FINANCIAL SECTOR ASSESSMENT
MEXICO

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LATIN AMERICA & THE CARIBBEAN REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FSAP

A. INTRODUCTION

1. **This Financial Sector Assessment (FSA) note summarizes the FSAP report for Mexico.** Fieldwork was conducted in Mexico City during March 1–23, 2001.[1] The preliminary results of the FSAP were discussed with the authorities on March 22, during a one day wrap-up meeting chaired by Mr. Carstens (Deputy Secretary of Finance) and attended by the presidents of the National Banking and Securities Commission (CNBV), National Insurance and Securities Commission (CNSF), National Pension Funds Commission (CONSAR), National Institute for the Protection of Savings (IPAB), Bank of Mexico (BOM) officials, and by economic advisors to President Fox. A second presentation was subsequently made to the BOM Board. The final FSAP report was formally delivered to the authorities in January 2002. *The FSAP report and this FSA are based on quantitative data through end-2000, although the qualitative discussion in this FSA has been updated to reflect salient developments since then.*

2. **The Mexico FSAP took place at an important juncture for the development of the financial sector, with major legal reforms being introduced**. The consequences of the 1994/95 banking crisis have been absorbed, with the associated fiscal losses transparently allocated to the public sector, in the form of explicit IPAB debt.[2] The disposal of distressed assets and resolution of troubled banks is well advanced. Banking system stability has been restored and the banks' financial position has improved significantly, following a period of pronounced shrinkage, consolidation, and internationalization. The regulatory and supervisory

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[1] The mission was led by Messrs. Alfredo M. Leone (IMF, MAE) and Augusto de la Torre (WB, LCR). Other mission members were: Ricardo Velloso (IMF, WHD), Mariano Cortés and Antonio Pancorbo (both IMF, MAE), Bruno Carrasco (ECB), Santiago Herrera and Mario Guadamillas (both WB, LCR), Alain Laurin (WB, BFR), Rudolph Zepeda (U.S.Fed), Carlos Conesa (Bank of Spain, Iñigo de la Lastra (CNMV, Spain), Thomas Glaessner (WB, FSP), Leora Klapper (WB, DECRG), Jonathan Katz (U.S. SEC), Mike Lubrano (WB, IFC), Jeppe Ladekarl, Manuel Peraita, Gregorio Impavido, Bertrand Renaud, and Lic Chiquier (all WB, FSD), Rodrigo Rodriguez (U.S. FDIC), Lajos Bokros (WB, ECA), and Adriana Rota (Staff Assistant, IMF, MAE). Mr. Conthe (WP, FSEVP) attended part of the wrap-up meeting with the authorities. The FSAP team gratefully acknowledges the outstanding hospitality, openness, and cooperation of the authorities and technical counterparts.

[2] The cost of the 1994-95 banking crisis allocated to the public sector, as measured by the total amount of *net* IPAB debt *plus* related cash outlays by the IPAB or the Government, is equivalent to about 20 percent of GDP.

environment has made a quantum leap forward. In these circumstances, the policy focus has understandably turned towards reincorporating banks to the lending circuit and enhancing the positive role the financial system can play in supporting economic growth. Reflecting these new priorities, in April 2001, the authorities submitted to Congress a number of draft bills directly relevant to the financial sector, many of which have been recently approved.[3] *The legal reforms were, for the most part, consistent with FSAP recommendations.*

B. The Macrofinancial Environment and Risk Issues

3. **Macroeconomic indicators strengthened markedly since the crisis of 1994/95 as a result of the improved policy management and closer links to the U.S. economy.** The augmented fiscal deficit (IMF definition) fell from 11¾ percent of GDP in 1995/96 to 4¼ percent of GDP in 2000 and to below 4 in 2001. The improved fiscal stance and the BOM's enhanced credibility in fighting inflation have facilitated a decline in the interest rate. The more flexible exchange rate has discouraged one-way bets against the peso and enhanced currency risk management by the private sector. Economic growth resumed to nearly 6 percent per annum for 1997-2000, before the recent slowdown driven by developments in the U.S. economy (growth was –0.3 per cent in 2001 and is forecasted at 1.7 for 2002). Inflation fell from 52 percent per year in 1995 to around 4.5 percent in 2001. Foreign exchange reserves have been rebuilt to over US$ 40 billion by 2001 (over 100 percent of external short-term debt on a residual maturity basis). The subdued contagion from the crises in Turkey and Argentina provides further evidence of Mexico's differentiation from other emerging market countries.

4. **During the rapid economic expansion of 1997-2000 the private sector substituted domestic borrowing with foreign borrowing, while the public sector stepped up domestic borrowing.**[4] Firms in Mexico have financed working capital and investment from retained earnings, suppliers' and trade credit, and nonpayment or refinancing of past debts to banks. While hard data are unavailable, it appears that significant intra-company finance has been built with large, NAFTA-linked companies raising funds in the U.S. and then on-lending to their local suppliers. Leverage in the corporate sector has been declining on average (although it has increased or remained the same for larger corporations). A potential weakening of large companies' capacity to borrow abroad would have relatively more disruptive effects (through inter-company finance) on small and medium enterprises, many of which have lost their traditional banking relationships.

5. **The policy of increasing the share of domestic public sector debt has gains in terms of reduced vulnerability, but not without costs**. Gross public sector debt decreased from 52 percent of GDP in 1997 to 48 percent in 2000 while the share of domestic debt in total government debt rose sharply from 52 to nearly 70 percent. This change in the composition of

[3] Financial sector legislation approved in April 2001 included reforms to the Credit Institution Law, the Financial Groups Law, the National Savings and Public Bank Services Law, the Securities Market Law, the National Banking and Securities Commission Law, the Mutual Funds Law, and the General Law on Ancillary Activities and Organizations of Credit. The reforms eliminate legal hurdles and inconsistencies, enable a tightening of prudential norms, and grant stronger inspection and enforcement powers to the CNBV.

[4] In 2000 alone the private sector reduced its domestic indebtedness by the equivalent of 5 percent of GDP and increased its debt to foreigners by a similar amount. By contrast, over four-fifths of the total net borrowing by the public sector in that year was in the form of domestic debt.

government debt is the result of a deliberate policy aimed at reducing the government's exposure to exchange rate risk and promoting local securities markets through benchmark instruments. The risk reduction gains have come at the expense of higher average funding costs. Roll-over risk may have been mitigated, given the growing and stable investment needs of local holders of government paper (i.e., pension funds), but considerable interest rate risk remains, as most of the public debt continues to be at floating rates. There are other trade-offs. The roll-over needs of the public sector in the domestic market constitute an obstacle to further declines in the real interest rate. The consequent displacement of the private sector, inducing it to borrow abroad, may have resulted in some unhedged private sector exposure to exchange risk—the magnitude of which remains unknown to the authorities.

6. **BOM regulations discourage loan dollarization and limit systemic liquidity risks, but may lead to lower credit and higher lending spreads**. Banks need to comply with high BOM liquidity regulations on their foreign exchange denominated assets and liabilities (including off-balance sheet items), which significantly limit systemic liquidity risk and tightly curbs dollar-denominated bank loans. Banks are allowed to take dollar deposits up to a limit and only from corporations (not from households), much of which have to be invested in safe and liquid assets abroad. The resulting constraint on dollar lending by banks clearly reduces the banking system's (direct and indirect) exposure to exchange rate variations, but probably at the expense of some reduction in the equilibrium level of bank credit to the private sector and of a higher intermediation spread. This is an issue that merits further research.

C. Private Banking System Trends, Performance, and Stress Testing[5]

7. **Shrinkage, concentration, and internationalization have been major trends affecting the Mexican banking system since the 1994/95 crisis**. Banking system assets shrank from the peak of 55 percent of GDP at end-1994 to 37 percent at end-2000.[6] Even more spectacular was the collapse of bank credit to the private sector—it represented 78 percent of bank assets (43 percent of GDP) at end-1994 and shrank to the equivalent of 22 percent of bank assets (10 percent of GDP) at end-2000.[7] The contraction in bank credit has bottomed out since mid-2000. Concentration in the banking industry marked another strong trend—the share of assets of the 5 largest banks rose from 74 percent in 1994 to 82 percent in 2000 and to 88 percent after the acquisition of Banamex by Citigroup announced in May 2001. Mexico has become one of the most concentrated banking systems in the world. Also striking has been the internationalization of the banking system, as the share in total assets of foreign-controlled banks rose from 24 percent in 1998 to nearly 50 percent at end-2000 and to over 70 percent

[5] Unless otherwise specified, aggregate banking data correspond to private commercial banks—i.e., it excludes development banks, banks intervened by the CNBV, and banks being rehabilitated under the control of the IPAB.

[6] The ratio of bank assets to GDP for 2000 is adjusted to reflect changes in accounting and reporting practices between 1994 and 2000. Under current practices, bank assets represented only 25 percent of GDP in 2000.

[7] These figures overstate the absolute extent of the shrinkage, as some banks included in the 1994 data were subsequently intervened by the CNBV or taken over by the IPAB and, as a result, excluded from the 2000 data. The relative extent of shrinkage was confirmed by the mission using a stable sample of the 8 largest banks.

after the recent purchase of Banamex.[8] Accompanying these trends has been a consolidation process—the number of Mexican-owned banks fell from 33 in 1994 to 16 in 2000.[9]

8. **Concentration has not fostered inefficiency and can bring benefits from economies of scale and risk diversification, but it intensifies the "too big to fail" phenomenon**. Standard econometric tests did not allow us to reject the null hypothesis—that observed interest rates and loan quantities have been statistically equivalent to those that a competitive system would have produced. Thus, larger players do not appear to exercise significant market power. The result is consistent with the fact that operational expenses and interest margins are not unduly high compared to other systems in the region.[10] The lack of evidence on market power in spite of increased concentration is likely explained by the rise in foreign bank entry, which has fostered market contestability. The concentration process is expected to yield benefits from economies of scale and loan portfolio diversification, and to facilitate cost reductions in banking. However, the few large institutions that now dominate the Mexican system are likely to be perceived as "too big to fail." The associated moral hazard could offset the gains in market discipline expected from the reduction of the universal guarantee on bank liabilities to a limited coverage of about US$100,000 per depositor per bank as from January 2005. To compensate for this risk, a premium must be placed on further improving prudential oversight, enhancing prompt corrective actions, and—given the large presence of international banks—strengthening coordination with foreign supervisors.

9. **Asset quality has improved in recent years—largely reflecting the conclusion of debtor relief programs—but bank profitability has been low**. The ratio of past due loans (PDLs)—excluding loans exchanged with claims on FOBAPROA and IPAB—to total loans fell from 17.6 percent at end-1997 to 8.5 percent at end-2000, largely reflecting the effects of the *Punto Final* debtor relief program.[11] The coverage of PDLs by loan-loss provisions rose from 60 percent to a comfortable 115 percent over the same period. Profitability has been low and subject to substantial variance across banks. For the system as a whole, the low return on assets (ROA) of under 0.7 percent and return on equity (ROE) of under 7 percent for the 1997-2000 period mainly reflected a sustained post-crises provisioning effort.[12] Profitability prospects are better to the extent that the deficit of provisions vis-à-vis existing loans has been virtually eliminated. Nonetheless, a decline in the CETEs interest rate would put some short-run downward pressure on bank profits—which depend heavily on earnings related to

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[8] The figure for 2000 reflects effective control rather than majority shareholder participation. Internationalization and concentration have continued since then—HSBC announced in August 2002 that it will acquire Grupo Bital.

[9] Consolidation has been masked by the increase in the number of private banks, from 30 in 1994 to 34 in 2000. However, the latter number includes 18 foreign bank subsidiaries, 14 of which have miniscule balance sheets.

[10] The 4.8 percent ratio of operational expenses to average assets in Mexico compares to a Latin American average of 5 percent, with Brazil at 7.9 percent, and to a 3.6 percent ratio for FDIC-insured commercial banks in the U.S.

[11] Under this program, agricultural, commercial, and residential mortgage debtors received subsidies to pay back their loans. About 70 percent of the decline in PDLs during 1999–2000 is attributable to the effect of *Punto Final* on residential mortgage loans, which were either paid off or reclassified as performing.

[12] ROA and ROE before provisions averaged 2 and 24 percent, respectively, for 1997-2000.

investments in, and repo operations with, public sector debt securities—raising incentives for banks to seek profits elsewhere, including by increasing lending to the private sector.[13]

10. **Banking system capital has strengthened and exposure to risk has been reduced through shrinkage. As a result, the system's capital could withstand low-probability but extremely stressful (e.g., Tequila- or Russia-type) scenarios.** After some adjustments to reported financial data (the main one being the reduction of the deferred-tax assets counting as part of capital to no more than 20 percent of tier 1 capital—i.e., the maximum allowed as from January 2003),[14] the net worth for the eight largest privately-owned banks was estimated to have risen from 2.7 percent of risk-weighted assets at end-1999 to 8.6 percent at end-2000. Under a Tequila-type scenario, the combined severe shocks (75 percentage points jump in short-term interest rate, a negative 14 percent GDP growth, 40 percent real exchange rate depreciation, and an increase of 400 basis points in international bond spreads) could consume about 25 percent of adjusted banking system net worth.

D. State Ownership in Financial Intermediation

11. **The government is active in the financial system through a large network of development banks (DBs) and funds (fideicomisos), entailing a significant fiscal burden and in many cases seriously hampering market development**.[15] DBs and *fideicomisos* jointly account (directly through first-tier lending *and* indirectly through second-tier lending) for 30–35 percent of the stock of loans to the nonfinancial private sector and provide partial guarantees for a nontrivial fraction of the remainder. Some DBs have unclear mandates and overlapping activities, which often block the development of private markets and compete with activities of private financial intermediaries. With the exception of BANJERCITO, DBs have tended to incur losses, even after several rounds of recapitalization, the last of which occurred in 1999. DBs and *fideicomisos* grant subsidies that are often not well targeted and normally

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[13] The mission estimated that a transitory decrease in the CETEs rate of 1 percentage point would result in a 0.4 percentage point decrease in banks' net interest margin, the effect felt mainly during two quarters immediately after the interest rate fall. This empirical finding should of course not be taken as a constraint for monetary policy.

[14] A pre-announced adjustment timetable, beginning in January 2000 and ending in December 2002, is in effect to gradually bring the Mexican definition and components of regulatory capital closer to international standards. However, the proportion of tier 1 capital that can be constituted with deferred tax assets as from January 2003 will, at 20 percent, be higher than the 10 percent maximum allowed, for instance, under U.S. bank regulations. But the current capital regulation in Mexico is stricter than international standards in one important respect—it requires that all permanent investments in non-financial companies be fully deducted from capital.

[15] DBs and *fideicomisos* are numerous. BANRURAL (a deposit-taking DB) and FIRA and FOCIR (two *fideicomisos*) focus on agriculture and the rural areas. NAFIN tends to work with SMEs. BANCOMEXT's mandate is to promote and finance exports and has moved increasingly towards first-tier lending. BANOBRAS finances subsovereign entities. BANJERCITO is a deposit-taking bank for the army, navy, and air force. PANHAL was a narrow bank that mobilized savings among the rural poor, investing them exclusively in government debt securities. PANHAL was converted into BANSEFI, a DB created in June 2001 that is focusing on technical assistance and other risk-free services to S&Ls and credit unions. The three public institutions involved in housing finance are INFONAVIT, FOVISSSTE (both receive mandatory pension contributions from private sector and government employees, respectively), and FOVI (a *fideicomiso* that funds the origination of mortgages). FOVI was transformed into the Sociedad Hipotecaria Federal (SHF), a housing DB created in October 2001. All DBs are subject to the regulation and supervision of the CNBV; *fideicomisos* are not. The Ministry of Finance (SHCP) has commanding control over the direction and operations of DBs.

hidden in below-market interest rates, which distort price signals and discourage the private provision of financial services in the sectors where they operate.

12. **Many of the problems of DBs and fideicomisos reveal an inherent tension between their social policy mandates, on the one hand, and their activities, on the other**. DBs and *fideicomisos* are charged with social policy mandates which, by definition, expose them to high-risk clientele and limit their capacity to diversify risks across economic and geographic sectors or across segments of population with different income levels. With subsidies typically hidden in below-market interest rates, these institutions incur low profits or losses—often magnified by weak risk management systems and vulnerability to political interference—and hence require repeated recapitalization by the government. (The *fideicomisos* administered by the BOM have not required recapitalization.) To minimize operational losses and associated fiscal costs, DBs are often moved (as in Mexico) under the same regulatory and supervisory standards applied to commercial banks. In response, DBs enter into less risky and more lucrative lines of business, in competition with private banks. But this tends to be unsustainable because the activities of DBs become increasingly inconsistent with their social policy mandate and this, in turn, prompts political pressures to re-orient their activities towards meeting their mandate, which leads to a new cycle of losses and recapitalization.

13. **A reform strategy to overcome this inherent tension should aim at separating subsidies from finance, at consolidating DBs, and at gradually transforming some DBs and fideicomisos into "development agencies" (DAs)**. The separation of subsidies (and their inclusion in the government budget) from finance is necessary to avoid distortions from below-market interest rates, and to make the public sector borrowing requirement more transparent. The profitable business lines of DBs and *fideicomisos* could be sold to the private sector as part of a transition whereby they are transformed into "development agencies" (DAs), a superior vehicle to pursue social policy and market development objectives. DAs, as defined here, would not take deposits from the public or issue debt. All their funding would come from the budget. Their main products would include technical assistance, matching grants, and other explicit subsidies to strengthen the bankability of targeted clients and to promote the development of, and access to, markets for the services (financial and non-financial) demanded by such clients.[16] DAs should be subject to high standards of transparency and accountability. DAs may be authorized to provide partial credit guarantees provided that they have sound risk control and management systems.

14. **However, a reform strategy for the transformation of DBs and fideicomisos into DAs would require a well-designed transition scheme.** A transition path would involve timetables to (i) phase out their deposit-taking and debt issuance authority; (ii) phase out their lending authority; and (iii) sell those lines of business that are profitable and could be more efficiently performed by the private sector. It would also include the consolidation of the various DBs and *fideicomisos* into a limited number of DAs, endowed with clear objectives and functions, sound governance, high standards of transparency and accountability, and adequate risk management systems. DBs and *fideicomisos* would continue to supply credit during the transition, but mainly through second-tier operations. Once deposit-taking and debt issuance are phased out, DAs would be funded completely through the Government budget. The switch

[16] FIRA is an example of better practices in the use of partial guarantees and of well-designed subsidies.

from below-market interest rates towards up-front subsidies could be initially absorbed in the capital of the transforming DBs and *fideicomisos*, until a suitable tax reform is in place.

E. Policy Issues in Housing Finance

15. **The current system of housing finance is dominated by the public sector and blocks the development of mortgage markets, which are necessary to support significant progress towards the government goals in the housing area**. The system is very small by international standards and totally dependent on government funding through FOVI-SHF (18 percent share of new mortgage loan production in 2000) and on mandatory wage contributions to publicly administered pension funds—INFONAVIT (70 percent share) and FOVISSSTE (5 percent share)—earmarked by law to housing. The system is fragmented—each of these three institutions has been operating independently with a degree of transparency that varies across institutions but is low overall. The majority of mortgage loans are made at below-market interest rates. (FOVI-SHF began funding new housing loans at market rates in late 1999.) The current system would be unable to support significant progress towards the government's goal of raising new house construction to 750,000 units per year by 2006, which entails more than doubling annual mortgage loan production.[17] Leveraging on private market finance is necessary to achieve that goal.[18] A strategic opportunity to develop this market is provided by the rapidly growing demand of institutional investors for quality long-term assets.

16. **A reform strategy should address interrelated challenges including the redesign of subsidy programs, the restructuring of the state owned housing finance institutions, and the development of mortgage securitization and of private mortgage originators**. The separation of subsidies from finance is a prerequisite to enable market pricing of mortgages—with targeted subsidies funded through budgetary contributions—while supporting social policy objectives. The sustainability of sound subsidy programs hinges on fiscal reform.

17. **The recent creation of the SHF—which takes over BOM's functions as trustee of FOVI—is on balance a positive move but needs an acceleration of complementary reforms.** The SHF—created by a law that was enacted in October 2001—is a housing development bank. Consistent with recommendations of the FSAP mission, the SHF's function will be restricted eventually (after an eight-year transition period) to the provision of guarantee products to primary private mortgage lenders. To avoid a collapse in the supply of mortgages, the SHF was given authority to act as a second-tier lender during the 8-year transition and to fund this activity by issuing government-guaranteed debt. Also in line with FSAP recommendations, the government guarantee on SHF debt is pre-set to disappear after a transition period of 12 years. This latter period appears too long, but it is expected that the SHCP will determine yearly ceilings for new indebtedness by the SHF. The authorities should consider, in addition, pricing the government guarantee according to periodic external rating of SHF's own financial strength (i.e., a rating without taking into account the government

[17] The current housing deficit is estimated at about 6 million formal housing units, at a time when Mexico is entering into a demographic phase of maximum housing demand.

[18] Not a sufficient condition—loans alone do not result in affordable housing, which is what Mexico needs. The government has created a National Council for Housing and Urban Development to coordinate policies across the sector and monitor performance.

guarantee).[19] Also, the operation of SHF without monopoly power and, preferably, the eventual privatization of the SHF should be envisaged to create appropriate incentives for its managers. Other challenges for the SHF include the elaboration of a business plan consistent with the promotion of healthy private mortgage markets as well as the implementation of high standards of professionalism, governance, risk management, transparency, and accountability.

18. **The restructuring of INFONAVIT is crucial, but constitutes a daunting challenge**. Its dominant market share and ability to fund (out of compulsory contributions) mortgages at below-market rates make INFONAVIT potentially the most disruptive institution to the development of mortgage markets. INFONAVIT embodies an inherent conflict between its fiduciary duties as a pension fund, its first-tier bank function as mortgage lender, and its social policy function as subsidy provider. This results in triple damage—erosion of value of long-term compulsory savings for retirement, severe price distortions that stifle the development of mortgage markets, and poor performance and opaque subsidies that widen the government contingent liability related to private pensions.[20] This conflict is exacerbated by INFONAVIT's tripartite governance structure—its Board of Directors is composed of representatives from employers, labor unions, and the government. A way out of this problem would require a transition period to avoid the disruption of new housing finance flows. The transition would include: improving loan collection; separating subsidies from finance; gradually restricting the production of INFONAVIT's housing loans, with any new loans made at market rates; generalizing the "portability" of accumulated contributions;[21] and allowing INFONAVIT to invest in mortgage-backed securities and mortgage bonds. Similar reforms should be considered for FOVISSSTE—unfortunately much worse managed than INFONAVIT.

19. **An agenda of reforms is needed to develop a secondary mortgage market that can support sustainable growth for mortgage originators and services.** Mortgage-oriented Sofoles display high quality loan portfolios and can become the core of private mortgage origination or servicing, businesses that would also attract commercial banks. To this end, Sofoles would need to graduate from their current reliance on FOVI-SHF resources for their funding. This requires the elimination of unfair competition from highly-subsidized mortgage products offered by INFONAVIT and FOVISSSTE and a uniform regulation by the CNBV across all mortgage lenders (commercial banks and Sofoles). The development of a secondary mortgage market is necessary in the medium-term, but related legal, regulatory, and tax reforms should begin in earnest, particularly given the SHF plans to introduce a guarantee to enhance the rating of mortgage-backed securities (so that they could be purchased by pension funds). Constraints for mortgage securitization include: the absence of adequate "raw material" (well

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[19] Under a World Bank loan operation, the SHF would commit to a formal pre-rating as a stand-alone financial institution (i.e., without consideration of the government guarantee).

[20] The pension reform in Mexico gave the older generation of private sector workers (those able to switch from the old to the new system) an option whose cost is to be paid by the government: upon retirement, if the sum of accumulated (mandatory) contributions to AFOREs and INFONVIT yields a lower pension than that which would have been received under the old pension system, the retiree has the right to the latter and the government must cover the difference. For the newer generation of private workers, the government guarantees a minimum monthly pension of one minimum wage (indexed to the CPI).

[21] The authorities have begun liberalizing the use of Article 43bis of the INFONAVIT Law, which allows affiliates to use their accumulated contributions to secure a non-INFONAVIT originated mortgage loan.

underwritten and standardized mortgages at market interest rates); an incomplete/untested legal framework (e.g., for bankruptcy-remote transfer of mortgages through a special vehicle); and deficiencies in the tax and regulatory framework for the would-be market players (mortgage originators and servicers, issuers, third-party credit enhancers, and institutional investors).

F. Banking Supervision and Prudential Regulation

20. **Mexico has successfully upgraded banking supervision, but some weaknesses need to be addressed to achieve full compliance with the Basel Core Principles for Effective Banking Supervision (BCPs), as discussed below.**

21. **The CNBV lacks adequate autonomy**. Certain regulatory powers are outside the CNBV. Given its governance structure and the manner in which its president is named, political interference in decision-making and politically imposed budgetary constraints are attendant problems. Greater autonomy for the CNBV is thus required. This should include budgetary independence with accountability, the appointment of its president for a minimum term and removal from office during such term only for reasons specified by law, a merit-based career scheme for CNBV staff, and adequate protection of staff from discretionary dismissals and against lawsuits for actions taken while discharging their duties.

22. **The CNBV should intensify efforts to continue to boost its credibility.** CNBV's credibility was eroded when it resorted to nontransparent forbearance during the 1994-95 banking crisis. Efforts undertaken by the CNBV in recent years have arrested and begun reversing such trend. Further restoring this credibility is a matter of utmost priority. The recently approved improvements to legislation are welcome, but these need effective implementation and enforcement. The CNBV must better communicate with the Mexican banks' boards of directors and senior management and enhance its knowledge of their strategic business plans and risks. More disclosure with respect to its decisions and sanctions will contribute to increasing the public's awareness of the CNBV's role and would also enhance its credibility. The CNBV should implement an action plan to improve its own corporate governance (including, strategies, internal policies, and quality control systems).

23. **There is a fragmentation of supervisory powers, which weakens accountability and enforcement.** The law establishes the CNBV as primarily responsible for banking supervision, but the SHCP and the BOM are also entrusted with regulatory and some supervisory responsibilities. For instance, the SHCP grants and revokes licenses, albeit on the basis of technical input by CNBV. The BOM issues regulations on liquidity and foreign exchange risks and regulations on capital and concentration of risks are issued by the SHCP, although the CNBV plays a pivotal role in the technical aspects. The responsibilities of the agencies involved in banking supervision (the BOM, the CNBV, and the SHCP) should be clarified to have a more rational division of labor and more accountability. Better coordination within the CNBV and among different agencies (CNBV, BOM, CNSF, and CONSAR) is needed.

24. **The CNBV should accelerate the move towards risk-focused supervision and seek to enhance monitoring by banks' boards of directors and external auditors.** In particular, CNBV needs to understand better the reasons behind banks' risk taking through a closer dialogue with the banks' directors. Until the recent legal reforms, the banks' boards of directors were not adequately required to monitor risk taking and ensure that sound risk management

systems are in place. There was no minimum requirement for the presence of independent board members, nor adequate rules to prevent conflicts of interest, nor clear rules for the removal of unfit directors or guidelines that ensure open communications between the CNBV and the banks' external auditors. The recent legal reforms would, once implemented, significantly correct these deficiencies.

G. Bank Failure Resolution and Deposit Insurance

25. **The current bank resolution framework is heavily biased in favor of open-bank resolution, which risks being inconsistent with the limited deposit guarantee that will enter into full effect in January 2005**. The IPAB Law approved at the end of 1998 represented a major improvement in bank resolution. It granted IPAB strong powers for open-bank resolution (a process whereby the IPAB takes full control of an insolvent bank, writes off or substantially dilutes the bank shareholders' equity, recapitalizes and rehabilitates it, and sells it back to the private sector, keeping it open to the public all along). IPAB has successfully applied these powers to resolve such large banks as Serfin and Bancrecer. However, open-bank resolution will become increasingly inconsistent with the gradual lowering of the full guarantee on all bank liabilities to a limited guarantee of 400,000 UDIs (about US$100,000) per depositor per bank, the same as in the United States. Once this limit is in effect, it would normally no longer be the case that open-bank resolution is a lower cost alternative compared to bank closure and liquidation.[22]

26. **Mexico lacks an adequate framework for efficiently and swiftly closing, resolving, and liquidating nonviable banks**. Neither the CNBV nor the IPAB have the legal power to suspend the operations of a bank and close it. The power to remove a bank license, which would precipitate its liquidation, rests with the SHCP. It is unclear whether the liquidation of a bank can be initiated by the IPAB or whether a judge would need to declare it. The law does not establish cessation of payments as a trigger for bank closure. The two legal routes for liquidation (the bankruptcy and the company law) are inadequate for banks, do not provide all the needed powers to the liquidator nor they specify a priority of claims order suitable to banks (no distinction is made between depositors and other bank creditors). Legal reform is thus needed. Closed-bank resolution should be established as the *default alternative*, which is necessary to foster market discipline. Triggers for bank closure should be clearly defined and responsibilities of the IPAB and the CNBV delineated.[23] Adequate sharing of information and coordination between these institutions should be ensured, with the IPAB necessarily consulted at the earliest detection of any risk to the deposit guarantee fund. The legal reform should enable efficient resolution techniques for closed banks (purchase and assumptions aided by a contribution from the IPAB, with the amount of such contribution subject to some "less cost" criteria).[24] A suitable order of priority for claims on a bank should be specified. IPAB should

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[22] The IPAB Law requires the determination by an independent "third" party (other than the CNBV) that rehabilitation of an insolvent bank is a less costly alternative than its liquidation.

[23] The regulatory implementation of the legal reforms adopted in April would ensure that increasingly tougher enforcement measures are triggered more automatically as a troubled bank deteriorates or fails to comply with key prudential norms and supervisory instructions. But the current framework does not establish precisely the circumstances that would move a troubled bank from intervention to resolution, or directly to resolution.

[24] Under this criteria the resolution technique chosen for a closed bank should not be more costly than the one involving the traditional liquidation of the entire bank.

be granted the broadest and strongest liquidating powers possible, subject to appropriate accountability and transparency.

27. **The current framework of open-bank resolution, suitably modified, could be retained, but only to be used in the cases of banks deemed to be "too-big-to-close" or under extraordinary circumstances of high systemic risk**. To ensure that it is used only under exceptional circumstances, open-bank resolution should be authorized at the highest levels of responsibility (a joint decision of the CNBV, the IPAB, and the SHCP) and under strict—albeit swift—protocols. The costs of open-bank resolution should be borne by the federal government, and not by the premium-based deposit insurance fund.

28. **A number of other IPAB-related reforms are also needed**. The IPAB's Board must be given greater flexibility to determine the structure of deposit insurance premiums. In particular, the current floor of 40 basis points per year for the premium rate should be removed.[25] Such a floor *de facto* eliminates the possibility of implementing risk-based premia, which are nonetheless allowed by law. The IPAB should promulgate as soon as possible rules and regulations regarding the nature and application of the deposit guarantee coverage, collect detailed information on the structure of insured deposits and other bank liabilities, widely publicize the nature and characteristics of the limited deposit insurance, and adopt a distinctive official sign to be posted in member banks (to signal that deposits in member banks are guaranteed to the maximum limit allowed by law). Also, to further facilitate the disposal of assets it inherited from FOBAPROA—a process that the IPAB has been implementing through sales and outsourcing and with significant success—certain taxes that unnecessarily hamper the secondary sale of assets should be removed.

H. Securities Markets Development

29. **Securities markets in Mexico play a very limited role in mobilizing finance for the private sector, with high concentration and fragmentation exacerbating illiquidity, particularly for equity and corporate debt securities**. During 1999-2000 there were only four offerings in the local securities market. Debt securities issued by the non-financial private sector account for only 9 percent of the total stock of the debt securities. Ownership of listed companies is highly concentrated. There is very limited "free float"—i.e., low proportion of shares effectively free to be traded. The effects of concentration on illiquidity are exacerbated by undue fragmentation of instruments. While the more relevant stocks have migrated and are now traded in New York,[26] locally listed firms issue too many different types of non-fungible shares—mainly to avoid dilution of corporate control. The markets for public sector debt—which dominates fixed income markets—have become deeper and duration has been extended, but liquidity remains concentrated in the shorter-end of the yield curve and fragmentation still exists. Debt issues by banks dominate markets for private sector debt, characterized by high fragmentation and very short duration (typically 1-7 day tenors). By spreading liquidity too thinly, fragmentation amplifies price volatility and reduces incentives for the development of securities lending activities, key to capital market development.

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[25] By law, the base for the application of the premium rate is the stock of a bank liabilities—not just insured deposits or total deposits.

[26] In 2000, about 60 percent of total trading occurred offshore and nearly half of companies were listed offshore.

30. **The institutional and retail investor base remains underdeveloped, but the potential for growth is substantial**. Funds held by institutional investors (insurance companies, privately administered mandatory pension funds in the AFORE-SIEFORE system, voluntary occupational pension plans, and mutual funds) are estimated at 11 percent of GDP, far smaller than most of the larger countries in the region. However, expected growth is very large. Funds in the mandatory retirement system (including the AFOREs and INFONAVIT) are projected to grow from 7 percent of GDP in 2000 to 17 percent in 2010. A significant share of pension-related mandatory savings has been unavailable for investment in securities markets, as it is concentrated in INFONAVIT (for private sector employees) and FOVISSSTE (for central government employees)—both public sector pensions whose resources are earmarked by law to fund subsidized housing loans. The vast proportion of resources of private institutional investors is invested in government debt securities and bank liabilities. The retail investor base is extremely small—less than 1 percent of the population invests in securities markets.

31. **Past macroeconomic instability and risks, and the associated high interest rates, have been an overarching constraint to the development of securities markets; but micro-level factors have also been harmful**. The government pays 15-16 percent per year (7-8 percent in real terms) on its domestic-currency short-term debt. The cost of funds for companies that do not have access to international markets is at a significant spread over government debt, with the added problem that a domestic market for long-term finance is virtually nonexistent. Savers are typically unwilling to consider alternative investments when risk-free government securities offer such high returns. *The consolidation of macroeconomic stability is, thus, a pre-condition for the development of securities markets.* Micro-level obstacles include: (i) weak corporate governance (mainly reflected in poor protection of minority shareholders); (ii) inconsistencies in the regulatory treatment of like transactions conducted by different entities (mainly stemming from insufficient coordination among regulatory agencies); and (iii) perceptions that markets are inadequately policed and, hence, vulnerable to manipulation, insider trading, and minority shareholder mistreatment. The latter problem appears partly due to a lack of public awareness of enforcement actions taken by the CNBV.[27] Problems (i) and (iii), together with the lack of autonomy of the CNBV, emerged as key areas of under-compliance in the assessment of IOSCO Principles, with which Mexico was otherwise found to be substantially in compliance. *The legal reforms enacted in April 2001should help address many of these micro-level problems.*

32. **To develop the fixed income markets the authorities should put a premium on strengthening the repo market and facilitating securities lending activities.** Mexico should adopt an internationally accepted master repo contract to facilitate greater standardization and liquidity. Money market funds operated by banks and mutual funds operated by brokers should be subject to the same ceiling on the amount of government debt securities they can invest in via repos.[28] And regulations affecting other institutional investors' use of repos (with

[27] Since 1998 the CNBV has imposed many heavy fines on individuals and intermediaries for such infractions as insider dealing and market manipulation. However, the names of the penalized individuals and intermediaries have not been disclosed, as authorities consider that there has been no sufficient legal ground to do so.

[28] The authorities are taking steps in this direction. They will continue to prohibit mutual funds to use reverse repos (i.e., the sale of a security with the agreement to buy it back at a pre-specified date in the future), as they do not want mutual funds to assume leverage.

government debt as underlying security) should be reviewed. In a second stage, the authorities should consider lifting the prohibition on repos that use private debt as underlying security, once adequate disclosure and valuation methodologies for illiquid securities are in place. A reduction in fragmentation would be a prerequisite, as it will be necessary for the development of securities lending activity, essential to enhance market liquidity.

33. **Enhancing the liquidity and depth of the existing centralized market for equity will be a far more difficult task than in the case of the market for debt securities.** Partly because of low liquidity and valuations in the domestic equity market, large and well-established issuers have tended to move to foreign markets, mainly the U.S.. This trend is unlikely to be reversed. Thus, the focus should be on developing the equity market for enterprises that could not enter international stock markets. The legal reforms introduced in April 2001 to reduce fragmentation in share classes and improve minority shareholders' rights constitute important steps. They should be complemented with actions to further improve liquidity and market integrity, reduce transactions costs, and deepen the role of institutional investors—all of which would help reverse the current phenomenon that listed companies are more highly valued in transactions outside the stock exchange than in a public offering.

34. **The development of a domestic market for private placements can bring additional benefits.** The April 2001 reforms created the legal foundation for such a market. A regulated private placements market may permit the application of better corporate governance standards than in public markets because of the greater leverage available to investors. It may help reduce the cost of disclosure, underwriting and issuance. It could enable internet-based private placements, allowing medium to small sized companies to display information about their business plans and raise equity finance from qualified institutional investors. This would, in turn, require that pension funds be permitted to make marginal investments in less than AAA-rated companies.

35. **Recent legal reforms are expected to foster development of the mutual fund industry.** Once implemented, the new law for mutual funds (*Sociedades de Inversión*) approved in April 2001 would permit a wide variety of collective investment vehicles, with different risk profiles, offering different fee structures to different classes of investors, all subject to stringent disclosure standards. It would allow mutual funds to outsource such functions as mid- and back-office operations and to take advantage of a much wider range of distribution channels to market products to a broader investor base. It would reduce conflicts of interest, facilitate supervision, and encourage competition between group-affiliated and independent fund managers by requiring all mutual fund asset management to be conducted through a separate subsidiary of a financial group.

36. **Prudent liberalization of pension fund investment regulations should be considered to enhance investor protection through risk diversification while fostering the demand for quality long-term securities.** This should include a broadening of the range of permissible domestic investments and some allowance to invest safely in foreign markets—through registered mutual funds and not just circumscribed to high-grade Mexican companies traded abroad.[29] SIEFOREs could be permitted to make marginal investments in debt securities

[29] Maximum limits on permissible investments are nonbinding in the case of insurance companies, as most of these companies' reserves are invested in government securities, given the dearth of alternative quality

rated less than AA and in real estate trusts, contingent upon proper valuation and risk management arrangements. In the case of voluntary (and unsupervised) occupational pension plans, competition in their management should be increased (currently only banks and brokerage firms are allowed to manage them) and the high requirements for investment in government securities reduced, but only after such funds are formally brought under formal supervision. As the investment management industry is already very concentrated, further mergers should be carefully reviewed to avoid eroding market contestability.

37. **Strengthened enforcement powers and a further shift towards risk-based supervision of securities markets are key to enhance CNBV credibility.** The implementation of the April 2001 legal reforms should improve enforcement. It would permit the CNBV to publicize its enforcement activities, broaden its subpoena power, and enhance its capacity to share information with foreign regulators—which is all the more important considering the increasing migration of Mexican companies offshore. Beyond the legal reform, CNBV should define minimum standards for risk measurement and management for investment banks, brokerage houses, and fund managers, and further shift supervision from a check-list compliance approach to a risk-focused approach.

I. Insurance Sector

38. **The market for insurance products is small, albeit fast growing, and highly concentrated, but insurance companies appear financially sound and well managed.** Penetration, as measured by the ratio of gross premium income (GPI) to GDP, increased from about 1 percent in 1990 to about 2 percent in 2000, mostly due to annuity premiums, while the number of insurance companies rose from 43 to 70. The five largest companies write around 65 percent of GPI, with concentration having significantly decreased in the annuity and nonlife markets but rapidly increased in life insurance. Since the signing of NAFTA, the wholly owned foreign subsidiaries increased from 0 to 29, and now account for 15 percent of GPI for all lines of business and 20 percent of the assets of insurance companies. The high quality of management is reflected in strong underwriting performance and rising productivity.

39. **Mexico is compliant with most of the IAIS Core Principles, but there are a few areas of under-compliance**. The CNSF's style of supervision is swiftly evolving from a traditional tight control of all activities of insurers to a more risk- and transparency-based approach. To succeed in this evolution, minimum standards for internal controls and self governance rules should be continuously upgraded. The law does not establish sufficient powers for the CNSF in the area of corporate governance. Pending a legal reform, the CNSF plans to implement several measures to address this limitation. CNSF is in the process of clarifying the responsibilities of boards of directors, to ensure sound internal control systems, the hiring of independent advisors approved by the CNSF, and the designation of a compliance officer who would report to the CNSF. The SHCP has the ultimate say on licensing and other regulations pertaining to the insurance sector. The CNSF does not have budgetary autonomy—

investments. The recently enacted legal changes allow CONSAR to issue regulations to permit SIEFORES to invest in securities issued by Mexican companies but traded abroad, but the strong correlation between securities listed at home and abroad suggests that broadening eligible SIEFORE investments to these securities will not materially help in terms of risk diversification.

its budget is determined by the SHCP—and this limits its capacity to attract and retain highly skilled professionals. There is no formal protection of staff when discharging their official duties. The regulation on sanctions should be revised to allow for gradualism, especially for minor infractions. The liquidation process allows too much time for the SHCP to revoke a license. CNSF lacks the power to suspend the operation of all or some lines of business. The CNSF presented to the FSAP mission a detailed action plan to improve the already high observance of IAIS principles.

40. **The insurance sector is generally well supervised, but there is room for improvement in respect of liquidity requirements, actuarial valuation of technical reserves, composite companies, and auto insurance**. The high professionalism of the CNSF is illustrated by the issuance of technically sound regulations on complex risks (on annuities, health, and earthquakes).[30] However, the liquidity requirement should be mainly defined by the marketability of the assets involved (rather by their maturity only) and should be lower for life insurance accumulation contracts, so as not to exacerbate the tendency to invest short term. The actuarial valuation of technical provisions should not be based on initial contractual assumptions but on updated assumptions regarding future risks over premiums. To enhance risk management, the authorities should consider either phasing out composite companies (which conduct life and nonlife insurance business under the same roof) or, at least, ensuring that assets of life and nonlife businesses are separately accounted and managed within composite companies. The adoption of compulsory auto insurance (third party liability insurance) throughout all the Mexican states should be encouraged for social safety reasons.

J. Secured Lending and Corporate Insolvency

41. **Legal reforms approved in May 2000 improved the framework for secured lending, but some shortcomings can hamper implementation and limit benefits.** The reform facilitates the use of movable collateral (e.g., inventories, accounts receivables, crops, etc.) to mobilize credit—through pledges without transfer of possession and regulated security trusts. It includes amendments to the Commerce Code to allow the (federal) public registries to work on an electronic basis and provides for accelerated judicial and nonjudicial enforcement. However, complementary institutional reforms are needed (e.g., in the registries and judicial processes) and certain legal shortcomings could hamper implementation. The requirement that only fully identified property could be pledged makes it almost impossible to pledge only a portion of a debtor's current assets, such as inventory or accounts receivable. The law over-regulates—it requires excessive specification of the characteristics, location, and other aspects of the collateral. Prior authorization of a judge or the creditor is required for a pledgor to sell the collateral in the normal course of business (if the collateral represents more than 80 percent of the assets of the pledgor)—which is impractical. There is a requirement to introduce a nonrecourse clause in every pledge providing that, if the collateral is sold and the proceeds are not sufficient to cover the debt, the uncovered portion is deemed to be extinguished. Banks are deterred by this nonrecourse clause, tending in response to ask for considerable over-collateralization or to simply avoid using the new pledge vehicles.

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[30] The CNSF should use its good experience with earthquake insurance regulations to develop regulations for crop and hurricane insurance.

42. **A new Commercial Insolvency Law, also approved in May 2000, revamped the framework for corporate reorganization and bankruptcy.** It overcomes the main problems of the old system and puts corporate insolvency exclusively under federal (rather than state) jurisdiction. It eliminates the risk of abuse of the “stay on payments” by unscrupulous debtors, by increasing informational requirements on debtors wishing to file for bankruptcy and by delaying the imposition of a “stay on payments” until a judge declares a situation of mercantile insolvency. It streamlines procedures, ensuring that procedural exceptions no longer suspend the conciliatory phase. It limits the role of the judges while maximizing the role of experts. It reduces conflicts of interest and adds flexibility to the settlement agreements (e.g., there is no limitation on the maximum amount of debt haircuts, capitalization of debts, and rescheduling terms)—which require the favorable vote of creditors representing 50 percent or more of the claims on the debtor. It contains provisions to deal with netting issues, including in respect of repos and derivatives. The new law, however, appears to have some drawbacks. It is not clear whether it protects sufficiently secured claims. In its efforts to avoid the abuse of “stay on payments,” the law may have gone too far, opening perhaps undue room for unilateral actions by creditors aimed as seizing assets ahead of other creditors.[31]

K. Debtor Information Systems

43. **The debtor information registry—essential to reduce information asymmetries in financial markets—could be improved by enhancing consumer rights and information sharing, and by broadening coverage to other forms of lending.** While the main credit bureau is controlled by banks (which own 70 percent), many nonbank lenders participate and supply their debtors’ information, which makes it a system of significant coverage. The CNBV requires banks to check the credit bureau before making new loans. However, the Mexican credit bureau ranks low in terms of protection of personal data and information sharing relative to other Latin American countries. Debtors do not have easy access to their private information in the bureau. The process to challenge an incorrect entry is lengthy and unnecessarily cumbersome. Individuals do not have a legal right for a judicial hearing to settle disputes on their personal credit data. Secrecy laws prevent lenders from learning the name of other lenders listed in the bureau, and explicit authorization by individual debtors is required for lending institutions to submit or request information. Legal and regulatory reforms are needed to address these shortcomings and obstacles. In addition, the government should consider supplying information to the bureau, at least on whether tax and utility payments are overdue. It should also encourage further broadening of the universe of participating lenders, including Telecoms, which maintain their own proprietary credit registry.

[31] For the effective operation of both secured lending and corporate insolvency processes, reforms to the judicial system would be needed, particularly regarding the so-called *amparo* procedures, which tend to be used excessively to delay the enforcement of creditor rights.