked the outbreak of the international debt crisis of the 1980s, which put a definitive end to the international bank lending boom and the petrodollar recycling process that had developed within the Euromarkets after the oil shock of 1973, launching a new phase of rescheduling and conditional lending as part of the negotiations of debtor countries with the group of international creditor banks, developed countries' governments and the IMF.[14]

The shrink in the flow of syndicated and direct Eurocredits to governments and the private and public companies from debtor countries was a salient implication of the crisis, but it also affected the international activities of their domestic banks. In the case of Mexico, the ability of the foreign agencies and branches to attract new funds from the world capital markets was seriously undermined. The international wholesale interbank market, which was the center of their funding operations, became highly sensitive about lending to Mexicans as the perception of risk increased. The policy of creditor banks in placing and lending in the interbank market was based on the creditworthiness of the borrower, which mainly relied on a country risk analysis. When assessing this risk, banks looked primarily to the nationality of the ownership but they also considered the location of the borrowing branch, treating with more caution those outside major financial centers.[15] Under this policy, as the BIS Interbank Market Study Group recognized, "it might be, for example, that the market comes to regard all banks of a certain nationality (e.g., Mexican) with some suspicion, perceiving the interbank operations with them more risky and therefore want to reduce their involvement with them."[16]

It was not a surprise therefore that when the country came into default, the confidence and credit standing of Mexican banks plunged, increasing their market risk and damaging their funding lines. Unlike in tranquil times when interbank placements were regarded as risk-free and trading volumes were large and automated within and across international financial centers, significant tensions and liquidity strains

[14] See, for instance, William R. Cline, *International Debt Reexamined* (Washington, DC, 1995).

[15] BIS, 'International Interbank Market', 35.

[16] BIS archive, File I/3A(3)M vol. 1: Policy Issue Paper, Draft of December 25, 1982.

could appear in the market when bad times emerged. Prior to the crisis, Mexican agencies and branches would typically roll over their interbank deposits when they came due, either by renewing them directly with the creditor bank or by borrowing from some other bank and refunding the first. However, when the crisis hit and concerns about banks from countries having debt-servicing problems raised, interbank credit lines became only available at shorter maturities and a higher price. Moreover, as lending banks began to implement and apply credit limits, in some cases Mexican banks became confronted with refusals on the rollover of deposits as they felt due.

Table 5.4 exhibits the net position of the Mexican branches in London as the percentage of total claims in different maturity bands and equivalent data for their interbank businesses. For the purpose of interpretation, a negative sign means that liabilities are larger than the correspondent assets, and therefore the branch is a net debtor or taker of funds at the given maturity band. Conversely, if there is a positive sign, the branch is a net creditor or lender. The net position of the branches highlights the great degree of maturity transformation performed by borrowing short and lending long, and how substantially the mismatch increased between August and November 1982. Lending in the three years and over band increased from 29.5 to 37% of total claims, while the sources of funding became shorter. On August 17, three days before the moratorium declaration, the share of liabilities with a maturity in excess of three months amounted to 36%, and by mid-November this proportion had fallen to 17%.

Regarding the interbank businesses, there was also a dramatic change in the maturity schedule. In the archival source, interbank is defined as the positions with UK banks and with bank overseas including the transactions with their own offices, which accounted for about 19% of their interbank liabilities and 73% of their interbank claims. The net position is given as a proportion of both total interbank liabilities and claims, since the former were significantly larger than the latter. The data in Table 5.4 show that the branches came to rely more on placements up to three months and less on six-month liabilities than before the outbreak of the crisis. The proportion of interbank liabilities with maturity of less than three months doubled from 30 to 59.8% of total interbank liabilities between August and November 1982, an increment that is even higher when considered as a percentage of interbank claims. Overall, the table illustrates the extent that the Mexican branches in London were relying

Table 5.4 Maturity analysis of the Mexican branches in London in 1982

	Net position		*Interbank business*			
	% of total claims		*% of total interbank liabilities*		*% of total interbank claims*	
	18-Aug	*17-Nov*	*18-Aug*	*17-Nov*	*18-Aug*	*17-Nov*
Less than 8 days	−5.8	+0.6	−6.3	−1.7	−11.8	−3.6
8 days–1 month	+2.1	−13.5	−1.6	−24.2	−2.9	−51.6
1 month–3 months	−14.2	−27.8	−22.1	−33.9	−41.1	−72.2
3 months–6 months	−14.1	+1.1	−21.6	+0.1	−40.1	+0.3
6 months–1 year	+2.0	−0.1	−0.1	−1.0	−0.2	−2.0
1 year–3 years	+7.0	+7.1	+1.1	+2.1	+2.0	+4.6
Over 3 years	+23.6	+30.4	+4.5	+5.5	+10.8	+11.8

Source Bank of England Archive, Task Force, 13A195/1

on the interbank market to fund longer-term lending to non-banks and how dramatically their funding sources shortened in the aftermath of the moratorium declaration.

The deterioration of the funding base of the Mexican foreign offices was also reflected on the price they had to pay for wholesale liquidity. The Mexican default, as next section explains in further detail, represented a major shock to the Eurocurrency interbank market and created tiering among banks and banking systems. The presence of tiering meant that instead of having uniform interest rates for all market participants, significant differentiation in spreads appeared according to creditworthiness and the assessment of the quality of the borrowing bank. While under normal market conditions, according to the Bank of England's International Division, the range of spreads was about 1/4 percent above LIBOR, it could extend to 1 or 2% in times of uncertainty and financial distress.[17] As for Mexican banks, though normally charged spreads of 1/8 percent or 1/2 percent at most prior to the crisis, by September–October 1982 they came pay rate premiums of 3/4 or 1% depending on the individual bank and its creditors. Lending banks began also to ask an extra fee or commission of 1/8 to 1/4 percent, which added to the greater spreads and arose premia up to 2% in some cases.

[17] John G. Ellis, 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin* September (1981), 351–64.

Furthermore, along with shorter maturities and higher spreads, Mexican branches and agencies suffered also from a shrinkage of wholesale funding lines. FRBNY's office memorandums on the meetings and calls held among Mexican authorities, US officials and international bankers refer to withdrawals by creditor banks and the drain of interbank deposits that followed the outbreak of the crisis. According to these records, large outflows of funds were indeed observed before the nationalization of Mexican banks in September 1, 1982, and the IMF-World Bank Annual Meetings in Toronto during the following week.[18] Between June and mid-November 1982, Mexican banks lost about US$500 million through their foreign banking offices and additional US$300 million up to the end of the year.[19] This amount represented an erosion of between 10 and 15 of the US$6.5 billion of interbank liabilities that their agencies and branches had as of mid-1982. Against the deposits that were paid off, the creditor banks responsible for the other 90% of interbank claims accepted to renew them, but at higher costs in terms of interest rate and with shorter maturity.

The dire funding conditions that Mexican banks faced in the international interbank markets created strong financial pressures in the foreign agencies and branches' balance sheets, calling into question their liquidity, and indeed solvency, position. Because the bulk of the assets were long-term loans to Mexican borrowers in debt payment difficulties or illiquid claims, their capacity to reduce the portfolio and adjust their position was very limited. Data submitted in August 1982 by Mexican banks to their national authorities show that the foreign agencies and branches were about US$6–6.5 billion mismatched in terms of their dollar assets and liabilities at a consolidated level. Of this amount, an estimated of US$1.25 billion was exclusively owed to the wholesale interbank market and was coming due by mid-September, while the remaining of US$4.75–5.25 billion were due to mature in the following months until the end of December 1982.[20] In the view of William Rhodes, the Citibank negotiator and chairman of the Bank Advisory

[18] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office Memorandum, October 19, 1982.

[19] FRBNY archive, Central Records, Bank Advisory Group November–December 1982: Office Memorandum, November 18, 1982.

[20] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

Group for Mexico, the US$6–6.5 billion mismatch in the dollar balance sheets of the Mexican agencies and branches was a potential "real bomb."[21]

Dealing with Liquidity Strains

Mexican banks confronted a series of difficulties and important challenges when looking to secure the financial position of their international agencies and branches during the aftermath of the debt crisis. On August 25, 1982, few days after the Mexican government declared the temporary moratorium on its external debt principal payments, Robert T. Falconer and Robert C. Flows from the FRBNY held "extensive conversations" (sic) with Mexican bankers about the situation of the agencies in the USA.[22] Both of them interviewed with representatives of four of the six Mexican banks operating in the country, namely Bancomer, Banamex, Banco Mexicano Somex and Banco Internacional, with the specific goal to learn about their liquidity position. They also asked about the availability of alternative sources to meet their funding needs given the new atmosphere of uncertainty and tensions that reined in the Eurocurrency wholesale and US interbank money markets as a consequence of the crisis.

Mexican bankers informed that they were still able to purchase overnight and term money in the Federal funds and Eurodollar markets, but that they were nevertheless working out credit lines with correspondent or partner banks in the USA and Europe. Marquis Gilmore, agent and senior vice president of Banco International's agency in New York, indicated, for instance, that they were capable to obtain the needed funds through its international banks correspondents and that they counted on continuing to draw upon them to make the payment that were coming due in the following months. In a similar vein, Manuel Farina, senior manager-finance of Bancomer's New York agency, reported that they had standby backup lines with several European banks, and that they could draw on these lines when no other sources of funds were available. Clifton Hudgins from Banamex said that the New York agency had confirmed term lines of credits for US$40 million with Bank of America,

[21] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Office Memorandum, August 25, 1982.

[22] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 25, 1982.

Chase Manhattan, Manufacturers Hanover and Security Pacific, and that they had an additional "overdraft" line with Manufacturers Hanover of US$120 million which had also been confirmed. Banamex also arranged "advance" lines with a number of other foreign banks, ranging in size from US$2 to 30 million that could be drawn down at the price of higher cost of borrowing and shorter maturity.[23]

Noteworthy, in addition to the credit lines worked out with correspondent banks, the US agencies of Mexican banks were receiving financial support from their home country. In the conversation with Falconer and Flows, Clifton Hudgins indicated that during the previous week Banamex' US agencies had received a shipment of currency for US$31 million from Mexico and that he was expecting more money to arrive in the upcoming days. As he explained to the FRBNY officials, these transfers represented dollars gathered by the head office through foreign exchange conversions in Mexico, but there was also financial assistance directly provided by the Mexican central bank. As a matter of facts, although there are no systematic or complete records of these transactions, data compiled in a FRBNY note of a Group of Ten (G10) governors' meeting at the BIS show that between Tuesday the 7th and Wednesday the 22th of September 1982, Banco de Mexico assisted the foreign agencies and branches of Mexican banks with at least US$311.3 million.[24] This amount represented about a quarter of the US$1.25 billion of their interbank liabilities that were coming due within that time, and 14.6% of the international reserves of Banco de Mexico, which totaled US$2.1 billion as of end August 1982.

Table 5.5 presents the breakdown of Banco de Mexico's "known" funding (sic) of Mexican agencies per day in the period September 7–22, 1982, as reported in the FRBNY archival source. Banamex was the main beneficiary of these funds, receiving US$118.5 million or 38.1% of the total amount, followed by Multibanco Comermex and Bancomer with about US$63 million or 20% each. Banco Internacional and Banco Mexicano Somex accounted for the balance with US$22.8 and 17.5 million respectively.[25] It is interesting to note the fact that those flows of funding are labeled in the document as "known," which would suggest

[23] Ibid.

[24] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[25] Ibid.

that there may have also been transfers in unknown amounts. If that is the case, as it probably was, the figures of the table would be underestimating the true extent of the financial assistance provided by Banco de Mexico to the international network of agencies and branches of Mexican banks at a time when they were increasingly confronted with liquidity problems and difficulties to raise dollars in the international wholesale interbank market.

However, the ability of Banco de Mexico to assist its banks with foreign exchange was very limited. In the midst of a major balance of payment crisis and dwelling international reserves, Banco de Mexico simply did not have enough resources to support the potential financial needs of the foreign agencies. Figure 5.4 plots the evolution at the dawn of the crisis of Banco de Mexico's total reserves against the estimated dollar liabilities of the London branches and US agencies of Mexican banks. The chart makes explicit the limited availability of the international reserves in relation to the external obligations of these agencies, which becomes more acute in the aftermath of the devaluation of the peso in February 1982.[26] In particular, the US$6–6.5 billion mismatch on the dollar balance sheet of the total network of foreign banking offices represented about 3 to 3.5 times the volume of international reserves of Banco de Mexico between August and December 1982. Furthermore, the interbank obligations of Mexican banks were just a portion of the amount of foreign exchange that the country was required to service from its US$84.1 billion of total external indebtedness by that time.

In fact, a considerable part of the dollars that Banco de Mexico used to assist the agencies were not own resources but external borrowing. According to the FRBNY records reported in Table 5.5, as much as US$218.3 million, or 70% of the US$311.3 million sent by Banco de Mexico to the foreign banking offices during September 1982, came from Federal Reserve swap lines. In addition, IMF historian James Boughton states that a "substantial portion" (sic) of the US$1.85 billion BIS bridge-loan approved in August 1982 was parceled out to repay a part of the outstanding claims during the interbank panic that broke out against Mexican banks on Tuesday, September 7.[27] In this respect,

[26] As of mid-1982, London and the USA accounted for about 65.2% of the total liabilities of Mexican foreign agencies (37.7 and 27.5% respectively), while the remaining 34.8% was in Nassau and the Cayman Islands.

[27] James Boughton, *Silent Revolution: The International Monetary Fund, 1979–1989* (Washington, DC, 2001), 301.

Table 5.5 Banco de Mexico's known funding of Mexican agencies (US$ million)

	September 1982							
	Tuesday 7	*Friday 10*	*Tuesday 14*	*Wednesday 15*	*Thursday 16*	*Friday 17*	*Monday 20*	*Wednesday 22*
Bancomer	40.0			4.6			17.0	
Banamex	36.0	52.0		6.5	13.0	11.0		
Banca Serfin		14.0		13.9				
Banco M. Somex	2.0	9.4		6.1				
M. Comermex				4.0		4.0	30.0	25.0
Banco Internacional		8.7	5.0	4.0				5.1
Daily total	78.0	84.1	5.0	39.1	13.0	15.0	47.0	30.1
Cumulative total	78.0	162.1	167.1	206.2	219.2	234.2	281.2	311.3
Of which swaps								*218.3*
Other								*93.0*

Source FRBNY Archive, Box 108406 (see text)

when reviewing the Mexican situation with its G10 counterparts, Bank of England Governor Gordon Richardson reported that indeed "most of the BIS-U.S. swap drawings have been for the purpose of providing funds for the Mexican offshore agencies and branches," while "the use of the swaps, other than for the Mexican banks' agencies, has been very modest." This funding was part of a financial package put in place by creditor countries to rescue Mexico, but, as Richardson pointed out, its use for assisting Mexican foreign agencies was not "what the facility was designed for."[28]

The reliance of Mexican authorities on foreign capital and international creditors for securing the external position of its banks is also evident from the other funding sources they intended to draw upon. Although US agencies of Mexican banks did not have access to lender of last resort facilities from the Federal Reserve, after the outbreak of the crisis, as Falconer and Flows reported, they "were all acting to make sure that they [were] in a position to borrow from the discount window."[29] In a discussion with Sam Cross from the FRBNY,

[28] FRBNY archive, Box 108406, Sam Y. Cross Chronological Files August–December 1982: Note, September 27, 1982.

[29] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 25, 1982.

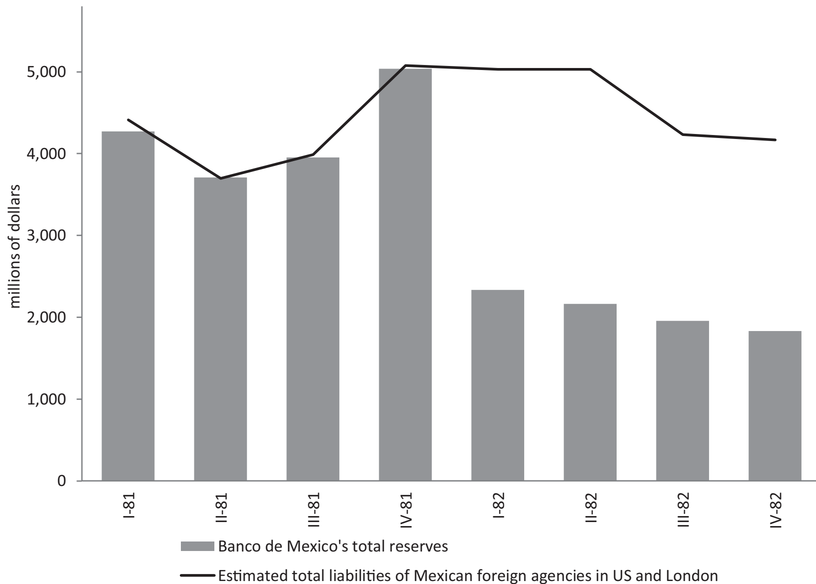

Fig. 5.4 Mexico's international reserves and banks' foreign liabilities (*Source* Banco de Mexico's 1983 Annual Report, FFIEC 002 Call Reports and Bank of England Archive, Task Force, 13A195/1)

Angel Gurría, Mexico's Director of Public Credit and leading external debt negotiator, explicitly stated that Mexican authorities were counting on Federal Reserve discount facilities to handle the possible dollar needs of these agencies. Raising doubts about the availability of such funding, Cross said that it "might be wise to consider how best to deal with any problem with [Mexico's] own resources," to which Gurría replied that "they would be happy to support Mexican banks," but "[they] were a 'little' [sic] short of cash."[30]

[30] FRBNY archive, Central Records, C261 Mexican Government 1917–1984: Office Memorandum, August 30, 1982.

Mexican consortium banks, which were also highly reliant on the interbank market for funding and exposed to defaulting countries, also confronted funding difficulties after the outbreak of the crisis, but they did not create the same worries among financial authorities. Unlike the foreign agencies and branches of Mexican banks, their consortium banks could benefit from financial support that the shareholder banks had committed to provide in case of emergency. In fact, after the liquidity crisis and the troubles experienced in the Eurocurrency markets with the German Herstatt Bank failure in June 1974, the Bank of England began to require firm assurances from shareholding banks that they will stand behind their London offspring in case of liquidity needs. The affirmation of support was done through a formal letter that the banks could couched in rather general terms with freedom to choose their own phrasing, but with explicit commitment to the provision of standby facilities. Although not legally binding, the fulfilling of undertakings by shareholders was regarded by the Bank of England as a solid moral commitment by parent institutions to support their respective affiliates.[31]

The case of Intermex illustrates how the financial problems confronted by Mexican consortium banks were dealt with. In early 1983, its Managing Director Gerard Legrain, as the Banking Supervision Division of the Bank of England reported, "described himself as a swimmer who is just about managing to keep his head above water." His bank was in troubles since it "[could not] get enough six-month money to fund [its] rollover assets which [meant] that [it] ha[d] a fairly large interest mis-match position," and "will have to continue to rely on shareholder funds to keep them going."[32] By that time Intermex had received about half a billion dollars form their shareholders, of which the Mexican partners, which were the majority shareholders, contributed with only US$30 million or 6%, although, according to the note, they "ha[d] apparently guaranteed their [non-Mexican] partners for the proportion they have provided on their behalf."[33] What this example shows is that, unlike the agencies or

[31] Richard Roberts, *Take Your Partners: Orion, the Consortium Banks and the Transformation of the Euromarkets* (London, 2001), 85–6; Charles Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974–1997* (Cambridge, 2011), 96–100.

[32] Bank of England Archive, Task Force, File 13A195/1: Note for Record, February 3, 1983.

[33] Ibid.

branches, the problems of the consortium banks did not bring about the intervention of Banco de Mexico and the funding that the Mexican banks were not able to provide was covered by the other shareholder banks before financial assistance from central banks might be required.

A Regulation Loophole on International Banking

The issue of a lender of last resort for international banking and the Euromarkets had been debated among G10 central bankers for some time prior to the 1982 crisis. The lacunae about responsibilities for securing financial support for foreign banking offices in case of emergency was a major problem during the banking failures of the mid-1970s, of which the Herstatt crisis is the most prominent example. On June 26, 1974, the Bankhaus I. D. Herstatt, a relatively minor German banking institution, went bankrupt because of losses arising from short positions in forward operations with short-term maturity schedules. The bank was heavily engaged in interbank foreign currency trading and its failure affected international creditor banks, especially in New York and London, which had outstanding deposits and forward foreign exchange contracts with it.[34] The collapse of the bank damaged interbank market confidence and, as Catherine Schenk observes, "prompted withdrawals from commercial banks in Germany, a sharp increase in Eurodollar market interest rates, and a contraction in international banking activities."[35] Figure 5.5 shows the impact of the crisis on the external and local interbank positions in foreign currency of BIS reporting banks, which dropped by 7% in the third quarter of 1974, marking an inflection point in the evolution of the Eurocurrency market during the 1970s.

The way German financial authorities managed the failure of the Herstatt Bank generated some controversies with their counterparts in the other countries affected by the crisis. On the one hand, the Bundesbank decided to close the bank in the middle of the business day, with many spot transactions with banks operating in different time zone

[34] Emmanuel Mourlon-Druol, '"Trust Is Good, Control Is Better": The 1974 Herstatt Bank Crisis and Its Implications for International Regulatory Reform', *Business History* 57 (2015), 311–34, esp. 326–8.

[35] Catherine R. Schenk, 'Summer in the City: Banking Failures of 1974 and the Development of International Banking Supervision', *The English Historical Review* 129 (2014), 1129–56, 1136.

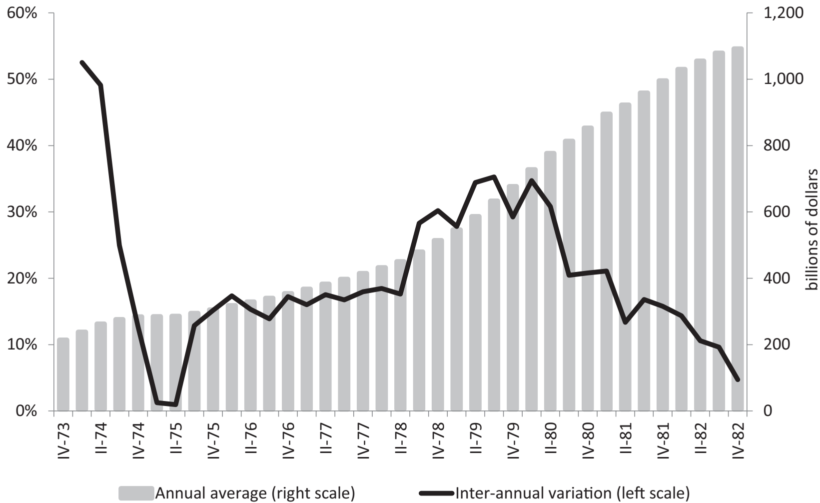

Fig. 5.5 Interbank position in foreign currency of BIS reporting banks, 1973–1982 (*Source* John G. Ellis, 'Eurobanks and the Inter-Bank Market', *Bank of England Quarterly Bulletin* September [1981], 351–64)

still in course, thereby interrupting transfers and leaving the correspondent payments unsettled. On the other hand, unlike the policy adopted by the US Federal Reserve when dealing with the collapse of the Franklin National Bank of New York earlier that year, the Bundesbank looked only to compensate local depositors.[36] While the Fed assisted Franklin's head office in the USA with the liquidity needed to meet the foreign obligations of its London branch, the liquidator of Herstatt refused to make payments to the bank's international creditors. Similar policy discrepancies arose with the liquidity problems of the Israel-British Bank's London subsidiary in the aftermath of the Herstatt failure, which confronted British and Israeli financial authorities. In this case, the Bank of England sought to bear responsibility on the Bank of Israel, which had quickly intervened to guarantee the deposits of the Israel-British Bank in Tel Aviv, but was not willing to take over the London subsidiary.[37]

[36] Joan E. Spero, *The Failure of the Franklin National Bank: Challenge to the International Banking System* (Washington, DC, 1980).

[37] Schenk, 'Summer in the City', 1150–3.

The reassessment of risks behind international finance after these events, along with the lack of understanding regarding lender of last resort responsibilities in the Euromarkets, led central bankers to discuss and coordinate their actions during their BIS meetings. In late 1974, G10 governors issued a communiqué confirming the availability of funds to be used in the event of a liquidity crisis and formed the Basel Committee on Banking Supervision (BCBS) to address the question of how to bear responsibility about foreign banking affiliates or international banks. The outcome of these conversations was the Concordat of September 26, 1975, which set out some basic principles and collaborative guidelines over banks' overseas operations and provided a framework for the allocation of certain duties between home and host countries.[38] A main point of the agreement was that, while host authorities were chiefly responsible for the supervision of foreign establishments' liquidity in the domestic currency, the parent financial authority should have primary responsibility for all other currencies. The Concordat was, however, an arrangement on supervisory duties and, as it would become clear in 1982, it did not necessarily embody or govern the allocation of support or bailing out operations of foreign banking establishments to prevent crisis.[39]

Archival evidence shows indeed important ambiguities among financial authorities with respect to lending of last resort functions in international banking as of the early 1980s. By that time, at the initiative of the Bank of England, G10 central bankers have been discussing a study about the potential implications of a major shock to the international capital markets, namely a default by a large borrowing country, on the banking system and individual banks. They recognized that a "main threat to the stability of the international banking system [was] likely to be lack of liquidity," which could generate funding problems for some banks or group of banks that may quickly turn into a solvency crisis if not properly managed.[40] In response to such diagnosis, the Basel Eurocurrency Standing Committee (BESC) prepared a questionnaire to review the

[38] James C. Baker, *The Bank for International Settlements: Evolution and Evaluation* (Wesport, 2002), 45–50.

[39] Anthony Saunders, 'The Inter-Bank Market, Contagion Effects and International Financial Crises', in Richard Portes and Alexander K. Swoboda (Eds.), *Threats to International Financial Stability* (New York, 1987), 196–238, esp. 237.

[40] Bank of England archive, Apocalypse Now, 3A143/1: Paper Draft, June 1980.

measures at the disposal of financial authorities for dealing with financial crises, and in particular the availability of liquidity support arrangement for international banking. The purpose was to assess the extent to which foreign banks operating in BIS member countries and the overseas establishments of the domestic banks could benefit from central banks' emergency lending facilities in domestic and foreign currencies.

The replies to the questionnaire demonstrated that, regardless of the legal authority that central banks had to operate on these matters, the views and positions of financial authorities were highly conflicting. The draft of the briefing note prepared by the International Division of Bank of England for the BESC points out two main outcomes. First, it stressed that all eleven central banks (G10 and Switzerland) had the ability to grant liquidity support indirectly for foreign establishments of their own domestic banks by providing support to the relevant head office, with some caveats in the case of Bank of France. Second, it underlines the fact that central banks had powers that enable them to provide liquidity support to branches and subsidiaries that operated in their countries, except for Canada where foreign banks had no access to central bank facilities and Sweden where there were no foreign banks operating.[41] However, while there were no immediately apparent gaps in the legal ability of the authorities to provide lender of last resort assistance to foreign subsidiaries and branches experiencing liquidity difficulties, important holes might exist in practice.

The response provided by the USA illustrates the extent of the misunderstandings and ambivalences among financial authorities on these important policy issues. In the reply document to the BIS questionnaire, the US position with respect to the overseas branches and subsidiaries of American banks was that the authorities of the country in which these establishments were located should deal with their liquidity problems when associated with developments affecting financial institutions in that country more generally. However, as far as branches and subsidiaries of foreign banks operating in the USA were concerned, it advocated that these institutions were first expected to make use of other "reasonably available" (sic) source of credit, including the resources of host authorities, before turning to the Fed and its discount window.[42] Such answers

[41] Bank of England archive, Apocalypse Now, 3A143/5: Note, July 8, 1981.

[42] Bank of England archive, Apocalypse Now, 3A143/5: Answers to BIS Questionnaires, United States.

generated controversies about potential distortions in the stance of US authorities and raised the question of whether the US Fed was prepared to offer the same facilities to foreign banking establishments located in the USA as it expected other host authorities to provide to their US counterparts abroad.

The incongruities underlying the US response to the questionnaire did not go unnoticed to the British financial authorities. In the words of J. W. Drage, the Bank of England's International Division official that prepared the first draft of the briefing note reporting the results of the survey to the BIS, "reading a little between the lines (…) and stating the position a little crudely the Fed appear[ed] to be arguing that if an American branch or subsidiaries of a British bank (for example) [was] experiencing liquidity difficulties then it [was the Bank of England's] job to provide support via the parent banks and if it [was] a British branch or subsidiary of an American bank in difficulties it [was] also [the Bank of England's] job as host authority to provide support."[43] Drage also pointed out similar inconsistencies in the responses of the Japanese central bank, which stated that it could only support local branches of foreign banks on their yen business in Japan, while foreign agencies and subsidiaries of Japanese banks were expected to seek liquidity support from the relevant host authority.

A main concern behind such contentious statements was the vacuums they left in the arrangements to provide liquidity as to what host and home authorities expected from each other. In light of the responses to the questionnaire, the presence of gaps in one central bank hoping that another one would take the lead in providing support seemed considerable. Moreover, as pointed out in the note, "the responses indicate[d] that in advance of knowing the circumstances of a particular crisis most respondents [were] not prepared to commit themselves as to whether liquidity should be provided by parental or host authorities."[44] The words of a Bank of England official make the dichotomy that central bankers faced very clear: "if [the necessary support for a foreign bank in London] was not forthcoming would [the Bank of England] be prepared to stand by and watch foreign banks become insolvent or would [it] find [it] necessary to act to protect London's reputation as an

[43] Bank of England archive, Apocalypse Now, 3A143/5: Note, July 8, 1981.

[44] Ibid.

international center?"[45] Such uncertainties about the respective roles of central banks prior to a liquidity crisis arising were problematic because authorities needed to move very fast to provide financial assistance and prevent funding problems from rippling through the banking system as had happened in 1974.

The lack of understanding and coordination among G10 governors was clearly worrisome, but what generated even more concern was the question of who, if anyone, would support banks from developing countries in the major international centers if they were to run into liquidity difficulties. Unlike industrial countries, no clear safeguard existed for them, since central banks from developing countries confronting debt problems were struggling to build up their international reserve and could only provide token support in foreign currency as the previous discussion on the Mexican case has shown. Moreover, these banks had not subscribed to the Concordat of 1975 nor had they participated in the subsequent discussions at the BIS, and were thereby not necessarily well aware of, nor committed to, the allocation of lender of last resort responsibilities in international banking and the Euromarkets as their G10 counterparts. In such a context, the liquidity problems that the foreign agencies and branches of Mexican and other developing country banks encountered in the wake of the crisis created major challenges as the following chapter will demonstrate.

[45] Bank of England archive, Apocalypse Now, 3A143/1: Paper Draft, June 1980.