SM/01/229
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

October 17, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Mexico—Financial System Stability Assessment**

The attached correction to SM/01/229 (7/17/01) has been provided by the staff:

Page 20, para. 27, line 12: for "present, several banks"
read "present, almost all banks"

Questions may be referred to Mr. Leone (ext. 38628).

Att: (1)

Other Distribution:
Department Heads

perception of market participants was eroded as a consequence of the management of the banking crisis. Political interference in decision-making and politically imposed budgetary constraints are attendant problems that undermine the CNBV's operational independence. Strengthening the supervisory framework requires greater autonomy and enhanced credibility for the CNBV. Also, the CNBV should implement an action plan to improve its own corporate governance (including, strategies, internal policies, and quality control systems). As discussed in the assessment of compliance with the Basel Core Principles in Section II, Box 2 presents the major measures needed to strengthen banking supervision.

26. ***The authorities are making efforts to address the shortcomings in enforcement and disclosure powers and in supervision and regulation vis-à-vis the securities markets.*** Strengthened enforcement powers, greater disclosure of actual infractions in insider dealing and manipulation cases, and a further shift toward risk-based supervision are all needed to enhance the CNBV's credibility. Legal reforms recently approved by Congress will strengthen the CNBV's enforcement powers by allowing it to publicize its enforcement and regulatory activities, broaden its subpoena power, and enhance its capacity to share information with foreign regulators—which is important considering the increasing migration of capital raising by Mexican companies offshore.

Box 2. Strengthening Banking Supervision

In general, Mexico has been successful in upgrading the quality of the supervision of banks under stressful conditions. Further steps to strengthen effective supervision should include the following actions:

- ***Moving toward greater CNBV autonomy, along with greater CNBV accountability and improved coordination.*** This should include budgetary autonomy of the CNBV, appointment of the CNBV's President for a fixed term, and strengthening legal protection for supervisory staff in the discharge of their duties.

- ***Clarifying the division of labor on supervision matters among the SHCP, the BOM, the IPAB, and the CNBV on banking.*** The designated supervisory authority, whether one agency or several closely coordinated agencies acting as one agency, should have the primary responsibility for proposing and drafting all prudential regulations, including having veto power in the enactment of regulations; enforcing prudential regulation, including corrective regimes; conducting on- and off-site supervision with coordination among different supervisors; and granting and revoking licenses and conducting fit and proper tests.

- ***Further restoring the CNBV's institutional credibility***. Accomplished by ensuring strict enforcement of prudential requirements, moving toward a more risk-focus supervision, and providing transparency on policy and decisions.

- ***Strengthening corporate governance within the CNBV.*** The CNBV should design an action plan addressing issues such as ensuring a consistent application of policies, establishing quality control of output, and enhancing internal controls.

27. ***The regulatory framework is being amended toward sound practices.*** The CNBV establishes the accounting criteria banks must observe in reporting financial information, which is broadly consistent with international generally accepted accounting principles. It also makes use of on-site examinations to verify bank records and compliance with prudential requirements. However, past, ad-hoc regulatory forbearance has been a source of distortion of the Mexican banks' public disclosures. The room for ad-hoc forbearance has been restricted by a recent regulation that limits the cases where forbearance can be granted and forces its full disclosure in banks' audited financial statements as of end-2000. The definition of capital currently in effect does not fully reflect the actual bank's economic capitalization to cover losses. However, a timetable is in effect through end-2002 to bring the Mexican definition of regulatory capital gradually closer to international standards.[16] At present, ~~several~~ almost all banks already meet the requirements of regulatory capital that will be in effect at the beginning of 2003. Finally, the ongoing review of the regulatory framework should be completed with a view to ensure a level playing field across different entities in the provision of like financial services.

28. ***The insurance sector is generally well regulated and supervised, but there is room for improvement in respect of liquidity requirements, actuarial valuation of technical reserves, composite companies, sanctions, liquidation, and automobile insurance.*** The liquidity requirement is defined by an asset's short-term maturity rather than its marketability, and it is too high for life insurance accumulation contracts, exacerbating the tendency to invest short-term. The actuarial valuation of technical provisions should be forward looking (i.e., based on updated assumptions regarding future risks over premiums). To limit contagion risk and enhance risk management, either composite companies (life and non-life insurance) could be phased out or their assets of life and non-life businesses should be separately accounted and managed. The regulation on sanctions should be revised to allow for gradualism. The liquidation process allows too much time for the SHCP to revoke a license from the moment the CNSF recognizes insolvency, with the CNSF lacking the power to suspend the operation of all or some lines of business (this can only be implemented through revocation of license). The adoption of compulsory automobile insurance (third-party liability insurance) throughout all the Mexican states should be encouraged for social safety reasons.

[16] Also, it should be noted that the regulatory definition of capital in Mexico is stricter than international standards regarding the requirement to deduct from capital all permanent investment in non-financial companies.