BEFORE THE
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
UNDER THE RULES GOVERNING THE ADDITIONAL FACILITY
FOR THE ADMINISTRATION OF PROCEEDINGS
AND UNDER THE NORTH AMERICAN FREE TRADE AGREEMENT

Fireman's Fund Insurance Company,
Claimant,
v.
The United Mexican States,
Respondent.

Case No. ARB(AF)/02/01

CLAIMANT'S RESPONSE TO THE TRIBUNAL'S QUESTION OF FEBRUARY 13, 2003

February 24, 2003

Judge Stephen M. Schwebel
1501 K Street, N.W.
Washington, D.C. 20005

Daniel M. Price
Stanimir A. Alexandrov
Sidley, Austin, Brown & Wood LLP
1501 K Street, N.W.
Washington, D.C. 20005

Raymundo E. Enriquez
Baker & McKenzie
Plaza Inverlat Piso 12
Blvd. M. Avila Camacho No. 1
México D.F. 11560

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1. Introduction

1. In its communication of February 13, 2003, the Tribunal posed the following question:

> Assuming, for the sole purpose of this question, that the "sociedad controladora" *Grupo Financiero BanCrecer, S.A. de C.V.* is a financial institution, was the purchase of convertible debentures at issue in this case an investment within the definition of investment set forth in NAFTA Article 1416, paragraph 7(a)?

2. The Tribunal went on to clarify that, in answering this question, the parties should have particular regard to:

> the expression "regulatory capital" and, as it emerged at the hearing, that it would appear that the "sociedad controladora" *Grupo Financiero BanCrecer, S.A. de C.V.* is not subject to minimum capital requirements that are applicable to certain financial institutions or entities, such as banks, in Mexico.

3. It is Claimant's position that—for the reasons set forth below—Claimant's investment in the convertible debentures issued by Grupo Financiero BanCrecer S.A. de C.V. ("Grupo Financiero") does *not* constitute an "investment" within the meaning of NAFTA Article 1416,

paragraph 7(a). As a result, there has been no "investment[]... in [a] financial institution[]" for purposes of Article 1410(1)(b), whether or not Grupo Financiero is deemed to be a financial institution under Mexican law. Therefore, this case is outside the scope of NAFTA Chapter Fourteen. Claimant may instead pursue its claims in full under Chapter Eleven of NAFTA, as it is undisputed that the debentures *do* meet all the definitional requirements of an "investment" within the meaning of NAFTA Article 1139, paragraph 12.

II. Scope of NAFTA Chapter Fourteen

4. The Tribunal's question prompts a brief review of the scope of NAFTA Chapter Fourteen. Chapter Fourteen's substantive provisions and specialized dispute resolution procedures apply *only* to the extent specified in Article 1401 ("Scope and Coverage"). In particular, the parties are agreed that Chapter Fourteen's reach in this case is delimited by Article 1401(1)(b), which provides, in pertinent part, that:

> This Chapter applies to measures adopted or maintained by a Party relating to: ....
>
> (b) investors of another Party, and investments of such investors, in financial institutions in the Party's territory; ...

5. In effect, then, there are two key provisions of Article 1401(1)(b) that must be satisfied before Chapter Fourteen may be held applicable. First, there must be an "investment," and second, that investment must be made "in a financial institution." Chapter Fourteen applies only if both elements are present.

6. Claimant has maintained in its earlier filings, and in its presentations at the hearing on the preliminary question, that the second element is not met: Grupo Financiero, a "sociedad

controladora," is not a financial institution under Mexican law.[1] Such controladoras are not authorized to do business as financial institutions, and they are not regulated or supervised as financial institutions, under Mexican law.[2]

7. Here, however, the Tribunal asks the parties to assume, *arguendo*, that a controladora is a financial institution for purposes of its question. That is, the Tribunal's question directs the parties' attention to the first element of Article 1401(1)(b)—namely, whether there exists an "investment" in the hypothetical financial institution.[3]

8. To answer that question, one turns to the specialized definition of "investment" for purposes of Chapter Fourteen, which is found in the seventh paragraph of Article 1416. If the "investment" is not an investment *within the meaning of Article 1416*, then it is not an investment within the meaning—or, more important, within the scope and coverage—of Chapter Fourteen. However, so long as it is an investment within the meaning of Article 1139, it is nevertheless within the scope and coverage of Chapter Eleven of NAFTA.

III. "Investment" under Chapter Fourteen

9. Article 1416 of NAFTA Chapter Fourteen specifies, in pertinent part, that:

> **investment** means "investment" as defined in Article 1139 (Investment Definitions), except that, with respect to "loans" and "debt securities" referred to in that Article:

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[1] *See* Claimant's Memorial on the Preliminary Question, December 20, 2002 ("Claimant's Memorial") at paras. 54-78.

[2] *Id.*; *see also* Opinion of Fernando Borja Mujica, December 17, 2002 ("Borja Opinion"), at paras. 18-38, C0004-10.

[3] While Article 1401(1)(b)'s text indicates that Chapter Fourteen also covers an "investor" in a financial institution, central to that definition is whether there exists an "investment" for purposes of Chapter Fourteen. Article 1416 defines "investor of a Party" for purposes of Chapter Fourteen by reference to whether a Party, state enterprise, or person of a Party "seeks to make, makes, or has made an investment." The foundational issue, then, in the first element of Article 1401(1)(b) is whether there exists an "investment."

> (a) a loan to or debt security issued by a financial institution is an investment only where it is treated as regulatory capital by the Party in whose territory the financial institution is located; . . .

A. "Investment" Under Chapter Eleven

10. The text of Article 1416 makes clear that to be within the scope and coverage of Chapter Fourteen, therefore, an investment must first meet all the definitional requirements of an "investment" under Chapter Eleven, as set forth in Article 1139.

11. Article 1139 provides, in pertinent part, that "investment" for purposes of Chapter Eleven includes

> (c) a debt security of an enterprise (i) where the enterprise is an affiliate of the *investor*, or (ii) where the original maturity of the debt security is at least three years, but does not include a debt security, regardless of original maturity, of a state enterprise

12. Importantly, Mexico has nowhere disputed that all of the elements of Article 1139's "investment" definition are satisfied with respect to Claimant's purchase of the Grupo Financiero debentures. Mexico does not dispute that:

- Claimant is a U.S. enterprise, within the meaning of Article 1139 and Article 201, inasmuch as Claimant is a corporation organized under the laws of the State of California, and it carries out business in the United States;
- Claimant purchased debt securities of a Mexican enterprise, Grupo Financiero;
- Those debt securities had an original maturity of at least three years, as specified in Article 1139, paragraph 12(c); and
- Claimant is thus an investor of the United States that made an investment in Mexico, for purposes of Article 1139, paragraphs 12 and 13.

13. Claimant's purchase of debentures issued by Grupo Financiero is thus undisputedly within the universe of "investments" protected under NAFTA Chapter Eleven.

B. "Investment" under Article 1416

14. Article 1139 of Chapter Eleven delimits the broadest set of "investments" protectable under NAFTA. Chapter Fourteen, however, provides different substantive protections and dispute resolution procedures with respect to a particular subset of those Chapter Eleven investments, as specified in Article 1416. Recall that Article 1416, paragraph 7, provides that an investment for purposes of Chapter Fourteen is defined as a Chapter Eleven investment, *except that* certain limits apply to loans and debt security investments that meet the Chapter Eleven requirements.

15. Thus, the sole question here is whether Claimant's investment, having satisfied all the requirements of Chapter Eleven's definition, also satisfies an additional requirement imposed under Article 1416, paragraph 7(a), that would make it an investment under Chapter Fourteen. Specifically, to be covered under Chapter Fourteen instead of Chapter Eleven, an investment in the form of a debt security issued by a financial institution must be "treated as regulatory capital" under Mexican law.[4]

16. Claimant maintains that, for reasons spelled out in the next section, the Grupo Financiero debentures are not treated as regulatory capital under Mexican law. As such, there exists no "investment" as defined under Article 1416 that would bring this case under the scope and coverage of Article 1410(1)(b). Therefore Chapter Eleven, rather than Chapter Fourteen, is applicable to this dispute.

[4] In an abundance of caution, Claimant notes that it continues to reserve its argument that the debentures issued by Grupo Financiero were not issued "by a financial institution," and hence that subparagraph (a)'s limitation is

IV. Regulatory Capital

17. As the Tribunal correctly notes, and as both parties agreed at the hearing on the preliminary question, controladoras are not subject to any capital requirements under Mexican law.[5] They have no capital adequacy requirements based on their risk-weighted assets and market risks.[6] They are not subject to any capital reserve requirements related to the solvency of their debtors or the risks involved in particular types of transactions.[7] Likewise, they have no minimum capital requirements (apart from the 50,000 pesos required to incorporate any company in Mexico).[8]

18. As explained, the Mexican government has no need to impose any such prudential capital requirements on controladoras. This is because controladoras are prohibited by law from engaging in any business—any financial services activities with the public—that could give rise to the sorts of risks that capital requirements are meant to protect against.[9]

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inapplicable. For purposes of the hypothetical question posed by the Tribunal, however, Claimant will refrain from reiterating that position herein.

[5] *See, e.g.*, Borja Opinion at paras. 29-32 (C0007-08); February 6, 2003 Testimony of Luis Mancera de Arrigunaga ("Mancera Testimony"), Hearing Transcript at p. 106, line 17 to p. 108, line 5, at p. 112, lines 1-16; February 7, 2003 Testimony of Fernando Borja Mujica ("Borja Testimony"), Hearing Transcript at p. 301, line 1 to p. 302, line 5; Claimant's Memorial at paras. 75-76. The contrast in this regard is sharp, for example, between controladoras and commercial banks (*bancas múltiples*). The Mexican Finance Ministry has set out extremely detailed and technical capitalization requirements for such banks—the *Reglas para los Requerimientos de Capitalización de las Instituciones de Banca Múltiple*—spanning nearly 35 pages when published in the *Diario Oficial* on 22 September 1999. No such regulations exist for controladoras.

[6] *See* Borja Opinion at paras. 30, 32 (C0007-08); Mancera Testimony, Hearing Transcript at p. 106, line 20 to p. 108, line 5; Borja Testimony, Hearing Transcript at p. 301, line 1 to p. 302, line 5.

[7] *See* Borja Opinion at paras. 31-32 (C0007-08); *cf.* Borja Testimony, Hearing Transcript at p. 301, line 1 to p. 302, line 5.

[8] *See* Borja Opinion at paras. 30, 32 (C0007-08); Mancera Testimony, Hearing Transcript at p. 112, lines 13-16; Borja Testimony, Hearing Transcript at p. 301, line 1 to p. 302, line 5.

[9] *See* Borja Opinion at paras. 18, 25-28, 32 (C0004, C0006-08); February 6, 2003 Testimony of Eduardo Fernández García ("Fernandez Testimony"), Hearing Transcript at p. 146, line 19 to p. 147, line 19; Claimant's Memorial at paras. 68, 71, 74-76.

19. One simply cannot speak of an institution as having "regulatory capital" when it is subject to no regulatory requirements related to capital. Put another way, when financial authorities impose capital requirements on financial institutions, they issue regulations explaining exactly what types of assets they will "count" as capital for purposes of fulfilling those regulatory requirements. This is the concept of "regulatory capital" referred to in Article 1416, paragraph 7(a).

20. For example, consider a bank or other financial institution that is subject to a capital lending limit. This means that the financial institution is required to hold capital in a specific ratio to its loans and other extensions of credit. Perhaps a bank may only make less than fully secured loans up to the level of 15% of its capital. The question becomes, what may the bank count as capital when determining whether it is in compliance with this 15% limit? The instruments that, by regulation, the bank is permitted to count towards capital requirements established by regulators are the "regulatory capital" of the bank.

21. Where the institution need not satisfy any such capital requirements, however, it effectively has no "regulatory capital."[10] It may, of course, have "capital" on its books, but that capital is not measured for any *regulatory* purpose. It does not matter to the financial authorities whether the controladora itself has any particular level of capital, because it is not subject to any capital regulations.[11]

22. Likewise, the 1988 report of the Basle Committee on Banking Supervision set out for banks (but not their holding companies) a standard ratio of capital to weighted risk assets of 8%,

[10] *See* Borja Opinion at para. 32 (C0008) ("Financial holding companies themselves are not required to hold any minimum levels of capital, and hence they have no 'regulatory capital' as such."); *see also* Claimant's Memorial at paras. 75-76.

and defined the types of instruments that could be counted in the numerator of that ratio.[12] Again, however, these definitions of "tier 1" or "core" capital, and "tier 2" or "supplementary" capital,[13] are only relevant to regulators to the extent that they identify the capital which will satisfy the 8% ratio—a regulatory requirement. As the Basle Committee itself describes it: "The Committee has therefore concluded that capital, *for supervisory purposes*, should be defined in two tiers...."[14] Absent any capital requirement, however, there is no such "supervisory purpose" at work, and thus no treatment of an institution's capital as "regulatory capital."

23. It is important to emphasize that the Basle Committee's 8% capital ratio applies only to banks, and not to holding companies of banks. However, even if the requirement—and thus the classifications of tier 1 and tier 2 regulatory capital for meeting that requirement—were applicable to a holding company, it is worth noting that the debentures acquired by the Claimant do *not* appear to satisfy the Basle standard to be counted as capital for that regulatory purpose. Specifically, the debentures issued by Grupo Financiero do not meet the fourth element of the Basle standard for "hybrid (debt/equity) capital instruments,"[15] in that they did not allow for service obligations (*i.e.* interest payments) to be deferred where the profitability of the issuing institution would not support payment. Thus, even if the 1988 Basle regulatory requirement had been applicable to holding companies, the Grupo Financiero debentures apparently would not have constituted "regulatory capital" under the Basle standards.

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[11] *See, e.g.*, Borja Opinion at paras. 29-32 (C0007-08); Claimant's Memorial at paras. 75-76.

[12] *See* Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, July 1988 at paras. 44, 14 (R0799, R0789).

[13] As noted,

[14] *Id.* at para. 14 (R0789) (emphasis added).

[15] *See id.* at Annex 1, § D(ii)(d) (R0804).

24. Mexico suggested in its submission of October 21, 2002 that Grupo Financiero's mandatorily convertible debentures are treated as "regulatory capital."[16] However, a closer look at the substance of Mexico's arguments reveals that that is not at all what Mexico has argued. Mexico has not in any way supported the proposition that Grupo Financiero's debentures were counted towards a *regulatory* capital requirement of any sort. Instead, Mexico simply argues that such debentures are treated—as a matter of accounting formalities—as "capital" of the controladora.[17]

25. Claimant does not dispute that Mexican accounting regulations classify subordinated debentures that are mandatorily convertible into capital stock as "capital" of the issuing entity. Nor does Claimant dispute that Grupo Financiero complied with those regulations when preparing its financial statements for submission to the authorities. What Claimant vigorously disputes, however, is the notion that treating such debentures as paid-in capital (*capital contribuido*) or towards net worth or total accounting capital (*capital contable*) for accounting purposes, is the same as treating them as "regulatory capital" for purposes of satisfying capital requirements. Again, controladoras simply do not face any such capital requirements.

26. The difference between the "capital" of a controladora, and the "regulatory capital" of the financial institutions it owns, is neatly illustrated in the present case. While the debentures

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[16] *See* Respondent's Memorial on Preliminary Questions of Competence, October 21, 2002 ("Respondent's Memorial") at heading to Part III.F ("El 'capital para efectos regulatorios'").

[17] Respondent's own description of its argument makes this clear: "During all of the relevant period the Claimant's investment complied with the specific rules of the competent regulatory entity which establish that subordinated debentures mandatorily convertible into shares should be accounted for as capital." Respondent's Memorial at heading to Part III.G ("Durante todo el período relevante la inversión de la demandante cumplió con la normatividad específica de la entidad regulatoria competente que establece que las obligaciones subordinadas de conversión forzosa en acciones deben contabilizarse como capital."). *See also* Respondent's Memorial at paras. 57-65 (describing accounting rules classifying such debentures as paid-in capital, *capital contribuido*, or a component of net worth, *capital contable*).

purchased by Claimant were accounted for as paid-in capital of the controladora on its books, they served no regulatory capital function. They were neither regulatory capital of the controladora, nor regulatory capital of any of the controladora's financial institution subsidiaries. It was only when the funds from the debentures were downstreamed to the bank that they took the form of regulatory capital—more specifically, regulatory capital *of the bank*. Here, Grupo Financiero used the funds from the sale of the debentures to subscribe directly to equity shares in BanCrecer (and BanOro, which was thereafter merged into BanCrecer). In other cases, controladoras purchased "mirror" debentures issued by their constituent financial institutions. In either case, however, it is only the *secondary* transactions (to which an original purchaser like Claimant is not privy) that result in "regulatory capital." The financial institutions owned by a controladora, unlike the controladora itself, face capital regulations and need to count the downstreamed funds as capital towards those regulatory requirements.

27. In sum, whether or not the debentures issued by Grupo Financiero were classified as "capital" of the controladora under Mexican accounting rules, they were not treated as "regulatory capital"—for the simple reason that the controladora faced no regulatory requirements related to its capital holdings. Regulatory capital is the capital that a regulator will count towards the satisfaction of a substantive capital requirement imposed on the institution. Where—as in the case of controladoras—no such capital requirements exist, there is no "regulatory capital" to measure.

V. Conclusion

28. For the reasons just explained, Claimant's investment in the debentures issued by Grupo Financiero does not constitute an "investment" within the meaning of Article 1416, even if Grupo Financiero is deemed, *arguendo*, to be a financial institution of whatever shape or kind.

As a result, Claimant's investment is not within the scope and coverage of Chapter Fourteen, because the first element of Article 1401(1)(b)—an investment as defined in Article 1416—is not satisfied.

29. Claimant's investment is, nevertheless, within the scope and coverage of Chapter Eleven of NAFTA. Investments in financial institutions that meet the particular requirements of Article 1416 fall, by virtue of Article 1401(1)(b), within the coverage of Chapter Fourteen. Investments that do not meet those additional specifications—but do, as here, satisfy all the requirements of Article 1139—are covered instead by Chapter Eleven.

30. For the foregoing reasons, as well as those set forth in Claimant's earlier written submissions and its presentations at the hearing of February 6-7, 2003, the Claimant respectfully requests that the Tribunal reject the Respondent's jurisdictional objections.

Respectfully submitted,

Daniel M. Price
Counsel for Claimant