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Teaching Notes

Assessing the effectiveness of financial reporting harmonization for emerging market banks: The case of Banco Serfin

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ABSTRACT

In the last decade there has been a proliferation of financial crises in emerging markets. To some extent, the suddenness and magnitude of some of these crises have been blamed on poor financial reporting standards for bank loan losses. As a result, prior to providing countries with "financial bailout" funds, international investors and international financial organizations have increasingly required that countries harmonize their bank financial reporting standards with international financial reporting standards.

Given this trend, this case requires students to assess the effectiveness of efforts to harmonize loan financial reporting (with International Financial Reporting Standards) for Mexican banks during (and after) the country's financial crisis of the late 1990s. Students are required to assess the extent to which both pre-crisis standards as well as new, post-crisis standards complied with international financial reporting standards. They are also required to assess the impact of the new standards on the reporting practices for loans of one particularly troubled financial institution. Through the examination of this institution's accounting practices for loans, students obtain a familiarity of the shortcomings of emerging markets' banks' loan financial reporting as well as the factors which influence the adoption of international financial reporting standards by emerging market banks.

Background

You are employed as a financial analyst by a small financial services company which is considering establishing an emerging markets mutual fund. As part of the effort to investigate this possibility, the firm is performing an on-going study of how recent devaluations and financial crises in emerging market economies have affected those countries' banks. The financial services company is aware that international investors and international financial authorities have stated that inadequate and insufficient information regarding banks' loan loss provisions and reserves contributed to the onset and magnitude of several of these crises (e.g. Rahman, 1998, Walter, 2008). In response to those pressures, many of these nations have undertaken steps to harmonize their bank financial

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reporting with international financial reporting standards (IFRS).[5]

Given this relation between poor financial reporting and financial crisis, the financial services firm has decided to assign a research team to study the evolution of Mexican bank financial reporting both before and after that country's financial crisis of the late 1990s. The purpose of the evaluation is to assess the effectiveness of Mexico's post-crisis efforts to harmonize Mexican bank financial reporting standards with International Financial Reporting Standards (IFRS). The team has been asked to study the financial reporting principles that Mexican banks used before and after the crisis and assess whether the changes in those principles resulted in more reliable and relevant financial reporting.

The report is to consist of three sections. The first section is to describe the political and economic context and factors which led to the 1994 peso devaluation and subsequent crisis. The second part is to assess the effectiveness of the country's post-devaluation reforms to the financial system, including, how financial "bailout" funds were used, the effectiveness of the country's efforts to restructure the banking system, and the effectiveness of the country's efforts to harmonize Mexican bank financial reporting standards with International Financial Reporting Standards (IFRS).

The final part of the report is to examine the effectiveness of these reforms on specific Mexican banks. As a financial reporting expert on the research team, you have been asked to write the portion (of the final part) of the report which examines the financial reporting of Grupo Financiero Serfin (GFSerfin), one of the country's largest and most troubled banks. In order to obtain a background for your study of GFSerfin, you have obtained excerpts from the first two sections of the report. Excerpts from these parts of the report are provided below.

Report section I: background of Mexico's 1990s financial crisis

From the 1930s through the early-1970s Mexico possessed a nationalistic financial system characterized by large, inefficient government-owned financial entities, large private sector institutions which frequently loaned funds on favorable terms to inefficient, closely-allied industrial companies, and a legal ban on any foreign ownership of Mexican financial institutions (Brothers, 1966; Thompson, 1979). By the late 1970s, these structures had resulted in an inefficient financial system which was concentrated in three large institutions (Banco Nacional de México (Banamex), Banco de Comercio (Bancomer), and Banco Serfin (Serfin)) (Maxfield, 1990).

In 1981 a dramatic drop in the price of petroleum initiated a decade-long economic crisis of deep recession and high inflation. This crisis, along with perceived corruption in the banking industry, compelled the government to nationalize the nation's banks (September, 1982). For the remainder of the decade, the government's domination of the nation's banks hindered the financial system's efficiency.[6]

In order to relieve the country of this economic crisis, in the late 1980s the presidential administration of Carlos Salinas de Gortari (1988–1994) proposed a far-reaching economic modernization program of trade liberalization, the loosening of restrictions on foreign investment, and the privatization of state-owned businesses. As part of this program, the administration proposed to reprivatize the nation's banks and reorganize the nation's banking system.

This restructuring of the financial system was based on a statute (the 1990 *Law to Regulate Financial Groups*) which encouraged the formation of large, Mexican-controlled financial services holding companies and (in contrast to the traditional exclusion of foreign investors from participation in the financial system) allowed for minority foreign ownership in the financial groups' holding companies (Hazera, 2000a). As a result of this measure, by early 1994 virtually all Mexican banks had been reprivatized and restructured as financial groups. Also, many of these groups' capital incorporated minority foreign investment. However, even with these changes, by the end of 1994, the financial system was still concentrated in the three groups associated with the country's traditionally three largest banks.[7]

By the early 1990s, President Salinas's economic reforms had resulted in a balanced federal government budget, reduced inflation and interest rates, a stable peso, and an acceleration of economic growth.[8] This, together with the NAFTA euphoria in 1993 and 1994, led Mexican consumers to purchase, on credit extended by the newly privatized institutions, large amounts of imported consumer goods. As a result, by the end of 1993, the country's current account deficit increased dramatically and banks had increased loans to entities and consumers with weak credit. At the end of 1994, the growing current account deficit led to an economic

[5] For example, as described by this case, after its financial crisis of the mid-1990s, Mexico engaged in a wholesale program to harmonize its bank accounting standards with international standards. For a detailed description of the final set of standards, see Marín Hernández and Martinez García (2002) or Del Angel, Haber, and Musacchio (2006). Also, Walter (2008) provides detailed descriptions of the efforts made by Indonesia, Korea, Malaysia, and Thailand to improve bank financial reporting after the Asian financial crisis of the late 1990s. All of these countries improved their financial reporting standards; however, questions remain concerning banks' actual compliance with the standards.

[6] During the period of nationalization (approximately 1982–1990), the government directed the country's banks to lend to small businesses and "productive" (i.e. non-speculative) entities, regardless of the borrower's ability to repay the loan. Also, given the government's borrowing needs, many banks specialized in lending to government agencies. As a result of these policies, banks' ability to screen and monitor loans to private entities eroded. For a description of the motivation behind the nationalization and the nationalization's immediate consequences, see Tello (1984) and White (1992).

[7] Banacci (24.75%), Gfbancomer (18.47%), and GFSerfin (10.49%), accounted for approximately 53.71% of the total assets of the 16 groups for which data are provided in the Stock Exchange's 1994 *Anuario Financiero* (Financial Annual). See Hazera (2000a).

[8] The fiscal deficit was eliminated in 1992. Inflation declined from 20-30% in the latter part of the 1980s to nearly 10% at the end of 1993. Interest rates declined from approximately 30% to about 10%. A "new" peso was issued in 1993 and traded within a "band" of approximately three pesos to the dollar. Economic growth accelerated to over 5% in 1993. See United States General Accounting Office (1996).