INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

ON A PROPOSED FIRST PROGRAMMATIC FINANCE AND GROWTH DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF US$501.26 MILLION

TO

THE UNITED MEXICAN STATES

January 27, 2006

Finance, Private Sector and Infrastructure Department
Colombia and Mexico Country Management Unit
Latin America and Caribbean Region
UNITED MEXICAN STATES - GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of January 26 2006)

Currency Unit: Peso
10.50 Pesos = US$1

Weights and Measures
Metric System

SELECTED ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>Afore</td>
<td>Administradora de Fondos para el Retiro (Pension Funds Administrator)</td>
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<tr>
<td>BdM</td>
<td>Banco de Mexico (Central Bank)</td>
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<tr>
<td>CPS</td>
<td>Country Partnership Strategy</td>
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<tr>
<td>CNBV</td>
<td>Comisión Nacional Bancaria y de Valores (National Banking and Securities Commission)</td>
</tr>
<tr>
<td>CNSF</td>
<td>Comisión Nacional de Seguros y Fianzas (National Insurance Commission)</td>
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<tr>
<td>CONSAR</td>
<td>Comisión Nacional de Sistema de Ahorro para el Retiro (National Pension Savings Commission)</td>
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<tr>
<td>DB</td>
<td>Government-owned development bank</td>
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<tr>
<td>DPL</td>
<td>Development Policy Loan/Lending</td>
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<tr>
<td>FM</td>
<td>Financial Management</td>
</tr>
<tr>
<td>FOVISSSTE</td>
<td>National Housing Fund for Public Sector Workers</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GoM</td>
<td>Government of Mexico</td>
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<tr>
<td>INFONAVIT</td>
<td>Instituto para la Protección del Ahorro Bancario (Banking Savings Protection Institute, the Mexican deposit insurance corporation)</td>
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<tr>
<td>IPAB</td>
<td>Instituto para la Protección del Ahorro Bancario (Banking Savings Protection Institute, the Mexican deposit insurance corporation)</td>
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<tr>
<td>MBS</td>
<td>Mortgage Backed Securities</td>
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<tr>
<td>MexDer</td>
<td>Mexican Derivatives Exchange</td>
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<tr>
<td>MI</td>
<td>Mortgage Default Insurance</td>
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<tr>
<td>PRONAFIDE</td>
<td>Programa Nacional de Financiamiento de Desarrollo (National Program for Financing Development)</td>
</tr>
<tr>
<td>PSBR</td>
<td>Public Sector Borrowing Requirement</td>
</tr>
<tr>
<td>ROSC</td>
<td>Report on the Observance of Standards and Codes</td>
</tr>
<tr>
<td>SHCP</td>
<td>Secretaría de Hacienda y Crédito Público (Ministry of Finance)</td>
</tr>
<tr>
<td>SHF</td>
<td>Sociedad Hipotecaria Federal (Federal Mortgage Institution)</td>
</tr>
<tr>
<td>Siefores</td>
<td>Sociedades de Inversión Especializadas en Fondos para el Retiro (Retirement Savings Institutions)</td>
</tr>
<tr>
<td>Sofoles</td>
<td>Sociedades Financieras de Objeto Limitado (Financial Institutions with Limited Purpose)</td>
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</tbody>
</table>

Vice President: Pamela Cox
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Lead Economist: David Rosenblatt
Sector Leader: Anna Wellenstein
Task Team Leader: Juan Carlos Mendoza
### LOAN AND PROGRAM SUMMARY

**UNITED MEXICAN STATES**  
**FIRST PROGRAMMATIC FINANCE AND GROWTH DEVELOPMENT POLICY LOAN**

<table>
<thead>
<tr>
<th>Borrower</th>
<th>United Mexican States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementing Agency</td>
<td>Secretaría de Hacienda y Crédito Público (SHCP, Ministry of Finance)</td>
</tr>
<tr>
<td>Amount</td>
<td>US$501.26 million</td>
</tr>
<tr>
<td>Terms</td>
<td>Commitment-linked fixed-spread loan in US dollars. Total repayment term of 15-years, including a 5-year grace period.</td>
</tr>
<tr>
<td>Tranching</td>
<td>Single tranche operation</td>
</tr>
<tr>
<td>Description</td>
<td>This proposed operation would support policy reforms in three areas: (i) strengthening market integrity and prudential regulation to set the foundation for continued sustainable growth of the financial sector; (ii) increasing the depth, access and diversification of financing to foster a more effective role of the financial sector in the development of the economy; and (iii) promoting diversified investment instruments to complement the aim of increased financial access through enhanced national savings levels and investment vehicles.</td>
</tr>
<tr>
<td>Benefits</td>
<td>The proposed loan would support sustainable growth and poverty alleviation by: (i) contributing to reduce the probability of a systemic financial crisis; (ii) fostering the sustainable growth of a financial system and capital markets that address the needs of the productive sector and increase the overall competitiveness of the economy; and (iii) increasing the diversification of savings and investment instruments available to households and institutional investors.</td>
</tr>
<tr>
<td>Risks</td>
<td>The main risks faced by the proposed operation are associated with the political transition that will take place as result of the presidential elections scheduled for July 2006 and the potential for macro-economic instability during the electoral period. The reforms that would be supported by the two operations of this program are, however, related to aspects of the financial sector agenda on which there is broad consensus among key political actors and which the Government is already actively implementing. Therefore, this limits the risk that the actions already taken could be reversed and that the indicative triggers of the next operation may not be reached within the 18 months following the effectiveness of this first loan. Additionally, an important part of the reforms supported by this loan are targeted at reducing the impact on the financial system of any potential macro-economic instability that could be generated by political volatility.</td>
</tr>
<tr>
<td>Operation ID Number</td>
<td>P097159</td>
</tr>
</tbody>
</table>
The World Bank Group greatly appreciates the close collaboration of the Government of Mexico in the preparation of this Development Policy Loan. This operation has been prepared by a team composed of: Juan Carlos Mendoza (Task Manager); Hela Cheikhrouhou, Martin Naranjo Landerer, Constantinos Stephanou (LCSFF); William Britt Gwinner (OPD); Joost Draizma, David Gould, (LCSPE) Mary Morrison (LCSFP); Emanuel Salinas Muñoz (YPP); Juan Carlos Alvarez (LEGLA), Victor Ordoñez (LCOAA), Solange Berstein, Mariluz Cortes and Alexia Santallusia-Serlavos (Consultants). The team benefited from the comments from other Bank staff including: Miguel López-Bakovic (LLC1C), Todd Crawford (LCOQE) and peer reviewers: Marilou Uy, Patrick Honohan, Roberto Rocha (OPD) and Aquiles Almansi (LCSFF). Editorial assistance was provided by Helena Issa.
I. INTRODUCTION

1. The Government of Mexico (GoM) has taken great strides in consolidating the stability of the financial sector. In the banking system, legal and regulatory reforms have fostered a more solidly capitalized sector operating under a prudential framework consistent with best international practices. Important reforms to the public banking sector have narrowed its focus thus limiting the potential for economic distortions as well as the creation of contingent liabilities for the GoM from its lending activities. Mexico has been a regional leader in the promotion of non-bank financial institutions, while avoiding their use for regulatory arbitrage purposes. In particular, their role has been essential in reinvigorating the housing finance sector, an area where Mexico is developing an increasingly sophisticated financing system. Enhanced corporate governance framework, supervision and institutional arrangements have also fostered the development of the capital markets. The most recent reforms have focused on the development of the equity markets, which have been lagging behind fixed income markets, a pervasive issue among emerging economies. Similarly, Mexico is addressing some of the most serious limitations being faced by countries that have reformed their pension plans towards privately-managed accounts. These limitations include limited competition among private pension administrators and the misalignment between workers’ and administrators’ incentives.

2. An ongoing program of reforms seeks to foster sustainable growth of the financial sector. The GoM has more recently embarked on a series of policy and institutional reforms which not only seek to continue strengthening financial sector stability, but also seek to promote the growth of a more diversified financial sector, offering a broader range of competitive financing and savings mechanisms to contribute more directly to the country’s overall economic growth. The Bank’s support for the GoM’s program of reform would consist of a two-phased programmatic development policy lending (DPL) operation. The entire program would be carried out over a period of 18 months and would be complemented by analytical work done at the request of the GoM on specific policy areas covered by the program. The first operation – the US$501.26 million proposed here – would support these aims through reforms in three policy areas: (i) strengthening market integrity and prudential regulation to set the foundation for continued sustainable growth of the financial sector; (ii) increasing the depth, access and diversification of financing to foster a more effective role of the financial sector in the development of the economy; and (iii) promoting diversified investment instruments to complement the aim of increased financial access through enhanced national savings levels and investment vehicles. Key triggers for the preparation of the second operation reflect continued reforms in these areas, including (i) the creation of a transparent banking resolution mechanism; (ii) strengthening the infrastructure for housing finance; and (iii) enhancing investment strategies and competition in the pensions industry. The second operation would be prepared provided that the reforms supported by this first proposed loan are sustained and that macroeconomic stability in Mexico continues.

3. The GoM has chosen to move ahead at this stage on those areas of the financial sector policy agenda on which broad political consensus exists. This approach seeks to minimize the risks associated with a program of reforms that will be implemented during an electoral period and will span two presidential administrations.
II. COUNTRY CONTEXT

4. A combination of fiscal discipline, prudent monetary policy and a positive international environment (particularly an improved U.S. economy) has fostered uninterrupted economic growth since mid-2003. The institutional strengthening of Mexican economic policy-making over the last decade has been reflected in the avoidance of instability during the last presidential transition, in 2000, and in the avoidance of a crisis during the most recent slow-down of the U.S. economy in the 2001-2002 period. The ensuing recovery has been broad-based. Business confidence and investment have risen, foreign direct investment inflows have strengthened, exports have picked up sharply, and market perceptions of Mexico remain favorable.

5. Financial sector stability indicators have continued to improve, not only due to improved macroeconomic indicators but also due to continued upgrading of the legal and regulatory framework. Since the 1994-1995 financial crisis, the last two administrations have concentrated their efforts in the financial system on improving the legal and regulatory framework, strengthening supervision, and fostering the entrance of foreign financial institutions to provide a bulwark against potential instabilities in the system generated by macroeconomic shocks. As a result of these initiatives, the main component of the financial sector, the banking system, has cleaned up its balance sheet and improved its prudential indicators to international standards.

6. Mexico’s consistent macroeconomic management during the last decade has generated confidence in international financial markets that instability will be limited during the upcoming electoral period. The period that led to the election of the current Administration broke the cycle of financial instability that had been associated with previous presidential transitions in Mexico. International markets reflect at this stage continued confidence in Mexico, as shown by the recent evolution of Mexican sovereign debt spreads (Figure 1). In addition, as in 2000, Mexican policymakers are in a position to take additional measures to reduce economic and market vulnerabilities in case of adverse developments or prolonged political uncertainty. Already, the GoM has announced the pre-funding and prepayment of external public debt service obligations due in 2006 and 2007, thereby suggesting it will not need to return to international bond markets throughout this period.

Figure 1: Emerging Markets Risk Premium

Source: JP Morgan Emerging Markets Bond Index (EMBI)
RECENT ECONOMIC DEVELOPMENTS IN MEXICO

7. Since mid-2003 the Mexican economy has gained momentum by taking advantage of the global economic recovery and high international oil prices, though growth is slowing. After a strong rebound of economic activity in 2004—when GDP rose 4.4 percent—the economy expanded at a more moderate 3.0 percent rate of growth in 2005. Global economic growth, high oil prices and export revenues, favorable external financial conditions, and increased domestic credit stimulated aggregate demand in all of its major categories—private consumption, investment, exports—raising economic activity and employment.

8. Continued price stability and increasing domestic credit have also contributed to the recovery. Price stability, sound public debt management and policies aimed at financial sector development allowed for a steady growth of domestic financial savings, whereas fiscal consolidation reduced the claim of the public sector on those savings thereby allowing for a sound expansion in domestic credit to the private sector. Since mid-2003, for the first time since the 1995 banking crisis, commercial banks’ outstanding credit to the private sector has grown in real terms, leading to higher private consumption and business investment. In addition, the government managed to extend the domestic yield curve issuing longer term fixed rate bonds (up to 20 years), thereby creating an important benchmark for longer term private sector credit contracts, including mortgage lending.

9. Inflation has come down after a substantial tightening of monetary policy. An increase of consumer price headline inflation in 2004, mainly attributed to supply shocks in the energy and food sectors, triggered a cycle of monetary policy tightening that lasted until mid-2005 and increased short-term interest rates to almost 10 percent annually. Consumer price inflation was effectively brought down from 5.2 percent year on year in December 2004 to 3.3 percent in December 2005, only slightly above the target of 3 percent. The successful reduction of headline inflation and inflation expectations allowed the central bank to start easing monetary conditions gradually throughout the second half of 2005, bringing down short term interest rates to 8.0 percent by the end of the year.

10. The government has kept the deficit within its annual budget targets and in line with its medium-term goal of fiscal consolidation. Higher than budgeted oil revenue has played an important role in achieving fiscal targets, compensating for lower tax revenue and higher public investment and revenue sharing with state and municipal governments. Oil-related budget revenue has grown by a total of almost 2.5 percentage points of GDP over the past three years allowing the budget deficit to be cut by almost half that amount, though substantially increasing public sector dependence on oil revenue, which in 2005 accounted for 40 percent of public revenue.

11. A modest external current account deficit has been maintained throughout the recovery due to strong oil revenue and workers’ remittances. The value of external trade resumed a double digit growth as of 2004 after its stagnation throughout the recessive 2001-2003 period. Mexican exports are closely related to the evolution of U.S. industrial production but face increased international competition as Mexico’s share in U.S. imports lost ground over the past two years. Though the non-oil trade balance is widening from a deficit slightly under 4 percent of GDP two years ago to a deficit close to 6 percent currently, the current account balance has kept a steady deficit at around US$ 8 billion or about 1 percent of GDP. In addition to rapidly increasing oil revenue, the current account is strengthened with strong and growing household transfers or workers’ remittances. These transfers are estimated at almost US$ 20 billion for 2005 slightly over 2.5 percent of GDP, making up an important revenue stream in the country’s external accounts and in the subsistence of poorer segments of Mexican society.
12. **Mexico’s macroeconomic framework is solid.** Progress in attaining macroeconomic stability is starting to pay off, with economic growth stabilizing around the economy’s growth potential. Improvements in Mexico’s sovereign credit risk ratings are another reflection of such progress and provide reasonable assurance of continued adequate access to external finance, even at times of increased market volatility.

13. **Structural economic and competitiveness constraints and the prevailing legislative gridlock** have reduced Mexico’s potential output growth to slightly over 3 percent per year over the medium term. In addition, the favorable external conditions are unlikely to prevail over the next few years and the government’s projection of 3.6 percent average annual GDP growth for 2006-08 may thus be difficult to attain. If the resolution of global imbalances were to result in a sharp slowdown in US growth, there is a risk that the Mexican economy could be adversely affected. Other factors like slightly lower oil prices, higher international interest rates, and political uncertainty related to the presidential elections and change in administration are likely to lead to a more moderate economic expansion over the next few years at an annual average growth of about 3.0 percent.

14. **The government’s medium-term fiscal framework aims to further increase fiscal consolidation and reduce public debt.** The government’s 2006 budget, presented in September, updated its medium-term fiscal projections for 2006-09. The projections include ambitious targets on the budget balance, with a small surplus in 2006, and a drop in off-budget financing. The fiscal consolidation envisaged in this framework would reduce net augmented debt to about 32 percent of GDP by 2009, from 41 percent in 2004.

15. **Public debt management has diminished the exposure to refinancing, interest and exchange rate risk.** A consistent implementation of the public debt management strategy aimed at reducing vulnerabilities and long-term financing costs has led to a significant strengthening of the government’s debt structure. The increasing use of longer term fixed rate peso bonds has contributed to an important increase in the average maturity of domestic public debt. A gradual reduction of external debt, by at least US$ 500 million a year, has also been part of the debt management strategy for a couple of years to reduce the country’s exposure to potential market vulnerabilities and external shocks.

16. **Mexico has no Purchases and Loans outstanding with the IMF and maintains periodic bilateral discussions as part of the Fund’s regular surveillance program.** The last Article IV consultation was concluded by the IMF Executive Board on November 9, 2005. The Executive Directors commended the Mexican authorities for the improvements they had made in the economic policies, institutions and structures over the last decade, which have contributed to greater macroeconomic stability and reduced financial vulnerability. The challenge ahead will be to launch a new round of structural reforms that will enhance the economy’s efficiency and competitiveness and ensure the transition to a more rapid growth path. The staff report, a Public Information Notice (see Annex 3) and a statement by the Executive Director for Mexico have been published in December 2005 and are available on the internet (www.imf.org).

### III. THE OVERALL GOVERNMENT PROGRAM

17. **The overall program of the current administration is set out in the National Development Plan 2001-2006 (Plan Nacional de Desarrollo).** This plan groups objectives, and the strategies for meeting them, into three broad areas: (i) social and human development; (ii) growth with quality; and (iii) order and respect. Table 1 below presents the principal objectives in each of these areas.
18. To meet the objective of managing the functioning of the economy responsibly, the National Development Plan sets out an agenda that includes different aspects of financial sector reform. Specifically, the strategies outlined toward this goal are: (a) coordinate fiscal and monetary policies; (b) promote a new form of public financial management; (c) promote efficient arrangements for regulation and supervision in the financial system; (d) promote a solid and efficient commercial banking sector; (e) strengthen non-bank intermediaries and build a culture of insurance in Mexico; (f) create a social banking sector; (g) strengthen the development banks; (h) foster efficiency in the capital markets; (i) promote productivity in the public sector; and (j) develop new instruments for risk control and the promotion of stability.

Table 1: Main objectives of the GoM’s National Development Plan 2001-2006

<table>
<thead>
<tr>
<th>Social and human development</th>
<th>Growth with quality</th>
<th>Order and respect</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Improve Mexicans’ levels of education and welfare</td>
<td>1. Manage the functioning of the economy responsibly</td>
<td>1. Defend independence, sovereignty and national territorial integrity</td>
</tr>
<tr>
<td>2. Increase equity and equality of opportunities</td>
<td>2. Increase and extend country competitiveness</td>
<td>2. Design a new strategic framework for national security, in the context of democratic governance and constitutional order</td>
</tr>
<tr>
<td>3. Promote education for the development of personal capacities as well as of individual and collective initiatives</td>
<td>3. Ensure inclusive development</td>
<td>3. Contribute to political relations taking place in the framework of the new democratic governance</td>
</tr>
<tr>
<td>4. Strengthen cohesion and social capital</td>
<td>4. Promote balanced regional development</td>
<td>4. Build a relationship of responsible, balanced and productive collaboration among the powers of the Union and advance toward true federalism</td>
</tr>
<tr>
<td>5. Achieve social and human development in harmony with nature</td>
<td>5. Create conditions for sustainable development</td>
<td>5. Foster the capacity of the State to manage and moderate natural disasters</td>
</tr>
<tr>
<td>6. Increase governmental capacity for responsiveness, to foster citizens’ confidence in institutions</td>
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<td>6. Reduce corruption and make absolutely transparent the management and performance of the federal administration</td>
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<td></td>
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<td>7. Guarantee public safety</td>
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<td></td>
<td></td>
<td>8. Guarantee the swift and efficient exercise of justice, bound by the law and respect for human rights</td>
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19. This proposed DPL has been designed to support the GoM’s policy priorities for the financial sector. Table 2 presents the measures that would be included in the operation, divided according to which of the seven financial sector strategies above they would support. Complementary Bank Group activities – the coverage of which this program also accommodates – are also included.
Table 2: Bank support for the GoM’s financial sector priorities

<table>
<thead>
<tr>
<th>Government strategy</th>
<th>Areas covered in this proposed DPL series</th>
<th>Other Bank Group support¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promote efficient arrangements for regulation and supervision in the financial system</td>
<td>Prudential regulation and supervision Market disclosure</td>
<td>Anti Money Laundering (AML) training</td>
</tr>
<tr>
<td>Promote a solid and efficient commercial banking sector</td>
<td>Risk management practices Solvency rules</td>
<td></td>
</tr>
<tr>
<td>Strengthen non-bank intermediaries and build a culture of insurance in Mexico</td>
<td>Non-bank intermediaries to the capital markets Promotion of competition and disclosure in pension funds industry</td>
<td></td>
</tr>
<tr>
<td>Create a social banking sector</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strengthen development banks</td>
<td>Housing finance infrastructure Promotion of risk capital industry</td>
<td>Savings and Credit Sector Strengthening and Rural Microfinance (Loan 7132-MX) Savings and Rural Finance - Bansefi Loan (Loan 7240-MX) Rural Finance Development Structural Adjustment Loan (Loan 7180-MX) FOVI Restructuring Loan (Loan 4443-MX)</td>
</tr>
<tr>
<td>Foster efficiency in the capital markets</td>
<td>New Securities Markets law Financial markets integrity</td>
<td>Accounting and auditing ROSC</td>
</tr>
<tr>
<td>Develop new instruments for risk control and the promotion of stability</td>
<td>New Securities Markets law Enhanced risk management in commercial banks Strengthening of the derivatives markets</td>
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</table>

20. In addition, PRONAFIDE, the GoM’s economic and fiscal program in support of the Development Plan, includes strengthening the financial sector and transforming the development banks as a central strategy. The expressed aim is to get a greater proportion of resources to flow through the financial system to all sectors of the economy. Overall, the National Program for Financing Development 2002-2006 (Programa Nacional de Financiamiento de Desarrollo, PRONAFIDE) seeks to permanently strengthen sources of financing, through increasing the growth potential of the economy and guaranteeing a stable macroeconomic environment. Specific financial reforms highlighted in PRONAFIDE are discussed in the appropriate sub-sectoral sections below. In addition to financial sector strengthening, PRONAFIDE establishes four other key strategies: (a) implementation of structural reform and provision of infrastructure; (b) increasing public savings efforts; (c) stimulating private savings; and (d) using foreign savings as a complement to domestic savings.

IV. KEY ISSUES IN THE FINANCIAL SECTOR

GENERAL CONTEXT

21. A decade after the Tequila crisis, Mexico has a stable financial sector, though it has left segments of the population/economy underserved. Starting in the late 1970s and for the following fifteen years, the Mexican financial sector experienced a series of boom and bust cycles in which the

¹ This support has been complemented by a joint World Bank-IMF Financial Sector Assessment Program (FSAP) carried out in 2002 which covered all areas of financial sector government strategy
bursting of credit bubbles led to the assumption by the public sector of substantial liabilities from the banking sector (through outright nationalization in 1982 or through bailouts of both lenders and debtors in 1995). During the late 1990s GoM’s financial sector policies concentrated on avoiding a bank run in the aftermath of the ‘Tequila crisis, cleaning up non performing loans of banks’ balance sheets and generating the macroeconomic stability necessary to attract foreign capital into the financial sector. These policies in principle addressed the majority of the most pressing issues associated with banking sector stability. However, this process was accompanied by a dramatic fall in private sector financing by banks, dropping from a peak of 39.9 percent of GDP in 1994 – a level which was probably associated with an irrational bubble – to 11.5 percent of GDP in 2004. Figure 2 shows the current overall structure of the Mexican financial system.

Figure 2: Distribution of assets of the Mexican Financial System
(Total Assets June 2005: US$397Bn)

Source: BdM, CNBV and CONSAR

22. **Capital markets have failed to fill the financing gaps left by the banks.** Domestic capital markets, including equity and debt issuance, developed quickly during the first half of the 1990s when they went from financing less than 1 percent of private investment to more than 6 percent in 1993 before contracting as result of the crisis. Since then, domestic equity markets have been anemic, while the private debt markets have started to recover since 2003 and have supported the development of financing and investment alternatives for non-bank financial institutions and pension funds. On the other hand, in part thanks to a more stable macroeconomic environment, the government has been able to develop the local public debt market, reducing its dependence on foreign debt. This has helped to develop a benchmark yield curve which should help to facilitate the pricing and, therefore, expansion of private sector issuances.

23. **Non-banking financial institutions and private pension funds are growing but still relatively small sources of financing.** As a result of the North American Free Trade Agreement (NAFTA) the legal and regulatory framework was set up to allow the development of non-bank financial institutions, which cannot take deposits but fund themselves in the debt markets or through bank loans, including those from government-owned second tier financial institutions. These institutions (Sofoles, Sociedades Financieras de Objeto Limitado) have concentrated their activities in the housing sector, a segment largely abandoned by the banks in the aftermath of the crisis. By 2004 Sofoles’s credit portfolios amounted to about 14.0 percent of the bank’s loan portfolio and about 29.1 percent of the total housing portfolio. The pension funds created as the result of the 1997 pension reform (Siefores, Sociedades de Inversión Especializadas en Fondos para el Retiro) are growing their assets under management at about 20 percent per annum and currently represent about 6.3 percent of
GDP. However, this important source of financing remains invested primarily in government debt (above 85 percent of total assets).

24. The dearth of financing vehicles also implies a lack of savings mechanisms for households and of adequate investment and hedging instruments for investors and firms, thus restraining growth and reducing employment opportunities. The limited depth of the financial sector not only constrains those demanding credit, it also hampers the ability to save and manage risks adequately, as a result of lower levels of competition and fewer incentives for the development of new financial products. The limited Sefores investment regime mandated by law, a natural result of its creation when the crisis was still fresh in policymakers’ memories, prevented adequate diversification of risks. The limited demand by Sefores reduced development of new investment and financing mechanisms. A combination of a weak legal framework in some areas and over-regulation in others prevented the development of derivative instruments essential for risk management.

25. The shrinking of the financial sector after the last crisis has extended longer than expected, with a particularly negative impact on credit flows to the private sector. A bank run and a generalized failure of the financial system were avoided in the aftermath of the 1994-1995 crisis. The ensuing contraction of the sector was expected, as prudent behavior by government regulators and new investors reined in the exuberance of the past. However, ten years later, the financial sector remains relatively small compared to other countries in the region (Figure 3). In some cases, other parties outside the financial sector have filled gaps. For example, real sector industries are now a major provider of supplier finance as reflected by the Banco de Mexico’s (BdM, the Central Bank) survey of enterprises and its balance of payments and credit flows analyses. But in many other cases, it appears that the lack of financing and investment vehicles has simply led to a loss of potential growth opportunities.

Figure 3: Credit to the Private Sector in Latin America

26. This contraction of the financial system has had an adverse impact on the overall competitiveness of the country. The ease, cost and efficiency with which businesses can access and manage financial resources have a major impact on the operation and investment behavior of firms. But the local productive sector is at a disadvantage internationally, in some aspects of the financial services available, particularly in the penetration of the financial system and the liquidity of the securities markets, according to a recent competitiveness study. (Table 3).
Table 3: Assessment of competitiveness for finance

<table>
<thead>
<tr>
<th>Mexico's competitiveness (2002) in terms of:</th>
<th>Rating from 0 (worst) to 100 (best)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Penetration of private financial system</td>
<td>3</td>
</tr>
<tr>
<td>Quality of banking sector and finance</td>
<td>67</td>
</tr>
<tr>
<td>Competition in the banking sector</td>
<td>91</td>
</tr>
<tr>
<td>Degree to which domestic banks face competition from foreign institutions</td>
<td>48</td>
</tr>
<tr>
<td>Liquidity of securities markets</td>
<td>12</td>
</tr>
<tr>
<td>Long term bank lending rates</td>
<td>90</td>
</tr>
</tbody>
</table>

Source: Situación de la Competitividad de México 2004, Instituto Mexicano para la Competitividad. [http://sinco.solutrends.com](http://sinco.solutrends.com)

27. **But this trend of decline in financial sector depth appears to be coming to an end.** The recent resumption of economic growth and maintenance of low inflation has renewed banks' interest in lending, especially to households. A more stable macroeconomic environment has led to lower interest rates and has encouraged the creation of long-term fixed-rate loan products. Accounting rules and capital adequacy and loan classification requirements have improved considerably, while risk management standards have been introduced that have enabled sound credit growth. Going forward, it is expected that maintenance of a favorable macroeconomic environment, combined with recent improvements in credit infrastructure, will help the process of financial re-intermediation.

28. **The recovery has been aided by improvements in the Mexican financial system’s infrastructure such as the development of a well-functioning credit bureau.** As shown in Figure 4, the depth and quality of credit information in Mexico compares very favorably with regional peers. The information available in credit bureaus is extensive, covering more than 33 million individuals and 1.4 million companies, which is estimated to account for more than 60 percent of the universe of possible borrowers. Although credit bureaus have been functioning since 1996, the introduction of a legal framework for the operation of credit bureaus in 2001 (*Ley para Regular las Sociedades de Información Crediticia*), whose impact has been fully felt during the last two years, has broadened the universe of participating lenders, enhanced the timeliness of data, and strengthened the protection of personal data and information sharing. In turn, improved credit information, together with stronger loan classification rules, has allowed banks to better measure and manage their credit exposures as well as to reduce transaction and monitoring costs.

![Figure 4: Credit Information Index (2005)](image)

Note: The credit information index measures, on a scale of 0 to 6 (where higher is better), the scope, access and quality of credit information available through public registries or private credit bureaus.

Source: Doing Business (World Bank, 2005)

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2 This is evidenced by the purchase of several Sofoles by banks since late 2004, allowing banks to penetrate the middle- to lower-income residential mortgage market.

3 Bank use of the credit bureau is mandated by CNBV for all new loans.

4 Creditors are required to update the information on their entire loan portfolio on a monthly basis.
29. **Improved auditing and accounting standards have also contributed to a better credit information environment and greater financial performance transparency among listed companies and financial institutions.** The Accounting and Auditing Report on the Observance of Standards and Codes (ROSC) carried out by the Bank in 2004 found that, during the last decade, Mexican Generally Accepted Accounting Principles (GAAP) have been converging towards International Financial Reporting Standards (IFRS). Local generally accepted auditing standards are also well developed although further steps are still required to harmonize them with International Standards on Auditing. In similar fashion, regulatory requirements for external auditors of credit institutions (amendments to *Ley para Regular las Agrupaciones Financieras*) have been introduced in 2005 that help to integrate external audits within the regulator’s (CNBV) supervisory process. These rules allow the CNBV to influence the scope of the external audit, to have access to auditor work documents, and to be informed directly of any material findings.

30. **Contract enforcement and creditor rights have also improved in recent years.** There have been significant efforts recently to enhance contract enforcement and creditor rights in Mexico. A new bankruptcy law (*Ley de Concursos Mercantiles*) in 2000 streamlined commercial litigation processes, clarified creditor ordering during liquidations and reduced the possibility of opportunistic insolvency filings that had been used to the detriment of creditors. A set of legal changes to the collateral framework (*Miscelánea de Garantías*) enacted in 2003 incorporated two new collateral mechanisms (non-possessor pledging of movable assets and the Guarantee Trust Agreement) and enhanced creditor rights by: (a) eliminating a burdensome non-recourse clause on pledges; (b) introducing new rules to expedite commercial procedures, which include harmonization of commercial litigation procedures across different states of the country under the Federal Code of Civil Procedures; (c) introducing out-of-court foreclosure procedures on security trust agreements (use of trusts as a vehicle of secured lending); (d) allowing the use of a blanket lien on assets to non-bank financial institutions; and (e) enhancing the collateral value of leased goods through enhanced repossession rules.

31. **The full impact of recent legal reforms on creditor rights has not yet been realized.** In the latest Doing Business Report (World Bank, 2005), the legal rights of creditors in Mexico continue to compare poorly to those in other regional and OECD countries (Figure 5). This report is based on data collected in 2004 and hence may not reflect the full effect of the recent reforms. Furthermore, while the laws governing creditor rights have been reformed, the process to improve enforceability of laws and the credibility and impartiality of the judiciary system through better judge selection, training and compensation may take longer, especially given the wide heterogeneity of institutional contract enforceability across individual Mexican states.
Figure 5: Legal Rights Index and Cost of Contract Enforcement (2005)

The legal rights index measures, on a scale of 0 to 10 (where higher is better), the strength of legal rights of creditors and their ability to promote access to credit. The cost of contract enforcement measures the cost of enforcing commercial contracts as a proportion of the actual debt.

Source: Doing Business (World Bank, 2005)

32. The GoM has designed a series of policy reforms to consolidate the renewed growth of the financial sector and continue strengthening the prudential regulation and market integrity to ensure sustainability. Given the history of previous financial crises and in spite of the significant advances that Mexico has made in strengthening its prudential regulation, the GoM has recognized that a reform program that concentrates on fostering the growth of the financial system without continuing to consolidate sector stability and market integrity would lack credibility, could have adverse effects or its impact could be set back if a financial crisis were to occur. Thus the program that would be supported by this DPL consists of reforms in three areas: (i) strengthening market integrity and prudential regulation to set the foundation for continued sustainable growth of the financial sector; (ii) increasing the depth, access and diversification of financing to foster a more effective role of the financial sector in the development of the economy; and (iii) promoting diversified investment instruments to complement the aim of increased financial access through enhanced national savings levels and investment vehicles.

33. The following sections describe in more details issues associated with each type of financial intermediary. This discussion concentrates particularly on issues related to the three policy reform areas to be supported by this loan.

BANKING SECTOR

34. Commercial banks continue to dominate the Mexican financial system, although non-bank financial institutions have progressively grown in importance. As shown in Table 4 below, the commercial banking sector accounts for more than 50 percent of the total assets in the financial system. However, its growth rate has lagged behind that of non-bank financial intermediaries such as Sofoles and Siefores, while its overall size remains relatively small (around 26 percent of GDP in June 2005). Changes in the legal and regulatory framework have facilitated the creation and growth of these non-bank financing vehicles, although they started from a low base and still represent a small share of the financial system. In addition to the traditional financial system, there are a significant number of “social” or “popular” banking institutions such as credit unions and cooperatives, which are relatively small in size (estimated to hold about 55 billion pesos in assets or 0.7 percent of GDP) but are important in terms of financial access for lower income households.

There is some “pyramidization” in the financial system arising from financial linkages between the different sectors, such as development banks financing Sofoles. On the other hand, assets are understated because the gross amount of securities repurchase agreements (repos) is not included on the balance sheets.
**Table 4: Mexico – Evolution of the Financial System (December 2001 - June 2005)**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>Jun-05</th>
<th>CAGR 1/</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Financial System Assets</strong> 2/</td>
<td>(in million of Mexican pesos)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial Banks 3/</td>
<td>3,529,174</td>
<td>3,646,240</td>
<td>3,897,850</td>
<td>4,163,268</td>
<td>4,223,659</td>
<td>5.3%</td>
</tr>
<tr>
<td>Development Banks 3/</td>
<td>1,871,941</td>
<td>1,873,673</td>
<td>1,993,656</td>
<td>2,141,993</td>
<td>2,124,851</td>
<td>3.7%</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>626,245</td>
<td>592,474</td>
<td>569,797</td>
<td>541,683</td>
<td>530,204</td>
<td>-4.6%</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>293,700</td>
<td>363,284</td>
<td>433,308</td>
<td>492,641</td>
<td>534,607</td>
<td>18.7%</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>330,009</td>
<td>364,433</td>
<td>391,943</td>
<td>407,706</td>
<td>453,743</td>
<td>6.1%</td>
</tr>
<tr>
<td>Sofoles</td>
<td>221,716</td>
<td>254,435</td>
<td>285,501</td>
<td>315,080</td>
<td>316,973</td>
<td>10.8%</td>
</tr>
<tr>
<td>Other 4/</td>
<td>103,003</td>
<td>134,982</td>
<td>154,550</td>
<td>191,553</td>
<td>204,137</td>
<td>21.6%</td>
</tr>
<tr>
<td><strong>Total Financial System Assets</strong> 2/</td>
<td>(in percent of GDP)</td>
<td>59.7</td>
<td>57.2</td>
<td>58.8</td>
<td>53.6</td>
<td>51.3</td>
</tr>
<tr>
<td>Commercial Banks 3/</td>
<td>32.2</td>
<td>29.9</td>
<td>28.9</td>
<td>28.1</td>
<td>26.3</td>
<td>-5.6%</td>
</tr>
<tr>
<td>Development Banks 3/</td>
<td>10.8</td>
<td>9.5</td>
<td>8.3</td>
<td>7.1</td>
<td>6.6</td>
<td>-13.2%</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>5.1</td>
<td>5.8</td>
<td>6.3</td>
<td>6.5</td>
<td>6.6</td>
<td>8.0%</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>6.0</td>
<td>5.8</td>
<td>5.7</td>
<td>5.3</td>
<td>5.3</td>
<td>3.4%</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>3.8</td>
<td>4.1</td>
<td>4.1</td>
<td>4.1</td>
<td>3.9</td>
<td>0.8%</td>
</tr>
<tr>
<td>Sofoles</td>
<td>1.8</td>
<td>2.2</td>
<td>2.2</td>
<td>2.5</td>
<td>2.5</td>
<td>10.7%</td>
</tr>
<tr>
<td>Other 4/</td>
<td>1.5</td>
<td>2.0</td>
<td>2.2</td>
<td>2.5</td>
<td>2.5</td>
<td>10.7%</td>
</tr>
</tbody>
</table>

**Memo item**

| Nominal GDP        | 5,811,776  | 6,267,474  | 6,894,993  | 7,634,926  | 8,074,121  | 9.8%      |

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1/ Compounded Annual Growth Rate (December 2001 - June 2005)
2/ Excluding Banco de Mexico
3/ Includes Fideicomisos and UDIs but excludes repurchase agreements (repos)
4/ Includes credit unions, brokerage firms, leasing and factoring companies, warehousing and foreign exchange houses

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35. **Substantial disintermediation has been apparent in bank balance sheets since the 1994-95 Crisis.** Disintermediation has occurred in both bank liabilities (financial savings) and assets (private sector credit). As Figure 6 shows, the share of bank liabilities to broad money (M2) has decreased, while the importance of public securities and pension funds (especially Sefores) has increased considerably. The recapitalization and restructuring of the banking sector following the 1994-95 crisis and the introduction of mandatory defined-contributions pensions in 1997 have been key determinants of this shift in financial savings. On the asset side, bank credit to the private sector has decreased relative to GDP and to other sources of financing, although it has experienced a recovery in real growth since 2001(Figure 7).
The commercial banking sector is highly concentrated in a few, mostly foreign financial institutions. As of June 2005, 6 out of the 29 commercial banks currently operating in Mexico controlled over 85 percent of total banking sector assets, with the top three banks accounting for 61 percent of total assets (Table 5). Many banks are owned by financial groups that are active in the full spectrum of financial sector activities, including pension fund management and insurance. Increased liberalization following the crisis has allowed foreign entry primarily via acquisitions, and foreign banks currently dominate the banking sector (82 percent of total assets).
Table 5: Mexico – Ownership and Market Share of Largest Banks (June 2005)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Ownership</th>
<th>Share of Assets I/</th>
<th>Share of Loans I/</th>
<th>Share of Deposits I/</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBVA-Bancomer</td>
<td>BBVA Group (Spain)</td>
<td>25</td>
<td>28</td>
<td>28</td>
</tr>
<tr>
<td>Citibank-Banamex</td>
<td>Citibank (USA)</td>
<td>21</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Santander-Serfin</td>
<td>BSCH Group (Spain)</td>
<td>15</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>HSBC</td>
<td>HSBC Holdings (UK)</td>
<td>11</td>
<td>11</td>
<td>13</td>
</tr>
<tr>
<td>Banorte</td>
<td>Grupo Financiero Banorte (Mexico)</td>
<td>8</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>Scotiabank-Inverlat</td>
<td>Scotiabank Group (Canada)</td>
<td>5</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Inbursa</td>
<td>Grupo Financiero Inbursa (Mexico)</td>
<td>4</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>All others</td>
<td>n/a</td>
<td>11</td>
<td>8</td>
<td>7</td>
</tr>
</tbody>
</table>

Memo Item (in million of Mexican pesos)
Total Assets/Loans/Deposits  2,124,851  1,118,480  1,410,045

Source: Comisión Nacional Bancaria y de Valores
1/ As of June 2005

37. Banks’ financial performance has improved considerably in recent years. The banking sector reports adequate capitalization and increased profitability (Table 6). The sector’s capital adequacy ratio has consistently remained above 14 percent, while both loan quality and profitability have improved considerably. Profitability is derived from relatively high lending spreads and service charges (especially on loans and remittances), as well as from the investment yield from mostly government securities. Banks remain heavily exposed to the public sector (almost 30 percent of total assets) for both their profitability and solvency.

Table 6: Mexico – Banking Sector Financial Performance Indicators (2001-2004)

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASSET QUALITY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Past Due Loans/Total Gross Loans I/</td>
<td>5.1</td>
<td>4.6</td>
<td>3.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Loan Loss Provisions/Total Gross Loans</td>
<td>6.8</td>
<td>6.7</td>
<td>5.6</td>
<td>5.3</td>
</tr>
<tr>
<td>Loan Loss Provisions/Past Due Loans</td>
<td>12.4</td>
<td>13.8</td>
<td>16.7</td>
<td>20.0</td>
</tr>
<tr>
<td>SOLVENCY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Worth/Total Assets</td>
<td>9.4</td>
<td>11.1</td>
<td>11.4</td>
<td>11.2</td>
</tr>
<tr>
<td>Capital Adequacy Ratio</td>
<td>14.7</td>
<td>15.5</td>
<td>14.2</td>
<td>14.1</td>
</tr>
<tr>
<td>PROFITABILITY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on Average Assets (ROAA)</td>
<td>0.8</td>
<td>0.7</td>
<td>1.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Return on Average Equity (ROAE)</td>
<td>8.3</td>
<td>6.7</td>
<td>14.3</td>
<td>11.2</td>
</tr>
<tr>
<td>EFFICIENCY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost-Income Ratio (Operating Expenses / Gross Income)</td>
<td>62.7</td>
<td>66.8</td>
<td>62.2</td>
<td>62.3</td>
</tr>
<tr>
<td>Operating Expenses / Average Assets</td>
<td>4.3</td>
<td>4.6</td>
<td>4.4</td>
<td>4.3</td>
</tr>
<tr>
<td>PUBLIC SECTOR EXPOSURE</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government Securities / Total Assets</td>
<td>8.4</td>
<td>8.5</td>
<td>15.6</td>
<td>17.4</td>
</tr>
<tr>
<td>Government Loans / Total Assets I/</td>
<td>26.5</td>
<td>28.1</td>
<td>22.3</td>
<td>17.0</td>
</tr>
</tbody>
</table>

Source: Comisión Nacional Bancaria y de Valores
1/ Loans past due 90 days or more
2/ Includes loans to government agencies, FOBAPROA and IPAB

38. Credit growth has picked up considerably, albeit from a low base. Total bank lending to the non-financial private sector rose from 8.2 percent of GDP in 2001 to around 10 percent of GDP in June 2005, but remains significantly below its pre-crisis level. Most loan types exhibited positive growth, especially consumer lending, which has been increasing by more than 40 percent per annum since 2001 (Figure 8). In contrast, commercial loans have barely grown in real terms and have declined in importance over this time period. FOBAPROA (Fondo Bancario para la Protección al Ahorro, Banking Fund for Savings Protection) and IPAB (Instituto para la Protección del Ahorro Bancario, Banking Savings Protection Institute) loans have declined primarily as a result of their

Footnote: This figure excludes loans to other financial institutions, public sector entities and restructured loans to FOBAPROA or IPAB, which totaled around 406 billion pesos or 5 percent of GDP as of June 2005.
ongoing resolution and repayment, as well as of the agreement reached in 2004 to convert FOBAPROA notes into tradable IPAB securities. Real annual growth rate of the banking sector’s performing loan portfolio had reached 30 percent as of June 2005, supported by the substantial pickup in the growth rates of both commercial loans (20 percent) and mortgages (45 percent) since early 2004. The prima facie paradox of substantial credit growth in spite of a still shrinking (as a proportion of GDP) banking sector can be explained by the loan asset re-allocation that has been gradually taking place, away from FOBAPROA and IPAB loans towards other loan types.

**Figure 8: Mexico – Evolution of Bank Lending by Type (Dec. 2001 – June 2005)**

<table>
<thead>
<tr>
<th>Type</th>
<th>CAGR 2001-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Institutions</td>
<td>35%</td>
</tr>
<tr>
<td>Mortgages</td>
<td>3%</td>
</tr>
<tr>
<td>FOBAPROA and IPAB</td>
<td>-12%</td>
</tr>
<tr>
<td>Government Agencies</td>
<td>6%</td>
</tr>
<tr>
<td>Consumer</td>
<td>44%</td>
</tr>
<tr>
<td>Commercial</td>
<td>8%</td>
</tr>
</tbody>
</table>

Source: CNBV

39. **Enhancing financial intermediation by commercial banks, particularly to firms, remains one of the most important challenges.** As a result of the severe contraction in bank credit following the 1994-95 crisis, other formal (e.g. Sofoles, capital markets) and informal (e.g. “tandas”) channels of credit have developed and proliferated. According to a BdM survey of corporate financing patterns (Figure 9), supplier credit has expanded at the expense of commercial bank financing in recent years. Since large Mexican firms are able to directly tap international capital markets, it has been the small and medium-sized firms that have borne the brunt of this adjustment. However, the emergence of a strong and profitable commercial banking sector provides a good foundation to revitalize financial intermediation going forward. Cross-border opportunities stemming from emigrants’ remittances and the expansion of credit to underserved domestic segments will likely remain a priority for banks, which are eager to reach credit penetration levels that are comparable with those of regional peers. This is also desirable given the relatively small proportion of the population that is currently served.

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7 These loans were granted as part of the banks’ recapitalization and restructuring program that was carried out by the deposit insurance and bank restructuring agency FOBAPROA (IPAB’s predecessor) following the 1994 crisis. Under this program, banks sold mostly impaired loans to FOBAPROA in return for promissory notes, but retained a downside risk if collections fell short of the sale value. Most of the FOBAPROA notes that were issued expire in 2005-2006. Under an agreement reached in July 2004 between SHCP, IPAB and the four remaining banks holding these notes (Banamex, Bancomer, HSBC - which acquired Bital - and Banorte), IPAB would issue new bonds to exchange most of the FOBAPROA debt under the same terms and conditions, once independent and final audits on all loans to be acquired by the IPAB took place.
by commercial banks\textsuperscript{8}. In that respect, the likely entry of new, mostly niche banks in 2005-2006 is a welcome development.

**Figure 9: Survey on Sources of Corporate Financing (1998-2005)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Suppliers</th>
<th>Commercial Banks</th>
<th>Foreign Banks</th>
<th>Development Banks</th>
<th>All Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998Q1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999Q1</td>
<td></td>
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<td>2000Q1</td>
<td></td>
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<td>2001Q1</td>
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<td>2002Q1</td>
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<td>2003Q1</td>
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<tr>
<td>2004Q1</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2005Q1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BdM

40. Significant modifications in the legal and regulatory framework have supported the modernization of the banking sector in recent years. The main banking sector-related objectives of the 2002-2006 PRONAFIDE have been to strengthen banking regulations and supervision, revive commercial bank credit, encourage competition and innovation, and strengthen corporate governance structures. These have resulted in the implementation of an ambitious legislative and regulatory reform agenda that has included:

- Stronger prudential requirements, including on the requirements for external auditors of credit institutions (amendments to *Ley para Regular las Agrupaciones Financieras*).
- Establishment of a system for prompt corrective actions ("acciones correctivas tempranas") based on banks' capital adequacy ratios (amendments to *Ley de Instituciones de Crédito*).
- Introduction of new instruments and procedures to strengthen creditor rights (*Miscelánea de Garantías*).
- Improved disclosure and transparency of terms and conditions in various types of financial transactions (*Ley de Transparencia y Fomento al Crédito Garantizado, Ley para la Transparencia y Ordenamiento de los Servicios Financieros*).
- Regulation of the activities of credit bureaus and consumer protection issues (*Ley para Regular las Sociedades de Información Crediticia*).
- Better corporate governance practices (amendments to *Ley de Instituciones de Crédito*).
- Combating money laundering and terrorism financing (*Miscelánea de Lavado de Dinero y Financiamiento al Terrorismo*).
- A series of CNBV (*Comisión Nacional Bancaria y de Valores, National Banking and Securities Commission*) regulations strengthening and harmonizing risk management practices and internal control procedures, as well as improving prudential requirements, external audit standards, and financial transparency and disclosure.

\textsuperscript{8} Branch penetration is relatively low (around 12,500 inhabitants per commercial bank branch), while it is estimated that around 20-25 million people, or less than 50 percent of the economically active population, hold commercial bank accounts.
41. **Prudential and developmental issues will continue to dominate the policy reform agenda going forward.** On the prudential dimension, the authorities will need to ensure that credit growth remains sound and does not compromise the quality of bank loan portfolios. Given the structure and characteristics of the banking sector (presence of large, mostly foreign, financial groups), the effective implementation of Basel II Accord on capital adequacy and the development of a consolidated supervision framework are high on the supervisory agenda. In addition, the development of alternative banking resolution mechanisms is an important policy priority to provide more flexibility to policymakers in cases of bank distress. On the developmental dimension, greater and lower-cost access to basic banking services remains an important consideration to support the process of financial re-intermediation.

42. **Over the last decade, the role of public development banks (DBs) has progressively diminished and by March 2005, accounted for just 5 percent of all sources of financing for the private sector (including loans through private financial intermediaries).** Measures to reform and improve the efficiency of the DBs started in the mid-1980s. However, the most far reaching reforms started in the 1990s, when the GoM required DBs to purchase resources in the market and focus on “second-tier” lending activities and extended to them the prudential regulations that applied to private banks. Subsequently, in mid-2002, the Credit Institutions Law, and the charters of all the development banks were amended to: (i) establish that the objective of DBs is to promote the development of the productive sectors, but preserving their capital, while reducing or eliminating their capacity to provide unlimited subsidies; (ii) provide DBs with greater autonomy of operation, but in exchange require from them better governance and greater transparency and accountability; (iii) eliminate management discretion in the determination of pension benefits to their employees; and (iv) reduce the excess of regulations.

43. **These legal reforms to the DBs were complemented with drastic institutional changes with substantial Bank support.** The Bank supported, with separate lending operations and analytical work described in more detail in Section V below, three major structural changes to the Mexican DBs:

- The liquidation of Banrural and its replacement with Financiera Rural (FR), a non-bank financial institution in charge of developing rural financial markets and lending to rural activities. FR had an initial capital endowment of MX$17.5 billion, and cannot mobilize deposits or issue debt. Its charter obliges it to maintain in real terms the value of its capital endowment dedicated to lending, and, over time, to move towards second-tier lending. After two years of operations, FR represents 15 percent of rural credit, and for the first half of 2005 it had positive operational results, with a Return on Assets (ROA) of over 4 percent. Its level of non-performing loans is 3.3 percent.

- The creation of the National Financial Services Bank (Bansefi, Banco Nacional de Servicios Financieros), on the basis of the previously government-owned Trust for National Savings (PANHAL), with the mission of promoting savings among low income groups though the development of popular savings and credit institutions.

- The creation of Sociedad Hipotecaria Federal (SHF), with the transformation of FOVI, a housing trust fund managed by the Central Bank. SHF is a national mortgage bank in charge of promoting primary and secondary housing financial markets. It provides second-tier credit for housing finance to banks, finance companies (Sofoles), and trust funds.

44. **The GoM will continue targeting DB’s activities toward areas in which they can facilitate the proper operation of the private financial sector though they will keep an important role as the government’s financial agent.** DBs have an important role as a financial vehicle for the
Government, including being financial agents of the Federal Government and passing-through external credits from international financial institutions.

NON BANK FINANCIAL INSTITUTIONS AND HOUSING FINANCE

45. Most non-bank financial institutions, Sofoles, have focused on residential mortgage lending to moderate and middle income households, an area from which commercial banks withdrew in the wake of the 1994-1995 financial crisis (Figure 10). The Mexican mortgage market grew rapidly in the past five years, in contrast with its collapse after the crisis of the mid 1990’s. In the wake of the crisis, high default rates and falling house prices led to the almost complete withdrawal of commercial banks from residential mortgage lending. In their place Sofoles rose to provide mortgage financing for moderate and low-income households. Sofol lending has been mostly financed with lines of credit from the federal government, first from FOVI, a trust fund managed by the BdM, and since 2002 by SHF, a government-owned development bank created with FOVI’s assets to promote the creation of private sector primary and secondary mortgage markets. SHF is a second-tier bank that offers lines of credit, mortgage default insurance (MI), and credit enhancements for pools of mortgages, with a focus on mortgages to moderate and low income households. The other major primary lenders in Mexico are INFONAVIT and FOVISSSTE, government-owned provident funds created to provide mortgages to private and public sector employees, respectively. Commercial banks have resumed lending to upper-income segments.

Figure 10: Distribution of Sofoles by Type (March 2005)

Source: Comisión Nacional Bancaria y de Valores

46. Mortgage Sofoles’ more labor-intensive business model and more flexible underwriting standards have permitted them to succeed in lending to segments that banks traditionally have ignored. Using SHF funding, Sofoles have targeted households that earn between three and eight times the monthly minimum wage, many of whom are informally employed, a segment that has been characterized as the urban working poor. In cooperation with developers, Sofoles set up origination and collection offices in the center of new housing developments targeted at this segment. As verification of the capacity to pay for informal workers, Sofoles accept alternative documentation such as receipts for rent and utility payments. Once a loan is originated, the Sofol collects it using employees located in the housing development, who stay in touch with each of the borrowers. This business model is distinct from that of commercial banks, which target formally-employed individuals with incomes greater than seven minimum wages, and rely on more traditional means to collect, such as mailed notices and phone calls. Sofoles pay for their more expensive business model by charging higher interest rates than banks, but they have maintained cumulative default rates over the past ten years of between 1 and 3 percent, which are quite manageable by international standards.

47. The housing market is now characterized by a system-wide loan portfolio that has reached about 11 percent of GDP, comparable with Chile, but much lower than wealthier
countries in North America or Europe. The sector depends on continued, substantial support from the public sector. Default rates are low (between 1 and 3 percent cumulative defaults for most mortgage Sofoles), interest rates are moderate (around 11 percent at commercial banks and government lenders, a bit more at Sofoles for 15 year, 80 percent loan-to-value (LTV) loans), and securitization has begun (12 transactions in the past two years). SHF’s mortgage default insurance (MI) product permits loans of 85 percent and 90 percent LTV, increasing affordability for moderate-income borrowers. Indices of mortgage affordability have improved. For example, the cost of financing a median priced house has fallen from a level of 5.6 times the median annual income in 1995 to 1.1 times in 2004. While this implies that a median house remains out of reach for a median income family, the gap is much reduced from the time of the crisis. However, most low-income households are not served by the formal financial sector, and lacking credit, rely instead on self-construction and informal title and ownership.

48. Although it has proven politically difficult to end long-standing direct lending programs, on the margin the government is designing programs for housing finance that promote private sector involvement and that leverage private sector resources. Past policies focused primarily on inefficient direct lending programs that continue to distort primary markets. Important remaining programs from this era are INFONAVIT and FOVISSTE, as can be seen in Table 7. The presence of labor unions on the board of these institutions has limited reforms to their lending programs, and they continue to dominate the market, originating more than 62 percent of loans in 2004. However, recent government policies have led to the increased influence of SHF MI and securitization programs. SHF funding of Sofoles lending has been the primary source of funding for low and moderate income lending over the past ten years. The strong performance of SHF-funded mortgages, in conjunction with improvements to foreclosure processes, economic recovery, and macroeconomic stability have attracted commercial banks to come back to mortgage lending, originating more than 55,000 loans in the first 10 months of 2005, versus about 3,000 in all of 1998.

<table>
<thead>
<tr>
<th>Source: CONAFONVI</th>
<th>Excludes FONHAPO and other direct subsidy programs and state-level initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>SHF 2/</td>
<td></td>
</tr>
<tr>
<td>INFONAVIT 1/</td>
<td>108,035 198,950 250,110 205,346 275,000 300,000 305,975 290,669</td>
</tr>
<tr>
<td>FOVISSTE</td>
<td>55,425 59,118 46,704 47,555 46,136 54,229 65,920 44,206</td>
</tr>
<tr>
<td>Other 4/</td>
<td>12,139 7,114 10,199 8,750 4,309 12,284 121,281 43,249</td>
</tr>
<tr>
<td>BANKS and SOFOLES 3/</td>
<td>3,269 865 1,101 3,707 9,735 17,648 35,772 55,327</td>
</tr>
<tr>
<td></td>
<td>182,052 275,795 322,216 283,249 341,939 440,045 590,604 403,931</td>
</tr>
</tbody>
</table>

49. The Mexican government has sought to create a legal and regulatory framework that encourages the private financial sector to serve as much of the population as is feasible. For the lowest income segments, the government is working to design and implement efficient and equitable subsidy programs. The government has sought to use agencies such as SHF to demonstrate the feasibility of financial products, and then withdraw from markets once private sector providers have entered. SHF has done this with residential construction finance, which banks were unwilling to provide after the crisis. SHF first provided direct credits to developers, then moved to guarantees for bank and Sofoles credits, and then gradually reduced the balance that it would guarantee. SHF also provided financial guarantees for construction loan securitizations. Now, banks lend to developers without the SHF guarantee, and Sofoles have securitized construction loans and sold the resulting bonds in the United States, also without SHF support.

9 BBVA Index of Mortgage Costs in Mexico
50. SHF is leading the government’s efforts to increase private sector participation in residential mortgage finance, given the persistent housing deficit. While mortgage production has risen, a housing deficit remains of 4.2 million units, and production still falls well short of the government’s target of 750,000 new housing units per year, a pace that would match that of new household formations. By law, SHF will close its line of credit in 2009, at which time Sofoles will either have to securitize their portfolios or change their business models to become more like mortgage brokers, which originate but never hold mortgages. To promote securitization SHF offers MI for individual mortgages and financial guarantees for pools of mortgages. To promote private sector participation in MI and financial guarantees, SHF has proposed legal changes that would permit insurance companies to offer each of these products. Within a few years, the Mexican market should operate with SHF providing MI and financial guarantees for low and moderate income borrowers, and the private sector financing moderate and upper income borrowers with similar products.

51. With respect to the roles of INFONAVIT and FOVISSSTE, the government’s focus to date has been on operational reforms and improvements to governance and transparency. Each serves three conflicting roles: direct lender, subsidy provider, and pension fund. Both institutions have had a long history of financial losses, poor operational performance, and political interference. INFONAVIT has made the most progress in reforming financial operations. In the third quarter of 2005, defaults were 8.6 percent of the total portfolio, much improved from the 21.7 percent experienced in 2000. Salary contributions, which in the past kept the institute afloat, made up 44.3 percent of cash inflows in 2004, will make up 41 percent of inflows in 2005, and since new loans are priced closer to market, and presumably will be collected, cash inflows should continue to grow with time. INFONAVIT’s organic law was amended in January, 2005 to improve its governance structure by involving external financial professionals in audit and risk committees. However, the government has not yet directly addressed the role of these state-owned and privileged institutions in affecting the supply of private sector financing to low and moderate-income borrowers. There remain substantial issues with respect to the strategic roles of INFONAVIT and FOVISSSTE in the mortgage market, and the efficiency and equity of the subsidies that they provide.

52. Reform of the strategic role of INFONAVIT and FOVISSSTE should support the development of a fully private primary market, the elimination of subsidies to upper-middle income borrowers, and more efficient public assistance for low income borrowers. Management of INFONAVIT is not permitted to structure its loan products or set prices in a way that would allow it to mitigate financial risk and so manage safely and efficiently. Sub-market pricing results in inequitable and inefficient subsidies. While 78 percent of INFONAVIT members earn less than 4 monthly minimum wages, half of INFONAVIT loans are made to members that earn more than seven monthly minimum wages, a sector served by both banks and Sofoles. In effect, low-income INFONAVIT savers sacrifice a portion of their pension savings to subsidize loans to individuals who could borrow from the private sector at market rates. The government has commissioned a strategic study of INFONAVIT and FOVISSSTE and their roles in the housing finance market that is planned to be completed by March, 2006. An agenda for the reform of INFONAVIT and FOVISSSTE should include: pricing and designing products on commercial terms, the re-design of the subsidy component of its products to be an explicit, up-front, demand-side subsidy harmonized with other government subsidy programs (Tu Casa and PROSAVI), and evolution from direct lending to acting as a second-tier institution or purchaser of mortgage-backed securities.

CAPITAL MARKETS

53. Mexico’s government recognizes that more effective capital markets and a broader range of financing instruments are essential to provide companies with the resources they require to invest and expand. New financing alternatives – primarily risk capital (private equity and
venture capital) - are particularly important for small and medium sized enterprises. While these firms represent the seeds of growth of the economy, they have little access to capital from banks or markets. From the demand side, there is also a need to expand the range of investment possibilities for individuals and institutional investors.

54. **Mexican authorities have taken important steps to bolster the country’s capital markets in recent years, with a focus on improving corporate governance.** In particular, the 2001 Securities Market Law (*Ley del Mercado de Valores*) revised much of the legal framework, eliminating some legal hurdles and inconsistencies. In the area of corporate governance, it reformed voting rights and the structure of boards of directors, strengthening the rights of minority shareholders. For example, the law restricts the issue of non-voting shares—often previously the only ones available to outside investors—to 25 percent of the float of a public corporation. The securities regulator (*Comisión Nacional Bancaria y de Valores, CNBV*) has subsequently issued further regulations to increase transparency and disclosure and reform other areas, such as the rules on tender offers (April 2002).

55. **Supervision and institutional arrangements have been strengthened.** The 2001 law granted stronger inspection and enforcement powers to the CNBV. In addition, the basic infrastructure of the markets has been upgraded, with the improvement of custody, clearing and settlement arrangements and the introduction of independent price vendors. A rulebook for securities issuance has been published, and additional guidelines issued on insider trading and accounting procedures, among other matters.

56. **Other significant achievements include the development of the benchmark local currency yield curve, through federal debt instruments.** After the 1994-1995 crisis, the federal government followed a proactive debt management strategy, to develop the local currency debt market, and reduce the vulnerability of its debt to interest rate and foreign exchange risks. Helped by a more stable macroeconomic environment with lower interest rates, and within an overall context of reducing public indebtedness, the government has issued increasingly on the domestic bond market, introducing longer tenor fixed-coupon bonds. Whereas outstanding domestic federal government debt represented 7 percent of GDP in 1994, the level had risen to 14 percent by 2004\(^\text{10}\). The local currency yield curve (Figure 11) has lengthened to 20 years, establishing a benchmark that facilitates private and sub-sovereign issuance. The growth of domestic federal bonds does pose, however, a risk in terms of crowding out private issuers, in as much as the former have grown to become dominant investment instruments, attracting a significant proportion of national savings. The government continues its efforts to strike a balance between strengthening public debt risk management and fostering increased private sector access to financing.

\(^{10}\text{This does not include IPAB debt.}\)
57. The local-currency denominated corporate debt market has expanded recently, but remains small. The Certificado Bursatil, introduced in 2001 in the Ley de Sociedades de Inversión, has played a key role here. As issuers understood the full flexibility of this debt instrument, it has been increasingly used by firms and sub-sovereign entities for structured solutions such as asset-backed securities, given the possibility to raise the financing before the actual move of the assets to the special purpose vehicle. Overall, peso-denominated private bonds outstanding exceeded US$20 billion in 2004, up from US$593 million in 1996 (Figure 12). However, this represents only about 2 percent of GDP and while the average tenor is around 3.5 years, the proportion of floating rate debt is high.

58. Another positive development is the growth of a vigorous derivatives exchange, which allows the diversification and mitigation of risks. Mexico has around 100 years of experience with unregulated over-the-counter (OTC) derivatives. These include mature foreign exchange derivatives products, as well as fast growing interest rate derivatives (Figure 13). An organized exchange for derivatives contracts –MexDer– was only created in 1998. Trading activity picked up significantly from 2001 onwards, especially for short term interest rates futures, fostered by the development of the peso yield curve and improvements to market infrastructure. As illustrated by Figure 14, even when including offshore trading of Mexican Peso derivatives (roughly 50 percent of foreign exchange OTC and 20 percent of interest rate OTC), MexDer interest rate futures daily turnover is noticeably high, only exceeded by the foreign exchange swaps volumes. In 2004, MexDer expanded its equity-related business by starting trade in stock options, stock futures, and index options. By that year MexDer had
become the fifth most active futures exchange worldwide, and the third for short term interest rate futures.

Figure 13: OTC Foreign Exchange and Interest Rate Derivatives Daily Turnover in Selected Emerging Markets

![Foreign Exchange Derivatives](chart)

![Interest Rate Derivatives](chart)

Source: Bank for International Settlements Triennial Survey

Figure 14: Consolidated (domestic & offshore) Daily Turnover of Mexican Peso Derivatives OTC and Exchange-traded\(^\text{11}\), by product (2004)

![Mexican Peso Derivatives](chart)

Source: Bank for International Settlements Triennial Survey and BdM

59. However, Mexico’s equity market remains relatively small and illiquid, and is not a major source of financing for most companies. Of the eight largest economies in the Americas,

\(^{11}\) In addition to MexDer, the Chicago Mercantile Exchange also lists two futures contracts on Mexican Peso interest rates, but there has been no activity recently.
Mexico has the second smallest stock market, relative to GDP (Figure 15). The free float is limited and trading volumes are also low. The stock market displays a high level of concentration, with the top 10 companies representing close to 70 percent of market capitalization. Ownership of listed firms is also highly concentrated, and listed firms may issue different types of non-fungible shares in order to avoid dilution of corporate control, which fragments the securities market and reduces liquidity.

Figure 15: Market capitalization of listed companies, End-2004 (Percentage of GDP)

![Graph showing market capitalization of listed companies]

Source: World Bank World Development Indicators

60. While a surge in the index has raised market capitalization, the equity market has been shrinking by other measures. Market capitalization increased to US$ 216.8 billion at the end of September, up 46 percent from a year earlier. But Mexico had only 149 companies listed at the end of September 2005, down from 206 at the end of 1994. There were only 5 new equity issues in 2004, a sharp decline from 100 in 1994. However 2005 has shown a slight increase, with 7 new issues in the first nine months of the year (Figure 16).

Figure 16: Number of listed companies and new equity issues

![Graph showing number of listed companies and new equity issues]

Source: IFC Emerging Markets Database

61. Larger companies have increasingly preferred to list on international markets. This has usually taken the form of cross listings in the U.S. market, through American Depositary Receipts (ADRs). In 2000, almost half of listed firms had a foreign listing or had raised capital abroad, and
trading in foreign stock markets exceeded domestic trading. Outstanding ADRs reached US$ 48.9 billion in May 2005, equivalent to more than 20 percent of Mexican market capitalization.

62. **Insufficient risk capital** is available. According to industry estimates, Mexico accounts for only around 0.1 percent of the overall risk capital investments globally and 10% of risk capital in Latin America, over the last ten years. A number of obstacles continue to impede the industry’s growth, particularly with regard to early-stage small and medium enterprises investments, including the absence of a pass-through investment vehicle, the legal constraints on shareholders’ agreements to protect minority stakes, the restrictions on participation by domestic institutional investors, and the low probability of stock market-driven exit strategies.

63. **The institutional and retail investor base has been expanding, but still has great potential for further growth.** The 1997 pension reform created an institutional investor base, which has gradually been growing and reached 6 percent of GDP in 2004. Pension funds administrators (Administradoras de Fondos para el Retiro, Afores) have been gradually permitted to invest in different assets and issuers, giving impetus to those markets. Mutual funds (sociedades de inversión) have also grown substantially since the 2001 reform to the Ley de Sociedades de Inversión, exceeding 5 percent of GDP in 2004. Life insurance and annuities companies will also be growing, though much more slowly initially, given their role in the payout phase of the pension system (Figure 17).

Figure 17: Evolution of Mutual Funds and Siefores Assets (US$ million)

![Figure 17: Evolution of Mutual Funds and Siefores Assets (US$ million)](image)

**Source:** MexDer

Through the *Mercado Global* (Global Market), Mexican authorities have been seeking to foster asset diversification among local institutional and qualified investors by providing easy access to international securities. The system, operational since 2003, allows Mexican investors to trade a pre-approved set of foreign securities or indices on the local stock exchange, denominated in pesos. It is based on the legal and regulatory framework of the “international quotation system” (Sistema Internacional de Cotizaciones), developed by SHCP, CNBV and the Mexican Stock Exchange. Use

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12 Risk capital investments refer to money provided by individuals and professionally managed funds that invest alongside management in growth-oriented companies. This spans (i) seed capital, investments made at the earliest stage of company formation; (ii) venture capital, investments made at an early stage of a company’s development but after some track record has been established, and (iii) private equity, later stage investments which tend to be larger and in more sophisticated companies.

of the Global Market has been increasing slowly, but remains slight, with outstanding investments of US$ 280 million in early 2005, for 190 listed securities and 12 exchange-traded funds. This initiative has therefore not yet contributed significantly to deepening the domestic financial sector. For qualified investors, the Global Market’s main advantages are fiscal incentives (capital gains tax exemption and 10 percent tax on dividends) and operational simplicity (all can be done through the account with the local broker). This also provides a new line of business to local brokers and stock and derivatives exchanges. However, the Global Market initiative might add to the transaction costs (through the addition of domestic brokerage and currency conversion costs on top of foreign brokerage costs). It could also lead to a crowding out effect for domestic issuers, in case it succeeds to channel more Mexican savings to foreign securities.

PRIVATE PENSIONS SYSTEM

64. The private pensions system was created in 1997 through a reform to the Retirement Savings System (Sistema de Ahorro para el Retiro). The reform replaced the Pay as You Go System (PAYG) with an individual capitalization system for private sector employees. The Afores were established as the companies in charge of managing the individual accounts and Siefores would invest pension funds in financial instruments, on behalf of the account holders. The main role of the Government in this system is to supervise and provide some guarantees. With respect to Supervision, the CONSAR (Comisión Nacional del Sistema de Ahorro para el Retiro) is the agency in charge of the regulation and supervision of the system. Among the government’s commitments, the most important are a minimum pension guarantee and allowing the possibility of choosing between benefits of the new and the old system, for the generations that contributed to the old system.

65. The system in Mexico combines in the Afore accounts the provision of different services: housing, old age unemployment and retirement. Voluntary saving is also possible under this system: the employer or employee can contribute to these accounts on a voluntary basis. The compulsory accounts receive contributions from the employer, employees and the government (the Cuota Social, which is 5.5 percent of the minimum wage). In the case of housing accounts the funds are directly managed by INFONAVIT.

66. Eight years after the reform, funds under management have increased significantly, from less than 2 percent of GDP in 1998 to more than 10 percent in 2005. This increase is mostly driven by obligatory pension savings, which increased from less than 1 percent to almost 7 percent of GDP (Figure 18). There has also been a major increase in the number of accounts from 11 million in December 1997 to more than 34 million in 2005.

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14 MexDer is also benefiting from the Global Market, which supports the trading on some of the new option contracts related to ETFs.
15 The Public Sector remains in a PAYG system.
16 CONSAR has a consultative committee and governing board, in which workers, employers and the government participate.
17 The minimum pension guarantee is equivalent to the minimum wage, but the worker has to be 65 years old and have made at least 1,250 weekly contributions to qualify.
67. Though the level of participants remains limited, the reforms have contributed to an increase in labor force participation in the system. The number of participants in the Mexican pensions system has increased since the 1997 reform in a trend similar to that observed in other countries in the region to about 60 percent of the economically active population from about 40 percent before the reform. The challenge is to allow this coverage among the labor force to increase in order to address the very low level of beneficiaries from pensions, standing at about 20 percent of those above age 65, low even by regional standards (Figure 19). While part of the reason behind the low coverage is related to the overall structure of the labor markets and the high level of informality, recent analytical studies support the idea that increasing competition among pension administrators and providing better disclosure of investments performance increase the level of sense of ownership by participants and ultimately increase their savings levels.\textsuperscript{18}

68. The GoM has carried out a process of reforms in the last three years, to liberalize the Sefores’ investment regime, boost competition and increase transparency for workers. As in

\textsuperscript{18} See for example, evidence from the Social Protection Survey conducted in 2002 in Chile, www.proteccionsocial.cl.
other countries that undertook similar reforms, the initial private pension regime was very restrained due to concerns associated with safeguarding workers’ savings from volatile investments. This prevented a better alignment of the risk appetite of workers according to their stage in the life-cycle (i.e., willingness to incur higher risks in exchange for higher long term returns during their younger years, and lower risk tolerance as they get closer to retirement age). Failure to allow for this changing risk aversion can ultimately lead to inadequate returns.19

69. Until December 2004, pension funds in Mexico could only be invested in fixed income instruments, leading to a concentration in government debt. In fact, given the short supply of corporate instruments of this kind in Mexico, among other reasons, more than 85 percent on average was invested in government issued paper between 1998 and 2004. This was the case in spite of regulatory changes that had taken place since 2002, seeking to foster a broader range of investments. These reforms had included:

(a) Removal of the minimum investment limit for government issued instruments, which had been set at 65 percent;

(b) Removal of the 35 percent maximum investment limit for the private sector;

(c) Removal of the 10 percent maximum investment limit for financial institutions;

(d) The risk rating floor for instruments invested in was lowered to A from AA;

(e) Investment in government instruments denominated in currencies other than dollars was allowed;

(f) Investment in derivatives was also permitted for the first time; and

(g) The requirement that at least 65 percent of investments have duration of less than 182 days was substituted for a weighted average duration limit of 90 days and afterwards replaced by a VAR of 0.6 percent.

V. BANK SUPPORT TO THE GOVERNMENT'S STRATEGY

LINK TO CPS

70. In fortifying and diversifying the financial sector and capital markets, and easing the flow of financing to businesses, the proposed loan aims at increasing competitiveness, the pursuit of which is the first thematic pillar of the Bank’s Country Partnership Strategy (CPS) for Mexico, which covers the period FY05 to FY08. The Bank strategy, as expressed in the CPS report 28141-ME dated March 18, 2004, which was discussed by the Executive Board in April 2004, has three other principal pillars: a) reducing poverty and inequality; (b) strengthening institutions; and (c) promoting environmental sustainability. The proposed loan would also advance toward the first of these, by promoting equitable economic growth, which creates jobs and reduces poverty (as discussed in the section on poverty and social impacts below). In addition, the program includes elements of institutional strengthening, particularly in enhancing the supervisory capabilities of authorities in the financial sector.

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19 Berstein and Chumacera 2004 show that for the case of Chile, which had a more flexible regime, investment limits had an important impact on pension fund returns.
71. In particular, this DPL series will contribute to the achievement of medium-term country targets linked to four elements of the CPS. These elements are: (i) support efforts to enhance market efficiency and increase competitiveness; (ii) improve corporate governance and social responsibility; (iii) develop financial markets, improve access to financial services, and expand property ownership opportunities; and (iv) support efforts to provide broader access to low-income housing and land ownership.

72. The CPS lending program envisages a $300 million financial sector loan for FY2007, with an emphasis on promoting access to financial services. However because another Bank operation (the Second Savings and Rural Finance Project) already focuses on improving access, the DPL proposed here instead pursues a broader program of financial sector strengthening and diversification, to promote stronger economic growth. The total amount has been increased to US$501.26M and the timing advanced at the request of the GoM.

COLLABORATION WITH THE IMF AND OTHER LENDERS

73. IMF and Bank staff maintain a regular exchange on macro policy in Mexico. There is no IMF program in Mexico. The Mexican government does maintain an active policy dialogue with the Fund, however, through the Fund’s bilateral and global surveillance activities. This summer, under Article IV of the IMF’s Articles of Agreement, the IMF held bilateral discussions with Mexican authorities which were presented to the IMF Board in early November 2005. No major issues or disagreements were reported.

74. The Inter American Development Bank (IADB) is implementing a two-tranche US$600 million Financial System Consolidation Policy Loan (FSCPL). That loan supports some of the reforms that the GoM has carried out in the areas of prudential regulation, markets integrity and public debt management. In addition to the overall dialogue between the two institutions in Mexico, the Bank staff preparing this operation has met periodically with the IADB team supervising the implementation of the loan to ensure consistency in the policies supported by the two institutions. Additionally, the IADB approved in November 2005 a line of credit and technical assistance to Bancomext, the government-owned export promotion financial institution, to foster its role as a second tier bank that lends funds to private financial institutions to support export-oriented small and medium enterprises.

75. The FSCPL’s three areas of policy support include areas that complement this proposed DPL. These areas are:

(a) Financial Institutions Regulation: This component supports many of the policies that this proposed DPL supports in its first loan and seeks to provide a solid prudential foundation on which to base the growth of the financial sector. The second tranche of the IADB operation would support additional strengthening of financial institutions internal credit processes, an effort that will complement the policies that the second loan of this DPL series would support in the area of increased disclosure and solvency rules of financial institutions;

(b) Capital Markets: The FSCPL supports the passage of the Securities Markets Law and the issuance of the regulations that will facilitate its implementation. Those regulations will, inter alia, support the development of the housing and non-bank finance infrastructure as well as provide a better investment environment for private pensions funds, policy areas that this DPL would support with its second loan; and

(c) Public Debt: Enhanced public debt management, including the development of a strategy for debt issuance that seeks to extend the tenor of debt, is essential for further
development of private sector capital markets. Therefore, FSCPL's support for enhanced public debt policies facilitates the development of capital markets to be supported by this DPL.

RELATIONSHIP TO OTHER BANK OPERATIONS

76. Several ongoing or recently completed Bank lending operations and analytical work in the financial sector and in economic competitiveness complement this operation (see Table 2). These include several policy-based and investment loans as well as Analytical and Advisory Activities (AAAs).

77. As the Competitiveness AAA has shown, an efficient, solid and diversified financial system is essential to enhance Mexican competitiveness. The reforms supported in this DPL will create the environment necessary to channel more efficiently the local savings and investment base towards productive investments, thus complementing the reforms supported by the Competitiveness DPL particularly with respect to improvements to the overall investment climate, for which access to finance is an essential element.

78. The ongoing Savings and Rural Finance loans (Loans 7132-MX and 7240-MX) are supporting the GoM in strengthening the savings and credit cooperatives system. These loans support institutions that are compliant with the Popular Savings and Credit Law (a Law providing a regulatory framework for these type of smaller financial institutions) and that are financially viable and operationally effective. This seeks to improve them managerially, upgrade technology, and provide an enhanced level of outreach and access to financial services by the underserved Mexican population, particularly in rural areas. This loan is also continuing to strengthen Bansefi's capacity to provide technical assistance and continue fostering the development of savings and credit cooperatives. The overall strengthening of the financial sector that this proposed DPL supports would indirectly assist these efforts by creating a better environment in which commercial banks, Sofoles and other financial institutions could develop relationships with cooperative institutions, an increasingly common practice for financing and cash management purposes.

79. The ongoing Rural Finance Structural Adjustment Loan (Loan 7180-MX) supported the creation and strengthening of Financiera Rural, the government-owned non-bank financial institution developing rural financial markets and lending to rural and agricultural sectors. As Financiera Rural increases its emphasis on developing markets, and away from direct lending, it is bound to benefit from the reforms to strengthen financial markets supported by this DPL.

80. The World Bank has supported the Mexican government's move to a market-based housing finance system in recent years. The recently completed FOVI Restructuring Project (Loan 4443-MX) supported the creation of SHF, which ultimately contributed to the development of the Sofoles market. A second series of projects is supporting reforms to housing and land markets for the poor, including actions in housing policy and institutions, finance (credit and savings, subsidies), property rights, urban development and slum upgrading, land development and access by the poor, and disaster mitigation (particularly the Affordable Housing and Urban Development Development Policy Loan, HUDPL II, Loan 7340-MX, and the Housing and Urban Technical Assistance Loan, Loan 7261-MX). Housing finance reforms supported by the HUDPL II, and the proposed HUDPL III, concentrate on fostering the development of microfinance programs for housing. The strengthening of the capital markets that this proposed DPL would support complements these loans, given the role that Sofoles, and their increasing access to capital markets, play in housing finance. The housing finance reforms to be supported by the second operation of these series will also complement the HUDPL series by addressing constraints in the housing finance infrastructure, particularly with regards to credit enhancement products to facilitate the operation of the private housing finance system.
The Innovation for Competitiveness Project (Loan 7296-MX) will strengthen the innovative capacity of the private sector. Among other elements, this Project supports a venture fund capital trust held by CONACYT (Comisión Nacional de Ciencia y Tecnología, the National Commission for Science and Technology) in Nafin. The reforms supported by this proposed DPL would facilitate the eventual listing in the capital markets of firms being funded through this mechanism (reforms included in the Securities Markets Law), a common mechanism in developed markets to graduate firms that have been successfully funded through venture capital.

The International Finance Corporation (IFC) has been particularly active in supporting housing finance activities through investments in the Sofoles sector. IFC also supports domestic capital markets through its involvement in local bond issuance, the provision of partial credit guarantees, associated technical advice, and direct financing in local currency. Direct financing totaled close to US$300M in FY04-06 (through September 2005).

LESSONS LEARNED

The design of the proposed programmatic DPL takes into account the lessons learned from the overall program with Mexico and in general from Bank work with other middle-income countries. In particular, lessons learned were incorporated from the Brazil First Programmatic Loan for Sustainable and Equitable Growth (Ln. 7218-BR) and the Colombia First Business Productivity and Efficiency DPL (Ln. 7334-CO), which highlighted the benefits that arise from addressing financial sector issues in the context of overall economic competitiveness which in this case is reflected in the simultaneous preparation of the Competitiveness DPL. The most important lessons from these operations are the following:

The special value that country ownership and partnership have in middle income countries. Though country ownership is essential for program success anywhere, this is particularly important in a country such as Mexico, which has a sophisticated and effective group of policy makers and a good internal consultation process. The program supported by this operation has been designed by the GoM with the Bank bringing to bear its technical expertise in selected areas where it can add value beyond the GoM’s already extensive capabilities. The proposed operation effectively responds to the Government’s own priorities and commitment as reflected in the actions already taken as well as the fact that the policy thrust supported by this operation lies directly along key policy axes of the Government’s National Development Plan.

The importance of flexibility to respond to changing circumstances. In order to implement a lending program that best addresses Mexico’s needs as a creditworthy middle income country, the Bank needs the flexibility to be able to respond quickly to changing circumstances. This is particularly important when supporting a Program, such as is the case in this DPL series that spans across two presidential administrations. The programmatic approach, as opposed to a multi-tranche operation, provides the necessary flexibility to respond to new needs and priorities that can emerge during the implementation process while ensuring a long-term approach to a reform theme.

The value of prior strong analytical work. In preparing financial sector policy-based operations, the Bank should contribute to enhance the government’s program by bringing to bear strong technical capacity and ample cross-country experience. The Bank has maintained a very fruitful dialogue with the GoM over the last five years in the financial sector including an FSAP and investment and policy-based lending in housing finance, rural finance and public banking strengthening.

The need to promote financial sector growth policies in the context of improved prudential regulation. As the analytical work carried out as part of the Bank’s support to the GoM’s efforts after the last financial crisis (First and Second Bank Restructuring Facilities, Loans 7003-ME
and 7060-ME), financial sector growth is unsustainable without continued improvements in the regulatory framework for supervision and regulation.

88. **The need to take into account the political economy of reform during program design.** In designing a policy-based operation, political factors and the legislative needs of the country need to be understood and included in the dialogue with the country, particularly if part of the implementation of the reform program will involve a future administration. The consultation and legislative process that has been carried out by the GoM has facilitated reaching the consensus necessary to enact reforms in the financial sector policy areas supported by this proposed operation as the 2006 elections approach. Additional reforms in the area of financial infrastructure, particularly as related to creditor rights, are important but the Bank and the GoM agree that designing a program that would address these at this stage – beyond the reforms already carried out - would be risky and thus should be left as part of the dialogue with the new administration and be included as part of the policy notes being prepared by the Bank for discussion with the presidential candidates.

**ANALYTICAL UNDERPINNINGS**

89. **The preparation of this operation has benefited from four key analytical documents prepared by the Bank during the last 18 months:**

   (a) *Competitiveness and Trade AAA.* This provides a broad overview of the constraints to competitiveness faced by the Mexican economy including the role that lack of access to financial services plays.

   (b) *Whither Latin American Capital Markets?* This report, prepared by the Regional Chief Economist office, highlights the constraints being faced by capital markets in the region with particular emphasis on the Mexican case.

   (c) *Mexico: Auditing and Accounting: Report on the Observance of Standards and Codes.* This report reviews important aspects associated with the overall credit information environment and transparency associated with markets integrity.

   (d) *Doing Business 2005 and Doing Business 2006.* This World Bank/IFC publication has followed the impact that financial sector reforms in Mexico have had on the real sector.

90. **The GoM and the Mexican academic community have also produced several analytical studies and other reports that were used in the preparation of this operation.** In particular, the PRONAFIDE document and other BdM, CNBV and CONSAR documents have helped set the framework for the development of this program. Annex 7 lists the sources used.

91. **The Bank, at the GoM's request, is currently undertaking additional analytical work that will support the preparation of the second proposed operation of this series.** This work will concentrate on three areas: (a) analysis of best practice alternatives for banking resolution mechanisms; (b) definition of adequate levels of regulatory latitude, as opposed to statutory definitions, for the private pensions sector; and (c) review of mechanisms to foster additional competition in the private pension administration market.

92. **In addition to these studies, the GoM has requested the preparation of a Financial Sector Assessment Program (FSAP) Update to take place during 2006.** The original FSAP was done in 2002.
VI. THE PROPOSED FINANCE AND GROWTH DPL

OPERATION DESCRIPTION

93. The development objectives of this operation is to support sustainable growth and the alleviation of poverty by:

(a) contributing to reduce the probability of a systemic financial crisis;

(b) fostering the sustainable growth of a financial system and capital markets that address the needs of the productive sector and increase overall competitiveness of the economy; and

(c) diversifying the range of savings and investment instruments available to households.

94. Some degree of tension may exist between policies seeking to consolidate stability and those seeking to foster growth of the financial sector (i.e., between the first and the other two development objectives mentioned above). The GoM has designed a policy program that minimize this tension by enacting prudential and disclosure reforms which are increasingly seen as international best practice essential to build the base on which to have sustainable financial growth.

95. The World Bank would support this policy reform process through a programmatic development policy operation in two phases, which would be executed over a period of 18 months. The programmatic series will focus on three policy areas through which the GoM seeks to attain the development objective presented above:

(a) strengthening market integrity and prudential regulation;

(b) increasing the depth, access and diversification of financing to foster a more effective role of the financial sector in the development of the economy; and

(c) promoting diversified investment instruments to complement the aim of increased financial access through enhanced national savings levels and investment vehicles.

96. The second DPL would support the completion of implementation of the reform agenda in the financial sector in these three areas. This operation would be prepared provided that the reforms supported by the first loan are sustained and that macroeconomic stability in Mexico continues to prevail. The GoM has defined this sequencing based on the availability of the analytical work supporting the design of some of the policy reforms as well as the political timing necessary for adequate consensus-building. The second loan is expected to be presented for Executive Board consideration in the first quarter of FY08.

97. The GoM has completed all the previous actions for presentation of the first operation to the Executive Board, as listed in Box 1. Box 2 presents triggers for the preparation of the second operation. Actions underlined in these boxes are also being supported by the IADB's Financial System Consolidation Policy Loan.
Box 1: Prior Actions for Executive Board Presentation of the First Finance and Growth DPL

Strengthen Market Integrity and Prudential Regulation

- **Enhance corporate governance and minority shareholder rights** of firms participating in the capital markets through the enactment of a new Securities Markets Law, published on December 30, 2005, establishing the role and duties of the management and boards of listed companies, as well as applicable sanctions.

- **Strengthen prudential regulations and risk management** in the banking sector through the issuance by Comisión Nacional Bancaria y de Valores (CNBV) of (a) Regulation (Disposición) dated April 27, 2005 defining standards for external auditors and credit institutions in relation to the provision of external auditing services; (b) Circular dated December 3, 2004 defining capital adequacy-based early warning indicators to trigger prompt corrective actions; (c) Circular dated July 1, 2004 establishing corporate governance requirements for integrated risk management of credit institutions; (d) Regulation (Disposición) dated July 5, 2005 strengthening credit management practices for credit institutions; and (e) Circular dated August 20, 2004 establishing risk-based loan classification and provisioning rules for credit institutions.

- **Enhance market disclosure and transparency** through the issuance by CNBV of: (a) Regulation (Disposición) dated April 27, 2005 establishing financial reporting requirements for financial group holding companies that are subject to supervision by CNBV; and (b) Regulation (Resolución) dated April 27, 2005 that modifies and harmonizes the disclosure of financial information by credit institutions.

Increase Depth, Access, and Diversification of Financing

- **Enhance access to the capital markets** through the enactment of a new Securities Markets Law, published on December 30, 2005 that (a) creates a new corporate vehicle, Sociedad Anónima Promotora de Inversion, SAPI, to facilitate stock market listing; and (b) rationalizes minimum capital requirements for securities brokers to foster the entrance of new participants.

- **Increase the role of capital markets in the supply of credit** through the approval by the Legislature of an amendment, published on November 30, 2005, of articles 2 and 103 of the Law on Credit Institutions allowing enterprises to tap capital markets in order to fund their credit activities.

Promote Diversified Investment Instruments

- **Enable better investment strategies and competition** in the pensions industry through (a) Enactment by the Legislature of an Amendment to the Ley de los Sistemas de Ahorros para el Retiro dated January 11, 2005 permitting the transfer of assets to lower cost Afores without losing seniority discounts; (b) issuance by Comisión Nacional de Sistemas de Ahorro para el Retiro (CONSAR) of amendments to Circular 15-12 dated February 1, September 22 and October 27, 2005 to make more flexible the investment regime of private pensions funds and allow better alignment with workers’ risk preferences; and (c) issuance by CONSAR of Circular 28-11 (July 19, 2005) and 22-10 (August 1, 2005) increasing cost transparency and lowering switching transaction costs for contributors.

- **Increase the range of investment vehicles in the capital markets** through the: (a) issuance by SHCP of oficio 305-186/2004, dated October 18, 2004 establishing rules allowing the creation of strips of public debt (i.e., allowing the separation and reassembly of public debt bonds into their interest and principal payment coupons) and subsequent implementation thereof by BdM; (b) issuance, by BdM of circular No.1/2004 dated June 7, 2004, (as amended on September 23, 2005) establishing the regulatory framework and operational rules for securities lending; (c) issuance by SHCP and BdM of circular No.13/2005, dated June 30, 2005, establishing rules aiming at increasing secondary market activity by reducing auctions’ ownership concentration; and (d) issuance by SHCP of the following regulations and approvals to promote greater activity by investors in Mexico’s organized derivatives exchange and to widen the range of derivatives instruments: (i) Fifth Modification to the miscellaneous fiscal resolution of 2005 dated October 12, 2005; (ii) updates, dated May 14, 2004, and January 4, 2005, to the derivative exchange regulations; and (iii) approvals by SHCP for new derivatives instruments issued in March 10, 2004, December 23, 2004, March 9, 2005 and August 18, 2005.
Box 2: Indicative Triggers for Second Finance and Growth DPL

**Strengthen Market Integrity and Prudential Regulation**
- **Create a transparent bank resolution mechanism** through the submission to the Legislature of legal reforms (Miscelánea) creating a new banking resolution mechanism
- **Enhance banking solvency rules** through the issuance by SHCP of a set of resolution that: (a) aligns the regulatory capital requirements of development banks with those of commercial banks; (b) improves the quality of regulatory capital by reducing the amount of deferred taxes that can be counted as capital; (c) eliminates distortions deriving from current market risk capital rules; and (d) defines lower regulatory capital requirements for insured mortgages
- **Increase market transparency and integrity** through the issuance by CNBV of circulars (a) requiring an ethics code for rating agencies; (b) preventing conflicts of interest for financial analysts; and (c) through the issuance by SHCP of an ethics code for public debt market makers

**Increase Depth, Access, and Diversification of Financing**
- **Enhance the financial infrastructure for private sector participation in housing finance** by (a) creating the legal framework for private sector provision of mortgage default insurance (MI) and financial guarantees for mortgage-backed securities (MBS); and (b) amending the Organic Law of Sociedad Hipotecaria Federal (SHF) to improve SHF’s corporate governance structure and enable it to segregate the capital that backs mortgage default insurance for lower- and middle-income families.
- **Promote the development of infrastructure bonds and other private and public securities** through the introduction of financial insurance for listed securities

**Promote Diversified Investment Instruments**
- **Enable better investment strategies and competitions in the pensions industry** through the finalization of studies on additional flexibility of SIEFORES investment regimes and disclosures of investment strategies and returns
- **Increase the range of investment vehicles for more effective risk management** through the issuance by SHCP and CNBV of a regulations expanding the framework to use derivatives to other intermediaries such as mutual funds and insurance companies

**POLICY REFORMS SUPPORTED BY THIS PROGRAMMATIC SERIES**

98. The three policy areas supported by this operation cut across all the main financial sector intermediaries as shown in Figure 20. The following paragraphs describe in detail the reforms that the GoM is carrying out in support of the objectives of this programmatic series for each one of these financial intermediaries.
With regards to the banking sector, the first proposed DPL would support stronger risk management standards and prudential regulations to ensure sustainability of the renewed growth in the sector. This would be achieved via the issuance by CNBV of a regulation defining standards for external auditors and credit institutions in relation to the provision of external auditing service. This establishes clear rules for credit institutions in relation to the independence, rotation and CNBV reporting of their external auditors. Prudential regulations would also be strengthened through the issuance by the CNBV of the following:

(a) Circular defining rules on capital adequacy-based early warning indicators. The CNBV would classify banks into different categories depending on their capitalization level and would require prompt corrective actions if the capitalization index of any credit institution drops below 25 percent of the minimum threshold (10 percent of risk-weighted assets);

(b) Circular establishing corporate governance requirements for integrated risk management of credit institutions. This regulation defines the responsibilities of the Board of Directors and of senior management, and mandates the creation of a risk committee and periodic audit of the risk management process;

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For example, auditing firms would not be allowed to provide auditing services to banks for more than five consecutive years, and could only be re-appointed by the bank after an interruption of two years.
Regulation establishing minimum requirements and strengthening credit management practices for credit institutions. Institutions are required to develop credit manuals detailing their processes, methodology and procedures for credit origination and management; and

Circular establishing risk-based loan classification and provisioning rules for credit institutions. This norm introduces a more granular loan classification system that can be based on banks' own internal models, and links it to specific provisioning rules.

The first proposed DPL would also support enhanced market disclosure and transparency. This would be achieved through the issuance by CNBV of a:

(a) Regulation establishing financial reporting requirements for financial group holding companies that are subject to supervision by CNBV. This norm enhances the transparency of non-listed financial holding companies by requiring the public (electronic) dissemination of financial statements and other information; and

(b) Regulation that modifies and harmonizes the disclosure of financial information by credit institutions. Credit institutions are required under this regulation to publicly disseminate, via their website, quarterly and annual financial statements, annual reports, as well as other information such as reports submitted to CNBV, loan classifications and board meeting resolutions.

In addition, the first operation would support increased competition in credit provision. This would be achieved through the submission to the Legislature of an amendment to articles 2 and 103 of the Law on Credit Institutions, allowing non-financial companies to tap capital markets to fund their credit activities. The aim of these amendments is to expand funding options for those non-financial companies that provide credit either as their main or ancillary activity (e.g. retailers and car dealers).

The submission to Congress of a new bank resolution law is expected to be included in the program for the second programmatic DPL. The current law provides for only two bank resolution methods: “financial strengthening”/“open-bank” resolution (whereby IPAB provides financial support to facilitate a problem bank’s sale) and “administrative bankruptcy” (whereby IPAB can effect the payment of guaranteed obligations and force subsequent liquidation or bankruptcy). While successful use of these methods has been made in the past, they tend to be time-consuming, costly and subject to legal disputes. The recent finalization of long-standing deposit insurance reform originally introduced under the 1999 IPAB Law provides an additional impetus to consider other internationally accepted bank resolution arrangements. The draft law would introduce new and more efficient instruments such as “bridge bank” and “asset purchase-and-liability assumption”, which would decrease the time and cost of bank resolutions. Conditions for the use of each instrument, as well as the process that would be followed in each case, would be outlined in the draft law and would depend on whether the institution is systemically important.

The proposed second DPL operation would also seek to further enhance the existing banking solvency regime. This would be achieved through the issuance by SHCP of a set of regulations that: (a) aligns the regulatory capital requirements of development banks with those of

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21 Resolution refers to the actions available to regulators to deal with a financial institution whose solvency has become impaired putting at risk its continued operation and, in the case of banks, their ability to cover their liabilities, particularly their deposits.

22 As of January 1st 2005, the maximum deposit insurance coverage per natural or legal person has been reduced to 400 thousand UDIs (inflation-linked units of account), about US$125 thousand.
commercial banks; (b) improves the quality of regulatory capital by reducing the amount of deferred
taxes that can be counted as capital; (c) eliminates distortions deriving from current market risk
capital rules; and (d) establishes lower regulatory capital requirements for insured mortgages. These
initiatives will also facilitate the eventual adoption of Basel II in the Mexican banking sector, which
has recently been tentatively set for 2007.

Non-Bank Financial Institutions and Housing Finance

104. The proposed second DPL would support the strengthening of the housing finance
infrastructure by fostering the credit enhancement market for housing finance and the role of
SHF. The proposed amendments to the insurance law would permit Mexican and foreign insurers to
offer mortgage default insurance (MI) and financial guarantees. To date, the Mexican government has
been the sole provider of MI, most recently via SHF. As part of its efforts to develop the market, SHF
is actively working to attract private insurers to offer MI. The contract terms, financial terms, and
claim requirements of SHF’s new MI product are patterned on those commonly used in the United
States. As SHF has built a portfolio of insurance in force, it has purchased reinsurance from two U.S.
providers to mitigate its risk and to introduce U.S. providers to the Mexican market. The introduction
of these amendments would allow the firms that have offered reinsurance to enter the market and
offer a product directly to lenders.

105. The GoM has announced its intention to define an enhanced framework for credit
enhancements in the mortgage sector and halve the capitalization requirements for residential
mortgages that carry mortgage insurance. MI protects the lender from a portion of the loss that it
would face should the mortgage borrower default. A well-designed MI program promotes mortgage
lending by mitigating a portion of lender credit risk, and increases mortgage affordability by reducing
the down payment required to buy a house. In well-developed mortgage markets, such as Canada and
the United States, MI offered by both the public and private sectors has played an important part in
developing mortgage markets for moderate and low income households. The capital requirement for
residential mortgages with MI will fall from 8 percent to 4 percent once SHCP issues new regulations
in the first half of 2006. Recognizing the lower risk of insured mortgages reduces the cost of banks
to make such loans. In a competitive system, these savings will be passed on to borrowers in the form
of lower interest rates.

106. Financial guarantees serve as credit enhancements for investors in mortgage securities.
A credit enhancement may take a number of forms, the simplest of which is a guarantee that the bond
holders will receive full and timely payment of principal and interest, even when the underlying
collateral pool fails to pay. For a fee, such an enhancement is used to boost the rating of the senior
bonds of an issuance to triple-A. Guarantees make mortgage backed securities (MBS) more attractive
to investors, such as Afores, that have restrictions on the quality of bonds that they may purchase.
SHF, private sector providers, and multi-laterals have offered credit enhancements for the dozen
mortgage securities that have been issued to date in Mexico. The proposed amendments would define
the guarantee product, how it may be offered, and how it is to be regulated from a safety and
soundness standpoint.

107. MI and guarantees would be offered only by specialized institutions subject to
registration and regulation by the finance ministry and the national insurance commission. The
proposed regulatory changes establish minimum qualifications for the individuals that offer the
insurance and manage companies that offer MI or financial guarantees. The proposed amendments
broadly outline the terms by which capital requirements are to be calculated by the insurer, require the
application of actuarial standards as approved by the national insurance commission, and require
sanctions against insurers whose capital falls below that required by the commission.
The proposed amendments to SHF’s organic law would enable it to better isolate the risk capital required for the MI business and enhance its corporate governance structure. SHF management plans to establish legally separate subsidiaries for its lending and insurance businesses. The financial risks of SHF’s products are distinct. In particular, the time horizon for MI is much longer than that of the other products, and so would benefit from a separate pool of risk capital maintained in connection with the actuarial risk of the portfolio of insurance in force. The separation of these functions would not increase the staffing of SHF, but rather enable it to legally isolate the risk capital that supports its separate lines of business. To make possible the segregation of capital for distinct business lines, the proposed amendments to SHF’s organic law would permit SHF to hold ownership interests in subsidiaries that offer insurance for housing credits and that offer financial guarantees.

The changes to SHF’s governance structure would better define the role of the audit committee of the board, alter the number and tenure of board members, and more precisely define prohibited conflicts of interest for independent board members. Audit committee requirements are spelled out in more detail, including defining SHF’s code of ethics, accounting, valuation and reporting policies, defining its internal control system, and reviewing the results of external audits. The number of board members would rise to nine, five from the government and four independent ones from the private sector, with staggered terms. The government members would include, as at present, the secretaries of SHCP, the sub-secretary of SHCP, the governor of the BdM, and a sub-governor of the BdM. The representative of the Secretary of Development would be replaced by the Commissioner of the National Housing Commission. The four independent directors would be required to have experience in finance, law, administration, or accounting. They would be prohibited from having financial or other links with people or firms doing business with SHF, or having any of a list of other links to SHF. The terms of independent board members are independent of the election cycle. The proposed amendments include a detailed definition of prohibited links and activities for independent board members. The director general of SHF and independent members of the board are prohibited from participating in partisan political activities.

None of the planned changes to SHF’s organic law will change the sunset provision for government support of its debt issuances. Debt issued up to 2009 benefits from the full backing of the Federal government. After that, SHF expects to terminate its credit line to Sofoles, which will have to either fund their mortgage portfolios from the capital market, or become more like mortgage brokers, that do not hold mortgages in portfolio. To support this transition, larger independent sofoles, such as Su Casita, have issued MBS and mortgage bonds. Some Sofoles have been acquired by commercial banks and so are now funded with commercial bank deposits. To support smaller independent Sofoles, some market participants are exploring the idea of starting a mortgage conduit, a company that would assemble portfolios from smaller Sofoles into securities.

Capital Markets

Strengthening equity markets and risk capital

The centerpiece of the government’s strategy to invigorate equity markets and risk capital is the new Securities Market Law recently approved by Congress, and to be supported through the first proposed DPL. The bill aims to improve corporate governance and transparency among listed companies, as well as making supervisory functions stronger, clearer and more agile. The roles of the board, general manager, auditors, advisory committees and majority shareholders would be clearly established and, in some cases, revised. The range of securities-related crimes and misdemeanors, and the penalties applicable will be expanded and specified more clearly, with “fraudulent administration” made a crime. The respective responsibilities of SHCP and CNBV are more clearly delineated. The bill also establishes a framework for supervision of securities
brokers (*casas de bolsa*) by the CNBV, which includes early corrective actions, the capacity to designate an intervening manager, and clear processes for license revocation, liquidation and initiation of bankruptcy procedures. This is going to bring Mexico more in line with international standards in corporate governance while tailoring it to local realities. The support that this bill has enjoyed among most business associations seems to indicate that the expected benefits in terms of attracting new investors outweighs the potential cost from increased compliance and disclosure requirements for listed companies.

112. The Law also aims to promote competition and innovation among intermediaries by recognizing different types of securities brokerages, and varying requirements accordingly. This should also reduce the barriers for market entry, as operations licensed for a limited number or type of activities would have a reduced initial capital requirement, to be determined through CNBV regulations.

113. More importantly, the bill would create a new legal form for private enterprises, to facilitate private equity investment. The investment promotion limited company or *Sociedad Anónima Promotora de Inversión* (SAPI), has enhanced protection of minority shareholders rights, in exception to the General Law of Corporations, to allow activities essential for private equity transactions, such as shareholders’ voting agreements, tag-along and drag-along rights\(^{23}\), buyback mechanisms for the redemption of shares and restrictions to preemptive and exit rights. If a SAPI lists on the market, it would enjoy a three-year grace period to converge to normal public companies’ standards. In the meantime, it is required to strengthen its corporate governance and information disclosure, and only qualified investors would be able to trade the shares. So far, a considerable proportion of risk capital in Mexico has been provided by US investors, who not only provide equity funding to local SMEs, but also tend to have an active input in the strategic management of the selected firms. As such, an objective of the new bill is to make more Mexican SMEs an attractive investment target for foreign venture capital funds. The local institutional investors may start to play an increased role, but not in the short run, especially not the private pension funds who have only recently been allowed to take some equity risk through a conservative index-based structure.

114. Beyond the new Securities Law, the government aims to stimulate the risk capital sector by streamlining the role of public DBs in this area, measures that would be supported through the second proposed DPL. Although public development banks are active in the risk capital industry, with investments totaling around US$255 million, they have been hampered by a fragmented approach, differing investment policies and duplication of functions\(^{24}\). In response, a working group was created in late 2004 under the guidance of SHCP with the participation of the development banks and BdM. Its mandate was to harmonize the risk capital investment criteria across these institutions.

115. Specifically, the working group is exploring the possibility of creating a single public sector vehicle (‘fund of funds’) for such investments, an initiative that would be supported by the second proposed DPL. It is envisaged that the founding shareholders of such a vehicle will be the development banks themselves, while the ‘fund of funds’ will only invest in risk capital funds that

\(^{23}\) Tag along is a contractual obligation used to protect minority shareholders, so that if a majority shareholder sells his stake, then the minority shareholders have the right to join the transaction at the same terms. Drag along enables a majority shareholder to force a minority shareholder to join in the sale of a company, but at the same price, terms and conditions, which is useful in case a strategic investor wishes to acquires all the shares. These two types of shareholders’ contractual agreements are frequently used in risk capital investment structures.

\(^{24}\) Of that amount, US$105 million represents paid-in equity investments (via funds and specialist venture capital vehicles called *Sociedades de Inversión de Capitales* or “Sincas”) mostly by Nafin and Bancomext, while another US$70 million represents direct lending primarily by FOCIR.
are active in Mexico\textsuperscript{25}. The creation of such a vehicle would allow the concentration of expertise and resources in one area, as well as ensuring operational independence via the use of a professional administration company that would run it under a management contract. This should be completed with the next year.

116. **Further government initiatives that would be supported by the second proposed DPL aim to strengthen market integrity.** CNBV is working on a circular to establish a code of ethics for credit risk rating agencies and another to define conflicts of interest for financial analysts. These circulars would bring Mexico more in line with international standards on the subject, and should increase the confidence of investors and issuers in the opinions and recommendations of risk rating agencies and financial analysts. However, the efficacy of such codes depends on what provisions are made for their enforcement.

**Developing local debt markets**

117. **The GoM has recently focused its efforts on second generation reforms, which would increase the number of private issuers, and provide more liquid benchmarks for investors and private issuers.** This is needed to help channel more of the accumulated contractual savings into financing the productive sector and away from their current concentration on public debt. For example, the fast-growing private pension funds hold more than 80 percent of their assets in government debt, and while this is already an improvement compared to earlier years, there appears to be significant scope for further asset diversification (Figure 21 and Figure 22).

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\textsuperscript{25} Existing investments by development institutions (Banobras, Bancomext, Nafin, FOCIR) will be transferred to the ‘fund of funds’ by exchanging these for shares in it. The institutions can also voluntarily increase their participation by contributing new financing. It is expected that new injections would come primarily from NAFIN.
Figure 22: Distribution of SIEFORE’s Assets in End 2000 and Mid 2005

Source: CONSAR and MexDer

118. **Mexican authorities are promoting legal changes to prompt greater private debt issuance, for increased access to credit by SMEs, households, and higher risk sectors such as infrastructure.** Firstly, the Credit Institutions Law was amended to allow common law companies to issue debt on the capital markets, in order to finance their credit activities. Given that only large and creditworthy enterprises can tap the bond market directly, the objective is to eliminate the prohibition26 such enterprises had on issuing debt to provide supplier finance to smaller enterprises and consumers. The first proposed DPL supports this measure. Secondly, draft amendments to the Insurance and Warrant Companies Laws aim at promoting infrastructure bond origination, by introducing the Financial Insurance figure and opening it to foreign companies. Private and public infrastructure projects tend to require extensive credit enhancement mechanisms to qualify for investment grade, a pre-requisite to attract institutional investors. The second proposed DPL would support this measure.

119. **The first proposed DPL supports the efforts underway to improve the regulatory and operational framework for secondary market liquidity tools, such as repurchase agreements and securities lending.** These two instruments allow market makers and authorized institutional investors to finance their securities positions and cover short positions, thus enhancing the capacity of participants to provide more regular quotes to their counterparts, both for government and corporate

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26 So far, in their bond issuance prospectus, Mexican companies could not mention “customer credit activities” as a main reason for the bond issuance, or else they would be committing an intermediation crime (*délito de intermediación*). The legal change means that corporate bonds issued as part of the funding strategy of a company can be clearly identified as motivated by the credit activity of the issuer, even as bond repayment remains a general obligation of the firm.
securities. Proposed legal and regulatory changes would allow insurance companies to participate in these transactions, and to put in place the processes needed for mutual funds, banks and Afores.

120. The Public Credit Directorate in SHCP (Crédito Público) is promoting several measures to improve the liquidity of benchmark Federal securities, and tailor them to investors' needs. Crédito Público has allowed for the possibility of stripping and reconstructing government securities, in preparation for potential demand from Afores for zero-coupon bonds, as they start to invest as allowed by their new investment regime. In order to promote liquidity, a 60 percent limit was introduced on the concentration of ownership of a single issue by a bank and a broker of the same group. These two measures would be supported by the first DPL. In parallel, Crédito Público is drafting an updated set of rules for quotation requirements, as well as a code of ethics for public debt Primary Dealers (formadores de mercados) to push for enhanced activity and professionalism in their business practices. This would be supported by the second proposed DPL, and could have positive externalities for most investors in the Mexican capital markets, given the dominance of government debt among financial asset.

Diversifying and strengthening derivatives markets

121. The regulators are taking several concrete steps to deepen the derivatives exchange – MexDer -, by allowing new classes of investors, and eliminating obstacles to increased activity by existing ones. This is because liquidity is the main value-added of organized derivatives exchanges as compared with over-the-counter markets. MexDer is playing an increasingly important role for risk management not only for domestic banks, corporates, and foreign investors, but also for domestic institutional investors. So far, the main users of the derivatives exchange had been brokers (for their own positions, but mostly on behalf of their corporate clients and foreign investors) and banks. As market liquidity deepens, it becomes an attractive alternative for risk management of domestic institutional investors, who in turn add to that depth. Accordingly, CONSAR (Comisión Nacional de Sistema de Ahorro para el Retiro, National Pension Savings Commission), SHCP, CNBV and CNSF (Comisión Nacional de Seguros y Fianzas, National Insurance Commission) are gradually opening up the possibility of using derivatives, respectively to Afores, mutual funds and insurance companies.

122. CONSAR is well advanced in certifying individual Afores to use derivatives, while CNSF and CNBV are finalizing the applicable legal and regulatory framework, for insurance companies and mutual funds. This is expected to be approved during 2006 and would be supported through the second proposed DPL. The following step in this process would be for the regulator to certify individual institutions' compliance with the main dispositions of BdM circular 2019/95, detailing a list of 31 operational requirements to transact derivatives. Provided that these steps are accompanied with adequate supervision and disclosure of derivatives positions, they could have a positive impact on the performance of mutual funds and insurance companies.

123. In parallel, a series of recent and upcoming measures aims at increasing liquidity by stimulating the activity of existing participants on the MexDer. First, SHCP has supported the

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27 The new Basic Fund 2 can invest up to 15% in capital-protected notes that are best structured as a package of a zero coupon bond and an investment in the stock exchange index.
28 These are chosen among banks and stock brokers, to act as the federal government's privileged partners in its domestic debt issuance and have exclusive access to the primary market, in return for obligations to participate actively in the primary and secondary market, and provide minimum liquidity to outstanding debt instruments.
29 To manage their asset-liability risks, as well as to act as market makers to generate income by providing liquidity to the market through continuous quotations.
30 For insurance companies, legal amendments will allow the collateralization of assets for derivatives transactions. For mutual funds, CNBV circulars will regulate the management and disclosure of derivatives positions.
introduction of Global (or Omnibus) Accounts on the MexDer, i.e. generic and anonymous “clientele” accounts for intermediaries in the MexDer. It is expected that this will help increase market depth and liquidity, as well as cost-effectiveness. Second, SHCP recently submitted and Congress approved a legal change that exempts foreign investors in interest rate derivatives (involving inter-bank rate indexed or government bonds) from double taxation, when they are from countries where Mexico has taxation treaties. This will promote increased activity on the MexDer, as liquidity is a crucial ingredient to make the market an effective solution-provider for local investors’ risk management strategy. These two measures would be supported by the first DPL, while the second proposed DPL would support CNBV draft of a banks’ regulation to harmonize the valuation of OTC and MexDer derivatives, reduce the capital requirement for synthetic swaps created through futures (engrapados), and allow for increased flexibility in using MexDer instruments as a hedge for OTC derivatives. This would increase the activity of banks, which are the main market makers on the MexDer.

124. **The first proposed DPL supports authorities’ efforts to further MexDer’s initiatives to widen derivative products offering and respond to institutional investors’ needs.** In early 2004, SHCP approved MexDer’s request to introduce options on the Mexican stock market index IPC. Until then, the only available contracts were futures. Options purchase can answer different risk management needs, among investors and issuers, essentially to limit exposure to falling price. Options may play a significant role in Afores’ penetration of the stock market through index-replication instruments, given the difficulty of trading on the cash market and complying with the requirement to replicate the index at all times, due to varying liquidity among individual stocks. More recently, MexDer introduced options and futures on some individual local stocks, domestic government bonds, as well as on exchange-traded funds (ETFs) on foreign stock indices, euro, gold and Brent crude oil.

125. **The BdM is leading the drafting of a bill for a comprehensive Derivatives Markets Law, which would be supported by the second proposed DPL.** The objective is to strengthen and upgrade the legal framework for derivatives.

**Private Pensions System**

126. **The first proposed DPL would support the GoM’s reforms to liberalize further the pension investment regime to allow a better alignment of worker’s risk appetite with their pension funds’.** In January 2005, CONSAR amended *Circular 15-12* to establish that at least two funds should be offered by each Afore. *Siefores Básica 1* continues with the same investment regime as before, but allowing for investing abroad of up to 20 percent of funds. The other fund, *Siefores Básica 2*, which could invest up to 15 percent in equity instruments and up to 20 percent abroad. Equity investment has to be through diversified instruments linked to indexes and with capital protection. All contributors under the age of 56 could choose between the two Siefores, and if they did not choose were assigned to *Siefores Básica 2*. Older workers have to be in *Siefores Básica 1*. The investment in capital protected variable income instruments can be done through structured notes, by investing in a fixed income instrument and an index or derivatives at the same time, or even buying the specific instruments that replicate the index. In this last case they have four days to buy all the necessary individual instruments and are allowed to have a permanent 1 percent deviation with respect to the index.

127. **The goal of this change is that Siefores obtain higher returns for their contributors.** In the case of Mexico this is important not only for pensioners but also for the fiscal position of the government, given the guarantees given to participants in this system. Expanding the set of instruments in which pension funds can be invested is crucial to obtain an adequate combination of
risk and return. Even if there are still important restrictions it seems that there is a significant potential gain in diversification of risks under the new regulation. However, more flexibility in investment regimes has to go together with a close supervision of risks and information disclosure as safeguarding compulsory savings is crucial for the sustainability of the private pension system. CONSAR has been strengthening financial risk supervision by hiring trained personnel and restructuring the Financial Vice-Presidency to create a unit for risk analysis.

128. The GoM is also seeking to foster competition among Afores to increase the attractiveness of the system to workers and reduce administration costs. In January, 2005 an amendment to the Siefores Law (Ley de los Sistemas de Ahorro para el Retiro) was approved by the legislature. The main component of this amendment aims to enhance price competition by facilitating transfers if this reduces costs, and in general increase the system’s accountability to contributors. Four key changes to the Law were made:

(a) Elimination of the one-year minimum stay period so that a worker could switch before the year-end, to a cheaper Afore. (Article 74). This has had a significant impact on transfers and price dispersion has fallen notably. This change also had an impact on the entrance of new Afores, because on the one hand this eliminated an important barrier to entry and on the other hand new Afores only managed to enter this market with lower prices.

(b) Increased flexibility in the requirements to qualify for discounts given to participants after being in the same Afore for a number of years. This was part of the price strategy of Afores to give incentives to participants to stay in the same Afore for a long time. The change in the Law now implies that instead of considering the number of years in the same Afore, they would have to consider the years in the system. As a result, commissions immediately dropped significantly to many contributors.

(c) A third change was related to those workers incorporated into the system without choosing an Afore. These were previously assigned to one of the cheaper Afores and were free to switch afterwards. But, following this change, they cannot switch unless it is to a cheaper Afore, as for other account holders.

(d) Establishment of fines for Afores in the case of fraud in the transfer process of contributors or if Afores charge participants more than they should.

129. Accountability is also being increased by enhancing cost transparency and reducing transaction costs associated with Afore switching. CONSAR issued Circular 22-10 in August 2005 to change the information forms sent to contributors. The new form simplified significantly the information provided to contributors and gives a comparison of the costs of each Afore, as well as information on returns in a more transparent manner. In order to facilitate switching from one Afore to another, so that commission reductions would be more effective in promoting competition, the CONSAR issued in July 2005 Circular 28-11, which allows switching through the internet. This has two major advantages; it reduces switching costs, enhancing competition, and operating costs are reduced.

130. Some of these reforms are already having the desired effects. The cumulative effect of these reforms has already increased transfers among different Afores (Figure 23 and Figure 24) and is lowering the average level and range of commissions.
Figure 23: Transfer of contributors between Afores

Source: CONSAR

Figure 24: Annual equivalent fee (Percentage of Assets under Management)

Source: CONSAR

Note: The annual equivalent fee is the commission for an affiliate who has been in the Afore for five years, has a balance of 22,000 pesos at the beginning of the year, and where the real rate of return on the fund is 5 percent, with a bimonthly contribution of 721 pesos. Source: CONSAR

131. **Regulatory changes have been implemented to make voluntary savings more attractive to Afores and participants.** Mexico, like other countries in the region with similar programs, has identified a lack of interest among workers in their pensions, due partly to the relative complexity of pension investments, as a serious problem. This needs to be addressed before the population in the new systems gets closer to retirement (i.e., when it would be arguably too late). Voluntary savings and employer-sponsored pension plans offered through the Afores would provide incentives to participants to become more involved with their pension decisions and contribute to legitimizing the
system. Circular 60-1 (August 2005) enabled workers not affiliated to the Mexican Social Security Institute (IMSS) to contribute to Afores. This is especially important for self-employed workers who were not affiliated to IMSS. The incorporation of self-employed should increase coverage and competition in the system. (It is estimated that 11 million workers are self-employed in Mexico.) The administrative procedures implemented for the self-employed also apply to civil servants who contribute to ISSSTE, the pay-as-you-go system for public sector employees. These workers could now contribute to Afores on a voluntary basis, subject to tax incentives.

132. Further liberalization of the investment regime would be supported by the second programmatic DPL. The Latin American Shadow Financial Regulatory Committee31, in Statement 13 (July 2005), mentions that foreign diversification is desirable and important for pension funds, adding justification for measures taken to this end in Mexico. In any case, it must be borne in mind that the primary goal of pension funds is not the development of capital markets but the provision of adequate pensions, and the safety of compulsory savings is crucial. CONSAR is currently reviewing potential additional liberalization of the investment regime based on continued development of appropriate risk management capabilities among Siefores.

133. A complete review of the functioning of Procesar (the collection agency) is being carried out to identify and implement improvements. This is not because fraud or diversion has been detected, but because of the lack of reliable identification numbers. As a result, in a significant number of cases an individual has more than one account, transfers between Afores take longer, and contributions are not allocated to accounts as soon as they should be. These improvements are expected to be included in the second DPL.

134. Given the strong price competition that has been fostered by CONSAR it is desirable to take measures to enhance competition for returns as well. CONSAR has been actively working on the development and publication of investment policies, and the proposed second DPL operation would support this effort. For this purpose CONSAR is developing a structure for the elaboration and disclosure of investment policies that Siefores would impose themselves. CONSAR calls these policies a “benchmarking” scheme. This would add transparency to the investment decisions of Siefores and, it is expected, better align incentives between Siefores and contributors. It is likely that this would imply more competition between Afores in returns, increase differentiation, reduce conflicts of interest and promote longer term investment strategies. There would be no penalty or reward for Afores that deviate from the benchmark or underperform it. However, CONSAR would develop a performance index that would be disclosed to the public.

LOAN AMOUNT

135. The proposed US$501.26 million first programmatic DPL would be disbursed in a single tranche. It is expected that this tranche would be disbursed upon loan effectiveness in the third quarter of the Bank’s 2006 Fiscal Year.

VII. OPERATION IMPLEMENTATION

POVERTY AND SOCIAL IMPACTS

136. Prevention of financial crises is essential to poverty alleviation. In strengthening the financial system through greater market integrity and enhanced prudential regulation, the proposed program aims to reduce the risk of future financial crises, which can have a devastating impact on

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31 The Committee is composed of senior Latin American financial policy makers, including past ministers of finance and central bank presidents.
employment levels and poverty incidence. The 1994-1995 crisis caused a surge in poverty levels which took a decade to reverse.

137. The proposed operation does not support policies that combat poverty directly, but instead seeks to reduce it primarily through fostering faster and more sustainable economic growth. A strong, efficient and more diversified financial system and capital markets can provide private enterprises – the engine of economic expansion - with more resources, to invest and expand. Growth has historically been a powerful force for poverty reduction in Mexico and worldwide, by raising living standards, creating jobs and increasing the public resources available for social spending.

138. The program also includes measures that would promote more equitable growth, which has a greater poverty impact. Strengthening corporate governance and the rights of minority shareholders, and generally fostering greater and broader participation in the equity market should lead to a more equal sharing of the fruits of economic expansion. As discussed above, the ownership structure of Mexican companies has been extremely concentrated, which has contributed to the country’s great income inequality. On the side of businesses, expanding access to the capital markets and other forms of financing, including risk capital, will benefit newer and smaller companies. Mexican poverty levels are highly sensitive to the pattern of economic growth – in terms of job creation and income distribution. Thus while in 1996-2000 the economy grew at 5.5 percent per annum, poverty fell slowly as unskilled wages dropped and income inequality increased. Conversely, while growth slowed between 2000 and 2002, extreme poverty fell considerably as rural incomes (including unskilled wages, remittances and transfers through Oportunidades3) increased, and income inequality narrowed across the board.

139. Measures to fortify the system for housing finance, particularly at the lower-income end of the market, should help make home loans more readily available. Broadening access to mortgages enables more people to acquire their own homes, which provides them – in addition to the housing itself – with a means of accumulating wealth. In particular, the development of MI that this DPL series would support is essential to allow the offering of higher loan-to-value mortgages, a mechanism that international experience has shown to be the best market-based instrument to provide home ownership to lower income households.

140. In promoting more transparent, efficient and competitive administration of pension funds, with access to a broader range of investments with potentially higher returns, the proposed program should strengthen these and make them more attractive as investments. This would contribute to providing more Mexicans with greater financial security in old age. The elderly are much more likely to be poor in Mexico, as elsewhere: in 1998, 38 percent of Mexicans aged 65 and over were poor, against 22 percent for the population in general33. However, Mexico’s pension system continues to exclude most of the poor. The social security system covers only one in every five of the urban elderly population and only two percent of the total poor.

141. While the program can therefore be reasonably expected to contribute to reducing poverty in Mexico, the impacts would be extremely difficult to quantify. This is because the drivers of economic growth and poverty reduction are multiple and intertwined. And many of them – including international economic conditions and commodity prices - are beyond the control of the GoM or the scope of this program.

32 Oportunidades is the government’s social program to alleviate extreme poverty.
PUBLIC PARTICIPATION

142. The program supported by this DPL has benefited from four types of public participation mechanisms. These are: (i) the consultative process carried out as part of the preparation of the National Development Plan and of Pronafide; (ii) the public review of regulations mandated by COFEMER (Comisión Nacional de Mejora Regulatoria, National Commission for Regulatory Improvement); (iii) focus groups conducted under the preparation of the Mexico Competitiveness DPL; and (iv) the formal political consultation process associated with legal initiatives in Congress.

143. This DPL supports the implementation of the financial sector component of the National Development Plan 2001-2006. This Plan was developed by the GoM on the basis of several consultation mechanisms including 150,000 answers received to direct mailings and website postings on the three thematic areas covered by the Plan as well as 1,100 public meetings with broad geographic distribution.

144. All regulations issued by the GoM have to be posted for up to six months for comments in COFEMER’s website. In particular, this requirement has covered all the regulations issued by SHCP, CNBV, and CONSAR that this DPL would support. Public agencies submitting proposed regulations to COFEMER must also include an impact assessment of the regulation identifying possible costs and affected stakeholders to facilitate COFEMER’s dissemination efforts.

145. Focus groups were also used. As part of the preparation of the proposed Mexico Competitiveness DPL, the GoM with the support of the Bank organized ten focus groups with approximately 90 businesspersons from various sectors of the economic activity; directors of associations and chambers of commerce; and more than 30 officials from the federal, state and municipal governments. The Consejo Coordinador Empresarial, the major business umbrella organization in Mexico, was instrumental in coordinating the implementation of these focus groups. These groups addressed the need for continued financial sector development to enhance Mexico’s competitiveness.

146. The current institutional and political arrangements in Mexico provide a solid discussion platform for legal reforms. Congressional debates are open to the public and broadcast on television. The lack of clear majority of any party Congress further opens up the space for debate as no laws can be approved without a certain degree of consensus among more than one party.

IMPLEMENTATION, MONITORING AND EVALUATION

147. The SHCP will be the representative of the United Mexican States (the Borrower) and will be responsible for the overall implementation of this program in coordination primarily with the BdM, CNBV, and CONSAR.

148. Bank staff will monitor actions and review progress of the implementation of the proposed operation, as well as the subsequent actions of the Government’s program through frequent visits to the country and constant communication with SHCP. Bank staff will focus on monitoring progress towards the indicative triggers for the second programmatic loan and the overall goals of the program.

149. Monitoring Indicators. In addition to the Program Outcomes presented in the Policy Matrix, which will constitute the fundamental indicators against which the success of the program will be evaluated, several quantitative indicators will be monitored to ascertain the level of progress towards such outcomes, bearing in mind that many of these indicators are influenced by factors beyond the scope of the program. The baseline data for these indicators exist and SHCP and the relevant regulatory agencies have the capability to monitor them on a timely basis.
### Table 8: Monitoring Indicators

<table>
<thead>
<tr>
<th>Development Objective</th>
<th>Policy Action Area</th>
<th>Indicators</th>
</tr>
</thead>
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| Contribute to reduce the probability of a systemic financial crisis | Enhance corporate governance and minority shareholder rights of firms participating in the capital markets | - CNBV reports on compliance
- Investor surveys
- World Bank Doing Business Investor Protection indicator |
| | Strengthen prudential regulation and risk management in the banking sector | - Prudential indicators of the financial system (Capital adequacy, coverage ratios)
- Reports of fines to financial institutions on non-compliance |
| | Enhance market disclosure and transparency | - CNBV reports on compliance |
| Increase Depth, Access, and Diversification of Financing | Enhance access to the capital markets | - Total financing to the private sector as percentage of GDP
- New debt and equity issuances
- Total market capitalization |
| | Increase the role of capital markets in the supply of credit | |
| Promote Diversified Investment Instruments | Enable better investment strategies and competition in the pensions industry | - Number of Siefores
- Average and dispersion of fees charged by Siefores
- Siefores portfolio structure by asset class
- Siefores portfolio yield
- Number of participants in Siefores including independent workers |
| | Increase the range of investment vehicles in the capital markets | - Liquidity of the domestic strips and repo markets
- Liquidity of secondary public debt markets
- Levels of MexDer trading |

### FIDUCIARY ASPECTS, DISBURSEMENT AND AUDITING

150. **The Mexico Country Financial Accountability Assessment (CFAA) was completed in October 2003.** The assessment focused on the federal public sector, which was considered to have generally sound financial management systems and institutions. Country Financial Management (FM) risk was rated moderate, and all individual risk factors were rated low or moderate. The results of the CFAA have a direct impact on this project, as funds will flow into Mexico’s public FM systems. The Bank has recently supported government efforts to strengthen some of the areas considered by the CFAA to be opportunities for improvement, such as the accounting processes and information systems.

151. **The proposed Finance and Growth DPL will follow the Bank’s disbursement procedures for development policy lending.** The untied balance of payment support will be disbursed against satisfactory implementation of the development policy lending program and not tied to any specific purchases. The U.S. dollar loan would be made to the United Mexican States. The loan would cover the first of the two operations under the program.

152. **Flow of funds (including foreign exchange) are subject to normal FM processes.** It is not possible to track the ultimate use of the foreign exchange provided by the Finance and Growth DPL.
proceeds, but loan proceeds flow into a dedicated account\textsuperscript{34} and from it to Mexico's budget, and are thus subject to normal public FM processes. By way of a letter, the Government will provide confirmation to the Bank when the loan amount has been credited to an account used to finance budgeted expenditures (as soon as step 3 in the following flowchart is concluded). The account in which the loan proceeds will be deposited are to be temporarily held by the Borrower in NAFIN, then, on the same day of the deposit, NAFIN will transfer the funds to the Treasury’s account in the Central Bank. The Bank’s Financial Management (FM) team for Mexico carried out activities to provide reasonable assurance that loan proceeds flow into Mexico’s normal public FM systems. Given the ample experience of Mexico managing Bank’s DPLs, the FM team analyzed project’s flow of funds, reviewed the audit report of BdM (the Central Bank) and the Country Financial Accountability Assessment report (CFAA). The IMF's report on the Safeguards Assessment of the Central Bank has not been conducted. Figure 25 illustrates the flow of funds.

\textbf{Figure 25: Flow of Funds for Loan Proceeds}

\begin{tabular}{|c|c|c|}
\hline
\textbf{US$} & \textbf{US$ or MX$} & \textbf{MX$} \\
\hline
World Bank & NAFIN / Central Bank & Secretariat of Finance National Treasury & Budget \\

Dedicated Account & General Account in the Central Bank & Public Financial Management Systems \\
\hline
\end{tabular}

153. The FM assessment concluded that from a fiduciary point of view, the control environment, procedures and regulations governing this Bank operation are generally adequate. Therefore, and based on the flow of funds described above, the results of the work done by the FM team and considering that the size of this DPL is relatively small if compared with Mexico’s overall public expenditures and foreign exchange reserves held by BdM, no additional FM-related arrangements are needed for this project.

154. The Bank will not request a special audit of the dedicated account established in Banco de México, as it is already audited as part of the standard local regulation e.g. these type of accounts are audited by the internal control unit of BdM, the Supreme Audit Institution ASF and an external private firm, the latter as part of the annual audit review of the Financial Statements of the Central Bank.

\textbf{ENVIRONMENTAL ASPECTS}

155. The reforms supported by the proposed Loan are not expected to have any significant adverse effects on the environment. However, increased economic activity derived from easier access to finance could potentially lead to negative environmental impacts. The GoM, with support through the Bank’s Programmatic Environmental DPL Series, is putting in place an effective environmental management framework associated with investments in key areas of the economy both at the federal as well as regional level. These efforts should mitigate the risks of any indirect environmental impact this Finance and Growth DPL may have.

156. This operation may benefit efforts to lower the destabilizing impact that natural disasters have. The Bank and other donors have been actively involved in providing technical advice

\textsuperscript{34} This dedicated account in the central bank is a local standard procedure for DPLs (established by the GOM for control purposes), and it is not an additional FM-related arrangement requested by the Bank. The FM team has accepted this procedure to-date, but as a result of the ongoing Country Systems work in Mexico, in the future funds might flow directly from the Bank to a general foreign currency account in the central bank.
to the GoM on the use of financial instruments that can lower the fiscal impact of natural disasters. In
particular, the GoM initiated with Bank support the technical studies necessary to issue a Catastrophe
Bond (Cat Bond) that would provide liquidity to the GoM in case of natural disaster and generally
enhance its ability to spread and hedge financial risks. This activity is currently being funded by
FIRST, a multi-donor financial sector trust fund. The reforms supported by this DPL seek to facilitate
the operation of the capital markets and ultimately its increase in liquidity. This environment is
essential for the GoM’s ability to issue Cat Bonds once the technical work has been finalized.

RISKS AND RISK MITIGATION

157. The two main risks faced by the proposed operation are associated with the upcoming
presidential elections. The political turbulence risk is associated with the potential for disruption of
some of the financial sector reforms supported by this operation if political events during the
campaign or the presidential transition were to lead to macroeconomic instability. The transition risk
refers to the possibility that the incoming administration reverses the actions already taken or fails to
continue implementation of future reforms.

158. The last presidential transition showed that Mexican political institutions have been
strengthened and the risk of political turbulence has diminished. The last presidential election
broke the cycle of financial instability that had been associated with previous elections in Mexico.
However, this risk is considered limited if some sort of political shock were to take place. The GoM
is seeking to mitigate this risk in the most effective manner possible, which is to continue its prudent
macroeconomic management and, with respect to the financial sector, continue strengthening its
prudential regulation and supervision in part through the measures supported by this DPL.
Furthermore, public debt management and the country’s fiscal situation is better than during the last
two transitions. Additionally, the banking sector, the usual source of financial crises when political
shocks have macroeconomic repercussions, is better regulated, capitalized and dominated by foreign
institutions with access to international capital.

159. The broad consensus across the political spectrum and the consultation process among
stakeholders on the reforms supported by this DPL point to a limited transition risk. All the
actions already taken that required legislative approval were approved with multi-party support –
necessary in Mexico due to the lack of an absolute majority for any of the parties in the legislature.
This indicates broad consensus on these elements of the financial sector agenda. For example, the
Securities Markets Law was already approved in the upper chamber of Congress with votes from the
three main political parties. In addition to the consultation process required for any law discussed in
Congress, Mexican law requires all regulatory changes to be submitted to COFEMER for public
dissemination and consultation before approval. This includes mandatory listing in COFEMER’s
website for comments for up to six months before a new regulation can be made effective. The Bank
will contribute to additional mitigation of the transition risk through its dialogue with political
candidates and the incoming administration. The Bank is starting the preparation of Policy Notes that
will be discussed with presidential candidates during the campaign and with transition teams after the
elections. These Notes will include a description of the key elements of the financial sector agenda
incorporated in this DPL.

160. Additional risks exist associated with specific reforms supported by this operation and
the GoM has sought to mitigate them through consultation processes. In particular, protecting
minority shareholder rights and enhancing disclosure and transparency can be resisted on the basis
that this could actually deter firms from seeking financing through capital markets. International
experience shows that the benefits derived from increasing the number of potential investors and the
potential that this has to reduce financing costs outweigh the costs associated with this type of
reforms. To emphasize this, the GoM has carried out an extensive outreach campaign particularly
directed toward firms that could be new entrants to the capital markets, as part of the discussion of the Law of Securities Market. A similar concern could exist regarding prudential regulation: that it could stunt financial sector growth. However, Mexican financial sector growth depends on continued public confidence in the sustainability of such growth and this type of reform will help build this.

161. **Finally, changes in the macroeconomic environment would immediately affect financial sector development but the GoM has mitigated this risk through a solid economic management program.** Even in the absence of political shocks or other events related to the political transition, the macroeconomic environment could be affected by other causes including external factors. Such an event would highlight the importance of the market integrity and prudential regulations supported by this DPL series as they seek to lower the probability of a systemic financial crises that such shock could generate. However, adverse macroeconomic conditions could also stunt or reverse the development of financial markets as appetite for new investments falls. The GoM has been carrying out solid macroeconomic management during the last decade to lower the possible impact of external shocks to the economy thus creating the conditions for the microeconomic-level reforms supported by this DPL to bear fruit.
La presente Carta de Política Sectorial describe la situación económica de México y los esfuerzos en curso del Gobierno Federal a favor de una reforma integral del sistema financiero. Dichos esfuerzos están dirigidos a consolidar un marco regulatorio más sólido que promueva la adecuada operación del sector financiero y que asegure una sana actividad crediticia y un creciente acceso al capital. Asimismo, se ha venido aplicando una política en materia de deuda pública cuyo objetivo principal es lograr satisfacer las necesidades de financiamiento del sector público con el menor costo financiero posible, sujeto a un nivel de riesgo prudente en una perspectiva de mediano y largo plazo. Todas estas acciones son congruentes con los objetivos establecidos en el Programa Nacional de Financiamiento del Desarrollo (PRONAFIDE) 2002-2006. Los frutos de esta estrategia se han reflejado en la estabilidad que ha caracterizado la economía y en el sano desarrollo de los mercados financieros nacionales en los últimos años, así como en la confianza de los inversionistas sobre las perspectivas futuras del país.

1. El contexto macroeconómico

Durante la década de los noventa la estrategia de crecimiento económico de México dependió de diversos acuerdos comerciales internacionales firmados en esos años, los cuales abrieron nuevas oportunidades de inversión y permitieron ampliar y diversificar la base exportadora del país. Como resultado, el intercambio comercial pasó de representar el 27.3% del Producto Interno Bruto (PIB) en 1993 al 52.8% en el 2004. Sin embargo, la desaceleración económica mundial que comenzó en el 2001 hizo evidente la necesidad de fortalecer e impulsar las fuentes internas del crecimiento.

En este contexto, la administración del Presidente Vicente Fox ha implementado una política económica que tiene como objetivo promover la inversión y la demanda interna mientras se consolida el proceso de convergencia con nuestros principales socios.
comerciales. Con este fin, el Gobierno Federal ha trabajado intensamente a través de dos líneas de acción: i) la reducción de los recursos financieros que absorbe el sector público mediante una estricta disciplina fiscal que ha permitido reducir el déficit público presupuestario del 0.72% del PIB en el 2000 al 0.3% en el 2004 y ii) el aumento del ahorro financiero interno a través de una ambiciosa reforma del sector financiero, que ha permitido que este indicador se incremente del 43% del PIB en el 2000 a 52% en el 2004.

Paralelamente, el Gobierno Federal ha implementado diversas medidas para mejorar la competitividad y promover la inversión privada, entre las que destacan las modificaciones al régimen impositivo de las empresas y las personas físicas, la depreciación acelerada de las inversiones, la promoción del sector vivienda, el apoyo a la competitividad comercial mediante mejoras en la logística de la infraestructura aduanal y el desarrollo de los mercados locales de deuda pública.

Adicionalmente, se ha logrado que el crédito bancario se convierta en un elemento sustentable para apoyar el crecimiento económico. En junio de 2005, por ejemplo, el crédito vigente a las empresas creció a una tasa real anual de 20.6%, mientras que la cartera de crédito vigente para vivienda y consumo se expandieron a una tasa real anual de 45.1% y 44.4%, respectivamente.

En conjunto, estas políticas han promovido una recuperación balanceada del crecimiento económico. En el 2004, el consumo privado y la inversión crecieron al 5.5% y 7.5%, respectivamente, mientras que las exportaciones se incrementaron 11.5%. Esta recuperación no hubiera sido posible sin el compromiso con la disciplina fiscal, el manejo responsable de la deuda pública y una prudente política monetaria.

II. EL PRONAFIDE

El PRONAFIDE 2002-2006 establece los principales lineamientos y estrategias de la política de hacienda pública necesarios para fortalecer las fuentes permanentes de financiamiento y, de esta forma, coadyuvar a lograr un mayor desarrollo. El programa pretende expandir la capacidad potencial de crecimiento del país y, al mismo tiempo, garantizar un entorno estable a través de una conducción responsable de la política económica. Su finalidad última es contribuir a la prosperidad económica general que ayude a reducir la pobreza, crear empleos y mejorar salarios dentro de un marco sustentable.

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1 Sin considerar programas de apoyo a deudores.
El pilar fundamental del Programa consiste en el impulso a la inversión a través del aumento permanente de los recursos disponibles para su financiamiento. Ello requiere de un entorno legal y económico que promueva la canalización de los recursos ahorrados hacia los proyectos de inversión más productivos y del fortalecimiento del ahorro público.

La parte financiera del Programa es indispensable para lograr sus objetivos, pero no es suficiente, dado que también es necesario avanzar en la instrumentación de la agenda de reformas estructurales contenida en el PRONAFIDE. Al abrir nuevas oportunidades de inversión y establecer un entorno económico que promueva una mayor inversión del sector privado en las actividades productivas del país, las reformas estructurales acrecentarán la disponibilidad de recursos, propiciarán que éstas se asignen con mayor eficiencia y resultarán en mayores y mejores oportunidades de empleo.

El Gobierno debe tener como prioridad fundamental establecer los incentivos correctos para promover una economía activa y en crecimiento. Lograr lo anterior, sin embargo, no es tarea fácil. Requiere que los diversos grupos que conforman el complejo mosaico político y social de nuestro país concuerden en una plataforma económica básica que garantice la estabilidad macroeconómica y propicie la iniciativa individual en un entorno con regulaciones mínimas.

La experiencia internacional ha demostrado que los recursos que transitan a través de un adecuado sistema financiero se canalizan de manera eficiente y expedita hacia los proyectos de inversión de mayor rentabilidad, y ha subrayado la importancia que tiene para el desarrollo el contar con un sistema financiero amplio que funcione bajo esquemas de regulación y supervisión apropiados. Por ello, el PRONAFIDE ha promovido el establecimiento de un marco regulatorio y operativo que propicie la confianza de los usuarios del sistema financiero, disminuya los costos de transacción, extienda la cobertura y estimule la eficiencia de la intermediación. En este contexto el Gobierno ha impulsado una serie de iniciativas para promover la cantidad y calidad del ahorro financiero y para fomentar el desarrollo integral de los mercados financieros.

III. Reformas al Sector Financiero

Gracias al trabajo coordinado entre las autoridades financieras y el H. Congreso de la Unión se ha avanzado en la modernización del marco jurídico del sector financiero. Durante la presente administración, el Congreso ha aprobado diversas iniciativas de reforma a la legislación financiera. Ello, junto con las normas emitidas por la Secretaría de Hacienda y Crédito Público (SHCP), la Comisión Nacional Bancaria y de Valores (CNBV) y Banco de México (BdM), se traduce en una reforma profunda y amplia de la actividad financiera en el país. Sería demasiado dispensioso efectuar un análisis de cada una de
estas iniciativas por lo que nos referiremos tan solo a las medidas más recientes y a aquéllas que esperamos implementar en los próximos meses.

1. Marco Regulatorio de las Instituciones de Crédito

Prevención del Lavado de Dinero y Financiamiento al Terrorismo

Con relación a la prevención del lavado de dinero y el financiamiento al terrorismo, entre junio de 2003 y mayo de 2004, México participó en la Segunda Ronda de Evaluación Mutua realizada por el Grupo de Acción Financiera sobre el Blanqueo de Capitales (GAFI). La evaluación tuvo por objeto examinar el grado de apego de nuestro país a las 40 recomendaciones emitidas por el referido GAFI, así como a las 8 recomendaciones especiales en materia de financiamiento al terrorismo. En octubre de 2005, se atendió a la primera reunión plenaria del GAFI, en la cual fue presentado el Reporte de seguimiento o Follow-Up de México respecto del cumplimiento de las Recomendaciones emitidas en la materia, del cual se originó una valoración favorable sobre las actividades realizadas por nuestro país en dicho tema.

En cuanto a modificaciones al marco regulatorio, fue aprobada, el 28 de enero de 2004, la Miscelánea relativa a Medidas contra el Lavado de Dinero y el Financiamiento al Terrorismo, la cual incluyó diversas disposiciones que deben observar los distintos sujetos obligados para prevenir y combatir estas actividades en nuestro país e incorporándose en la legislación mexicana las mejores prácticas internacionales en la materia.

Asimismo, en diciembre de 2005 fue publicada la reforma a la Ley de Instituciones de Crédito en lo relativo a los secretos bancario y fiduciario, con el objeto de hacer más eficiente la obtención de información protegida por los mismos y cumplir con las recomendaciones emitidas por el GAFI.

Por otro lado, se encuentra en análisis de la Cámara de Diputados la modificación a diversas leyes penales, previamente aprobada por el Senado de la República, a efecto de tipificar diversos delitos relacionados con el terrorismo, cuyos aspectos más relevantes son los siguientes:

- Se incorpora como delito el financiamiento a actividades u organizaciones terroristas.
- Se incluye la figura de terrorismo y financiamiento a organizaciones y actividades terroristas internacionales.
- Se incrementa y ajusta la punibilidad del delito de terrorismo, tanto nacional como internacional.
Se tipifican como graves las conductas relacionadas con dichos ilícitos.

**Alertas Correctivas Tempranas**

Se reformó y adicionó diversas disposiciones de la Ley de Instituciones de Crédito, a fin de introducir acciones correctivas tempranas, la cual permite fortalecer las medidas preventivas y correctivas para evitar oportunamente el deterioro de la situación financiera de las instituciones de banca múltiple, con el objeto de proteger al público ahorrador, cuidar el comportamiento fluido del sistema de pagos y fortalecer la estabilidad del sistema bancario mexicano.

Esta reforma obliga a la autoridad supervisora a actuar antes de que una institución sufra un deterioro, reduciendo la discrecionalidad en la aplicación de medidas correctivas y dando certeza jurídica a las instituciones.

Los principales casos a considerar son los siguientes:

- Cuando la institución cumple con un nivel de capital superior al 10%, las instituciones tienen la certeza jurídica de que no se les aplicarán acciones correctivas tempranas.
- Cuando la institución registra un índice de capitalización entre el 8% (mínimo requerido) y el 10%, sólo se aplican medidas de carácter informativo y de prevención, reconociendo que la institución cumple con el mínimo exigido por la regulación.
- Cuando el índice de capitalización de una institución se ubica por debajo del 8%, se obliga a la Comisión Nacional Banca y de Valores (CNBV) que imponga una serie de medidas correctivas, otorgándole a la institución un plazo máximo de 12 meses para corregir su situación financiera y cumplir con el mínimo que exige la regulación.

Es importante mencionar que esta reforma, corresponden a medidas y etapas preventivas, otorgando una tregua cuando una institución comienza a experimentar un deterioro.

**Resoluciones Bancarias**

En el caso del marco normativo del proceso de resolución de instituciones bancarias, se está por presentar al Poder Legislativo un proyecto de reforma a la Ley de Instituciones de Crédito y a la Ley para Regular las Agrupaciones Financieras que contempla diversos mecanismos que le permitan al Instituto para la Protección al Ahorro Bancario (IPAB), la posibilidad de tomar decisiones oportunas respecto al cierre de una institución de crédito,
con base a la regla de menor costo, o bien, sanearla y venderla, respetando siempre el monto de depósitos que se encuentren asegurados de acuerdo al régimen vigente, considerando las potenciales contingencias de carácter legal asociadas a este tipo de procesos.

Los principales puntos a considerar del esquema que se propone son:

- Cuando el banco se ubique en una causal de revocación (índice de capitalización menor al 8%) se le dé la oportunidad de continuar operando. No obstante, se deberán afectar las acciones de la institución en un fideicomiso de garantía y presentar el plan de restauración de capital definido en la etapa acciones correctivas tempranas.

- Cuando el nivel de capital sea inferior al 4% o se incumpla de manera grave con el plan de restauración de capital, se ejecutará automáticamente algún método de resolución.

En el caso de que la institución no cumpla con la restauración del capital en el plazo predeterminado o si el deterioro es grave, la reforma contempla definiciones de causales de revocación.

Es un esquema pacífico porque la ejecución del método de resolución es de forma voluntaria y se respetan los derechos de propiedad de los accionistas. Lo anterior permitirá reducir el riesgo de que se presenten impugnaciones en este proceso por parte de los accionistas, ya que desde la etapa inicial, las acciones de la institución se encuentran en un fideicomiso de garantía.

Asimismo, en una etapa posterior, se reformará la Ley de Concursos Mercantiles, con el objeto de incluir un capítulo específico y detallado para el caso de concurso de una institución de crédito, reconociendo las particularidades de la actividad bancaria.

**Sanciones**

Con el fin de actualizar el marco jurídico aplicable a las sanciones que se imponen a las instituciones de crédito, existe en el Congreso de la Unión una reforma a la Ley de Instituciones de Crédito, que busca, por una parte, reducir la discrecionalidad de la autoridad, transparentando aun más su quehacer, y por otra, proveer mayor certidumbre jurídica al afectado. La reforma plantea, entre otras, las siguientes modificaciones:

- Crear un catálogo de conductas específicas sancionables para todos los sujetos obligados por la Ley de Instituciones de Crédito.
Establecer rangos delimitados de sanción pecuniaria para cada tipo de conducta.

**Reglas para regular las inversiones que establecen la fracción III del Artículo 75 de la Ley de Instituciones de Crédito**

Se emitieron disposiciones para regular las inversiones en empresas no financieras que establecen la fracción III del Artículo 75 de la Ley de Instituciones de Crédito, con la finalidad de:

- Fomentar una mayor competencia en el sector crediticio y hacer llegar servicios financieros a segmentos de la población que hoy no tienen acceso.
- Promover la apertura hacia nuevas opciones de negocios, buscando siempre conservar los principios de no arbitraje regulatorio y a su vez otorgar a las autoridades financieras capacidades de supervisión indirecta sobre este tipo de empresas.

**Reglas con Base en el Artículo 88 de la Ley de Instituciones de Crédito**

Se emitieron nuevas reglas con base en el artículo 88 de la Ley de Instituciones de Crédito, con el objetivo de abrir el esquema de regulación para que las empresas de servicios complementarios, no sólo operen para el sistema bancario, sino también para otros sectores, aprovechando la infraestructura y especialización de estas empresas.

**Regulación aplicable a Sofoles que tengan vínculos con alguna institución de crédito**

Debido a que recientemente se han celebrado adquisiciones de Sociedades Financieras de Objetos Limitados (Sofoles) por parte de algunas instituciones de crédito, y que las reglas actuales son imprecisas respecto a la regulación aplicable a entidades de este tipo que tengan vínculos patrimoniales con algún banco, se emitirán diversas disposiciones, con el objeto de preservar los principios de no arbitraje regulatorio y de independencia entre la Sofo y la institución bancaria, en cuanto a su interacción con los particulares, principalmente en las actividades que les son permitidas a ambos intermediarias (otorgamiento y manejo de crédito).

**Disposiciones en Materia de Administración Integral de Riesgos**

Las nuevas disposiciones en materia de administración integral de riesgos para instituciones de crédito sustituyeron a las reglas anteriormente enfocadas a banca de desarrollo y banca múltiple. Éstas disposiciones redefinen la taxonomía de riesgos, distinguiendo entre los riesgos discrecionales (de crédito, mercado y liquidez) y los no discrecionales (operativo, tecnológico y legal) e incorporan la distinción entre límites y
niveles de tolerancia al riesgo. Asimismo, se sustituye la revisión de los modelos de medición de riesgos, antes a cargo de un experto independiente, por un informe técnico interno más completo. En materia de riesgo operativo, se establece la creación de una base de datos sobre los eventos de pérdida por dicho riesgo, por línea y unidad de negocio, asegurando la recolección de información histórica suficiente para avanzar en línea con los esfuerzos de capitalización de Basilea II. Por otro lado, se plantea un nuevo enfoque en materia de administración de riesgo de mercado, limitando los modelos de Valor en Riesgo a las posiciones claramente vinculadas a la negociación y valuación de mercado; dejando el resto del balance sujeto a consideraciones en torno a los ingresos financieros esperados y el valor económico del capital. Adicionalmente, se definen con mayor precisión las funciones del Consejo de Administración, el Comité de Riesgos y la Unidad de Administración de Riesgos.

**Calificación de la Cartera Crediticia**

Con el fin de garantizar la aplicación de sanas prácticas bancarias, se emitió una nueva circular en materia de calificación y provisionamiento de la cartera crediticia de las instituciones de crédito (tanto para banca múltiple como para la banca de desarrollo), la cual actualiza, homologa y compila, las distintas regulaciones emitidas al respecto. Esta regulación considera cambios que permiten a las instituciones de crédito ajustar la calificación asignada a los financiamientos, tomando en cuenta todas las garantías que los respalden, ya sean reales o personales; extiende la aplicación de metodologías internas para la cartera crediticia de consumo, asimilando ésta a las existentes para las carteras hipotecaria de vivienda y comercial; incluye nuevos mecanismos para calificar y provisionar créditos concedidos a estados, municipios y sus organismos descentralizados, reconociendo de manera específica el nivel de riesgo asignado por las agencias calificadoras y las particularidades de las garantías de este tipo de acreditados.

**Requerimientos de Capital de Instituciones Bancarias**

Derivado de la innovación y dinamismo del sistema financiero también se reformaron las reglas para determinar los requerimientos de capital, ya que constituye uno de los pilares más importantes de la regulación y supervisión financiera, por lo que su adecuada calibración es de especial importancia.

En este sentido, la reforma responde al dinamismo propio de las operaciones realizadas por las instituciones de crédito, por lo que en cuanto a riesgo de mercado se refiere se determina una serie de mecánicas de valuación de operaciones específicas, tales como instrumentos derivados que permitan reflejar de manera adecuada los riesgos que asumen las entidades financieras y se actualizan los coeficientes para determinar los requerimientos de capital por riesgos de mercado bajo las condiciones de mercado.
actuales, con el propósito de que éstos reflejen la sensibilidad de las posiciones tomadas
por los intermediarios ante las actuales variaciones en las tasas de interés en un horizonte
de vencimiento mayor.

Otro importante cambio fue adecuar, conforme a prácticas internacionales, la deducción
de impuestos diferidos para que éstos sólo computen como parte del capital básico de las
instituciones hasta el 10 por ciento. Asimismo se incorporaron principios de administración
de activos y pasivos, así como el tratamiento de los seguros hipotecarios para determinar
el valor de ponderación a riesgo crediticio.

Es importante señalar que esta reforma permitirá sentar las bases para la implementación
del Nuevo Acuerdo de Capital conocido como Basilea II.

**Auditores Externos**

El desarrollo de los mercados financieros se sustenta en la confianza que depositan en
ellos sus participantes, así como en la transparencia en su operación y en la información
que se hace disponible. Con este propósito, se ha revisado el marco de actuación de los
despachos de auditoría externa que prestan sus servicios a las instituciones bancarias,
ya que constituyen un elemento adicional que resulta indispensable para reforzar la
credibilidad del público en la información que se genera.

Destaca, asimismo, la incorporación de lineamientos específicos relativos a los requisitos
de independencia que tanto el despacho de auditoría externa como el socio auditor deben
 cumplir, particularmente por lo que respecta a la prestación de servicios adicionales a los
de auditoría. Adicionalmente, se sustituyeron los informes que se requieren al socio
auditor, con el propósito de que éstos sean de utilidad para la supervisión de las
entidades mencionadas.

**Control Interno**

En materia de control interno, se mejoró y adecuó la regla vigente a estándares
internacionales; asimismo, se incorporó a la banca de desarrollo al esquema hasta
entonces limitado a la banca múltiple. El proyecto reforzó las funciones de contraloría y
auditoría interna y determina las responsabilidades, funciones y facultades entre el comité
de auditoría, la alta dirección y el consejo de administración. Por otra parte, requiere el
desarrollo y perfeccionamiento de los sistemas de información.
Disposiciones de Carácter Prudencial en Materia de Crédito.

Las disposiciones de carácter prudencial en materia de crédito actualizan la regulación en materia del proceso crediticio, homologando la regulación tanto de la banca múltiple como de la de desarrollo. Asimismo, busca que las instituciones identifiquen, midan y limiten de manera oportuna, la toma de riesgos estableciendo a efecto políticas y procedimientos de crédito. Dichas disposiciones prevén que, para alcanzar un adecuado desarrollo de la actividad crediticia, los órganos sociales así como el personal que participa en las distintas etapas del proceso crediticio, tengan claramente definidas sus facultades, funciones y responsabilidades.

2. Mercado de Valores

El mercado de valores es uno de los sectores de la economía más dinámicos a nivel mundial, sin embargo, en México ese mercado no ha alcanzado aún un nivel de desarrollo acorde con su potencial. Considerando el tamaño de nuestra economía, todavía resulta bajo el número de empresas cuyas acciones se encuentran listadas en la bolsa de valores, el valor de capitalización del mercado accionario, así como la liquidez de las empresas. Además, se observa que América Latina atrae sólo el 1% de los flujos de capital de riesgo en el mundo y que México sólo capta el 10% esos recursos.

Con el objeto de tener el marco institucional adecuado para impulsar el mercado de valores se ha reformado su legislación en varias ocasiones para incrementar la transparencia a sus participantes, reforzar la confianza de los inversionistas y profundizar los mecanismos que proporcionen una adecuada protección a los intereses patrimoniales del público. Así, con base en estos principios, será posible continuar desarrollando la infraestructura de ese mercado. Adicionalmente, se ha llevado a cabo una serie de adecuaciones a las leyes fiscales para eliminar distorsiones que limiten el desarrollo de vehículos de inversión en el mercado de valores.

Ley del Mercado de Valores

La Ley del Mercado de Valores, en vigor desde 1975, ya había comenzado a modernizarse a lo largo de sus múltiples reformas y, de manera importante, con la reforma efectuada en junio de 2001, en la que se incorporaron: (i) el reconocimiento de mejores derechos a favor de los accionistas minoritarios, (ii) la introducción de un mínimo de prácticas de buen gobierno societario en las emisoras, (iii) los límites para la emisión de acciones sin voto, (iv) las contrapartes centrales para mejorar la liquidez y (v) la sustitución del régimen de inscripción de valores y aprobación de su oferta pública basado en méritos, por un sistema que privilegia la revelación de información. Uno de los
resultados exitosos de la reforma del 2001 fue la incorporación del Certificado Bursátil, un instrumento de deuda que ha resultado en una expansión importante del crédito a las empresas.

A pesar de los avances logrados con la reforma del 2001 prevaleció la necesidad de revisar integralmente la legislación relativa al mercado de valores y de homologar nuestra regulación con los mejores estándares internacionales, respetando en todo caso las características que distinguen a nuestro sistema jurídico. Por lo tanto se trabajó en una nueva Ley del Mercado de Valores. Esta nueva ley fue aprobada por el H. Congreso de la Unión en diciembre de 2005 y comprende los siguientes objetivos:

- Promover el acceso de las medianas empresas al mercado de valores, entendido éste en su más amplio sentido, para que de manera voluntaria, dichas empresas adopten buenas prácticas de gobierno societario y adecuados derechos a accionistas minoritarios.
- Consolidar el régimen aplicable a las sociedades anónimas bursátiles, cuyas acciones se encuentren listadas en la bolsa de valores, para adecuar su organización y funcionamiento mediante la modernización de sus estructuras societarias y su régimen de responsabilidades, haciéndolos más congruentes con la práctica.
- Actualizar el marco normativo aplicable a los intermediarios del mercado de valores (las casas de bolsa) y el resto de las entidades financieras participantes de este sector, tales como bolsas de valores, instituciones para el depósito de valores, contrapartes centrales, empresas que administran sistemas para facilitar operaciones con valores, proveedores de precios e instituciones calificadoras de valores.
- Modernizar el régimen de delitos y sanciones.
- Redefinir las funciones y facultades de las autoridades financieras, con el ánimo de evitar duplicidad o redundancias en los procesos de autorización, regulación y supervisión de los participantes del mercado.

**Fideicomisos de Infraestructura y Bienes Raíces (FIBRAS)**

El impulso de las FIBRAS (Fideicomiso de infraestructura y bienes raíces) forma parte del esfuerzo de las autoridades por potenciar el desarrollo inmobiliario a través del sector financiero. Los principales objetivos de las FIBRAS son: i) democratizar la inversión en bienes raíces dando acceso masivo al mercado de bienes raíces al público inversionista, ii) destrabar las inversiones en bienes raíces dándoles liquidez que tradicionalmente no poseen, iii) desarrollar el mercado de bienes raíces y, iv) promover un nuevo tipo de activo (“asset class”) en el mercado de valores, con lo cual se diversifica el riesgo.
Las FIBRAS permitirán obtener financiamiento mediante la emisión de Certificados de Participación (CPs) en los mercados financieros públicos o en oferta privada. Los inversionistas en estos certificados participarán de una parte alicuota de los bienes raíces del fideicomiso. El valor de los certificados estará directamente relacionado con el valor de los inmuebles y con los ingresos que generen.

Las FIBRAS son fideicomisos, fiscalmente transparentes para efectos del impuesto sobre la renta (ISR) y del impuesto al activo (IMPAC), cuyo patrimonio está constituido por bienes raíces. El fideicomiso no paga impuestos ni hace retenciones, lo cual implica que se evita la doble tributación y que los tenedores de los CPs tributan conforme a su régimen. El fideicomiso está obligado a trasladar sus utilidades a los inversionistas, los cuales deberán acumular sus ingresos y pagar impuestos, según su régimen fiscal (persona física, persona moral, residentes extranjeros, fondos de pensiones nacionales y extranjeros).

El marco legal de las FIBRAS se encuentra contenido en los artículos 223 y 224 de la Ley del Impuesto sobre la Renta introducidos en enero de 2004 y reformados en diciembre de 2005.

**Capital de Riesgo**

El mercado de capital de riesgo le permite a las empresas acceder a fuentes de financiamiento para proyectos nuevos y para crecer en una etapa intermedia entre el crédito bancario y el mercado de deuda y de capitales en la bolsa de valores. El financiamiento de capital de riesgo evita el apalancamiento que le resta flexibilidad a los proyectos de inversión. Además, la participación en el riesgo promueve la transferencia de tecnologías y la institucionalización de las empresas.

En varios países el capital de riesgo ha sido una fuente fundamental para financiar nuevos proyectos y el crecimiento de empresas en diversas industrias, principalmente en sectores de alta tecnología. En los países desarrollados, ha permitido la profundización del sistema financiero y ha logrado ser un apoyo importante al crecimiento económico.

Con la introducción de la S.A. Promotora de Inversión, se le permitirá a las empresas no listadas en bolsa mandar una señal a potenciales inversionistas que sus derechos serán respetados, aumentando la demanda de proyectos de inversión de capital de riesgo y privado.

Por su parte, se ha trabajado legislativamente para lograr un vehículo de inversión ágil que intermedie la oferta y la demanda eficientemente y que tenga características regulatorias y fiscales que lo hagan atractivo para los inversionistas. En diciembre de
2005 el H. Congreso de la Unión aprobó la inclusión de los artículos 227 y 228 en la Ley del Impuesto sobre la Renta, con lo que al vehículo de inversión en capital de riesgo se le otorga la transparencia fiscal. Esto contribuye a que los fondos de inversión de capital de riesgo puedan establecerse en México con costos más competitivos y así se impulsa de manera importante este tipo de financiamiento para actividades productivas.

5. Mercado de deuda pública

Durante la presente Administración, el manejo de la deuda pública se ha consolidado no sólo como un elemento fundamental para coadyuvar a la estabilidad macroeconómica y financiera sino también como un instrumento de promoción del desarrollo del sistema financiero nacional. El objetivo principal de la política de deuda pública ha sido captar los recursos necesarios para hacer frente a las obligaciones de deuda vigente y a las necesidades de financiamiento neto en las condiciones de costo más favorables posibles en el mediano y largo plazo, de acuerdo con un nivel de riesgo prudente.

En general, la estrategia de gestión de pasivos de la presente Administración ha seguido tres vertientes fundamentales:

- El déficit público ha sido financiado en su totalidad mediante endeudamiento interno.
- El financiamiento interno se ha realizado de forma ordenada, recayendo en la medida de lo posible en la captación neta de recursos a través de emisiones de instrumentos a tasa nominal fija de largo plazo.
- El hecho de que el financiamiento neto se realice en el mercado local ha permitido que en el ámbito externo se instrumente una política proactiva para mejorar las condiciones de los pasivos públicos denominados en moneda extranjera.

Estas vertientes han resultado en una mezcla más adecuada entre la deuda interna y la externa, disminuyendo la importancia relativa de los pasivos denominados en moneda extranjera dentro de los pasivos totales y, con ello, la vulnerabilidad de las finanzas públicas ante perturbaciones externas y movimientos en el tipo de cambio.

Paralelamente, se ha alcanzado una estructura de la deuda interna robusta y diversificada. De particular importancia ha sido el desarrollo del mercado local y la creación de una curva de rendimiento de largo plazo en moneda nacional a través de la emisión regular de instrumentos a tasa nominal fija con plazos de 3, 5, 7, 10, y 20 años. Al tercer trimestre del 2005, los títulos a tasa nominal fija con plazo mayor a un año representaron el 47.9% del saldo en circulación de valores gubernamentales, lo que se compara favorablemente con el 14.5% registrado al cierre del año 2000.
El desarrollo de un mercado local líquido y profundo ha permitido también que el Gobierno Federal avance en la tercera vertiente antes mencionada, al facilitar que las operaciones de crédito externo se dirijan a obtener los recursos para el refinanciamiento de los vencimientos en moneda extranjera en las condiciones de costo y plazo más favorables posibles y no a captar recursos netos. En particular se ha instrumentado una política proactiva de manejo de pasivos que ha mejorado el perfil de vencimientos, ampliado la base de inversionistas y brindado mayor liquidez de los títulos mexicanos en el exterior. A la fecha, se ha cancelado prácticamente en su totalidad la deuda asociada con el difícil proceso de reestructuración de los ochenta, lo que ha evitado que existan vencimientos abultados de deuda pública y que se logren ahorros a valor presente en el costo financiero de la deuda pública.

Evidentemente, los resultados alcanzados han tenido una gran trascendencia para el desarrollo económico en general y para el establecimiento de mercados financieros nacionales eficientes en particular. Asimismo, estos resultados han permitido sentar las bases para que el Gobierno Federal lleve a cabo una gestión del crédito público compatible con las mejores prácticas internacionales.

IV. Apoyo del Banco Mundial

Nuestro compromiso con un decidido programa de reformas del sistema financiero queda plasmado en la anterior sinopsis. Consideramos que el apoyo del Banco Mundial ha sido, y seguirá siendo, una valiosa herramienta en esta fase de reforma del sector financiero. El préstamo propuesto se inscribe en el marco del programa de respaldo a las reformas del sector financiero que el Banco Mundial ha venido desarrollando en los últimos años, el cual incluye operaciones de asistencia técnica y préstamos en apoyo de reformas específicas en dicho sector. Este programa ha permitido instaurar un diálogo provechoso con el Banco y contribuido al logro de avances significativos en la reforma del sector financiero.
TRANSLATION OF THE LETTER OF DEVELOPMENT POLICY

This Sectoral Policy letter describes the economic situation in Mexico and the Federal Government’s current efforts to support an integrated financial system. These efforts are intended to consolidate a regulatory framework that promote adequate financial sector operations, assure healthy credit activity and improving access to capital. Moreover, the main objective of the public debt policy has been to meet the financial needs of the public sector at least possible cost with prudent risk within a medium- to long-term time frame. These actions are in line with the objectives established in the National Financial Development Program (PRONAFIDE) for 2002-2006. The results of this strategy are reflected in the stability of the economy and the healthy development of national financial markets during the last few years, as well as in investors’ confidence in the future prospects of the country.

1. Macroeconomic Context

During the 1990s, Mexico’s economic strategy depended on a number of international commercial agreements, which created new investment opportunities and expanded and diversified the country’s export base. As a result, international trade grew from 27.3 percent of GDP in 1993 to 52.82 percent in 2004. Nevertheless, the worldwide economic slowdown that began in 2001 made clear the need to strengthen and promote domestic sources of growth.

Within this context, the Fox Administration has implemented an economic policy to promote investment and internal demand as it seeks to consolidate its close relationships with its main trading partners. To that end, the Federal Government has worked intensively along two lines of action: 1) implementation of strict fiscal discipline to reduce the public sector’s demand for financial resources; this has reduced the public deficit of 0.72 percent of GDP in 2000 to 0.3 percent in 2004; and 2) improvement of internal financial savings through an ambitious reform of the financial sector; this has resulted in an increase of this indicator from 43 percent of GDP to 52 percent.

At the same time, the Federal Government has implemented a variety of measures to improve competitiveness and promote private investment. These measures include changes in the tax regime for companies and individuals, accelerated depreciation of investments, promotion of the housing sector, support of competitiveness through improvements in customs infrastructure and logistics and the development of local public debt markets.

In addition, banking credit has been transformed into a sustainable element in support of economic growth. In June, 2005, for example, available credit for business grew at a real annual rate of 20.6 percent, while available credit for housing and consumption grew at real annual rates of 45.1 percent and 44.4 percent, respectively.35

Together, these policies have led to a balanced recovery of economic growth. In 2004, private consumption and investment grew from 5.5 percent to 7.5 percent, respectively, as exports increased 11.5 percent. This recovery would not have been possible without the commitment to fiscal discipline, responsible management of the public debt and a prudent monetary policy.

35 This does not include support for debtors.
2. PRONAFIDE

PRONAFIDE 2002-2006 establishes the main financial policy guidelines and strategies necessary to strengthen permanent funding sources and thus to contribute to achieving greater development. The Program seeks to expand the country’s potential growth capacity and, at the same time, guarantee a stable environment through the development of responsible economic policies. Its ultimate goal is to contribute to general economic prosperity, which aids in poverty reduction, creates employment and improves wages within a sustainable framework.

The Program’s fundamental pillar is to encourage investment through the permanent increase of available resources. This requires a legal and economic environment that promotes the channeling of savings to the most productive investment projects and the strengthening of savings by the public.

The financial aspects of the Program are indispensable to achieving its objectives, but, not sufficient, given that it is also necessary to go forward in the implementation of the structural reform agenda. By creating new investment opportunities and establishing an economic environment that promotes increased private sector investment in productive activities, the structural reforms will increase the availability of resources, provide for their efficient use and result in more and better employment opportunities.

The Government must have, as a fundamental priority, the establishment of the correct incentives to promote an active and growing economy. This is not an easy task. It requires the diverse groups that make up the complex political and social mosaic of our country to agree on a basic economic platform that guarantees macroeconomic stability and provides a favorable environment for individual initiative with minimal regulation.

International experience has demonstrated that an adequate financial system channels resources in an efficient and expeditious manner to the most profitable investment projects. It also underlines the importance of a financial system with broad outreach, based on appropriate regulation and supervision for development. To that end, PRONAFIDE has promoted the creation of an operational and regulatory framework that will encourage confidence among financial system users, reduce transaction costs, extend coverage and improve efficiency of financial intermediation. In this context, the Government has begun a series of initiatives to improve the quantity and quality of financial savings and encourage the integrated development of the financial markets.

3. Financial Sector Reforms

a. Credit Institutions Regulatory Framework

Modernization of the financial sector legal framework has advanced thanks to the coordinated work of the financial sector authorities and Congress. During the current administration, Congress has approved a number of reform initiatives in financial sector legislation. This, with the norms created by the Treasury and Public Credit Ministry (Secretaria de Hacienda y Crédito Público, SHCP), the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, CNBV) and the Bank of Mexico (Banco de México, BdM) has resulted in profound and wide reaching reform of the financial sector. It is beyond the purposes of this letter to provide an analysis of each one of these initiatives, however, we describe the most recent measures and those that we hope to implement in the near future.
Prevention of Money Laundering and Financing of Terrorism

Between June, 2003 and May 2004, Mexico participated in the Second Round of Mutual Evaluation of the Financial Action Task Force (FATF-GAFI). The evaluation’s objective was to examine Mexico’s adherence to the Task Force’s 40 recommendations and the eight additional recommendations regarding terrorism financing. In October, 2005, Mexico attended the First Plenary Session of FATF-GAFI and presented its follow-up on compliance with the recommendations. The Session gave a favorable evaluation of Mexico’s activities in this area.

Likewise, among other changes, the Miscellaneous Law on Money Laundering and Terrorism Financing (Miscelánea Relativa a Medidas Contra el Lavado de Dinero y Financiamiento de Terrorismo), approved January 28, 2004, included a variety of resolutions to be observed by interested parties to prevent and combat these activities and to incorporate international best practices in Mexican law.

Likewise, in December, 2005, the reform of the Credit Institutions Law on banking and fiduciary secrets was published. The goal of this reform of the confidentiality of bank and fiduciary information was to comply with the FATF-GAFI recommendations and make access to protected information more efficient.

In addition, the House of Deputies is pursuing an analysis of changes to a number of laws, already approved by the Senate, to classify international terrorism crimes whose most important aspects are:

- Financing of terrorist activities or organizations.
- Inclusion of terrorism and financing of organizations and international terrorist activities.
- Penalties for domestic and international terrorism are increased.
- Classification as major crimes of these activities.

Early Correction Alerts

The Credit Institutions Law (Ley de Instituciones de Crédito) was reformed to include early corrective activities, which strengthen preventive and corrective measures and avoid the deterioration of the finances of banking institutions. The reforms include protection of savings, the smooth operation of the payment system and strengthening the Mexican banking system’s stability.

This reform requires supervising authorities to act before an institution suffers a decline, reducing the discretion to apply corrective measures and providing legal certainty to institutions.

The main cases to be considered are:

- When the institution complies with an amount of capital greater than 10 percent, it can be assured that no early corrective actions will be imposed.
- When the institution registers a capitalization index between eight percent (minimum required) and 10 percent, only informational and prevention measures are applied, recognizing that the institution is in compliance with the minimum capital adequacy requirements.
• When the institution’s capitalization index is below eight percent, the National Banking and Securities Commission is required to impose a series of corrective measures, giving the institution a maximum of 12 months to correct its financial situation and comply with the minimum requirements.

It is important to mention that this reform includes preventative measures and stages to provide time when an institution begins to experience a decline.

Banking Resolutions

In terms of the normative framework for the resolution of banking institutions, a proposed reform will be presented to the Legislature to reform the Credit Institutions Law and the Financial Group Regulatory Law. This proposal contemplates various mechanisms that will permit the Institute for Bank Savings Protection (Instituto para la Protección al Ahorro Bancario, IPAB) to effect decisions on the closing of a credit institution (based on the rule of least cost) or reform and sell it, with the goal of assuring deposits based on the current legal regime and the potential associated legal contingencies.

The main points to be considered under this plan are:

• When the bank is under consideration for closure (capitalization index less than eight percent), it is allowed to continue operating. Nevertheless, it must place its assets in a guarantee trust and present a capital recovery plan including the early corrective stages.

• When capital falls below four percent, or the bank fails to comply with the capital restoration plan, a resolution is automatically put in place.

If an institution does not comply with capital adequacy requirements in the agreed time or if the decline is significant, the reform provides for the determination of grounds for closure.

This is a non-controversial proposal because the resolution is voluntary and the property rights of stockholders are respected. This will reduce the risk of stockholder takeover because the institution’s assets have been placed in a guarantee trust.

Likewise, the Commercial Proceedings Law (Ley de Concursos Mercantiles) is expected to be reformed at a later date. This reform will include a specific and detailed section on proceedings for a credit institution, recognizing the particular needs of banking.

Sanctions

To update the applicable legal framework for sanctions imposed on credit and other non-bank intermediation institutions, a reform of the Credit Institutions Law will be presented to Congress. This law will seek to reduce the discretion of the authorities and provide greater legal certainty to the affected institutions.

Investment rules based on Section III Article 75 of the Credit Institutions Law

Section III of Article 75 of the Credit Institutions Law establishes rules for investment in non-financial institutions to:

• Encourage greater competition in the credit sector and provide financial services to segments of the population that do not now have access.

• Promote new business options, preserving the principles of non-regulatory arbitrage, and providing financial authorities the capacity to provide indirect supervision.
Credit Institutions Law Article 88 Rules

New rules based on Article 88 of the Credit Institutions Law will expand regulations to include businesses with complementary services in the banking system and other sectors, taking advantage of infrastructure and business specialization.

Regulations applied to SOFOLs with links to a Credit Institution

Because some credit institutions have acquired Limited Objective Finance Companies (Sociedad Financiera de Objeto Limitado, SOFOL) and the regulations are imprecise regarding these types of institutions with ownership links to banks, new rules will be generated to preserve the principles of non-regulatory arbitrage and the independence of the SOFOL and the banking institution with regard to their relationship with individual, principally in terms of the activities in which both types of institutions engage (lending and credit management).

Integrated Risk Management Rules

The new rules on integrated risk management for credit institutions replaced those originally focused on development banks and universal banks. These rules redefine risk types, distinguishing between discretionary risk (credit, market, liquidity) and non-discretionary risk (operational, technological and legal), and incorporate these distinctions into limits and levels of risk tolerance. Likewise, the review of risk measurement models by an outside expert has been replaced by a more complete internal technical report. The new rules provide for the creation of a database of loss by risk, line and business unit, to assure the collection of enough historical information to continue with the capitalization efforts of Basel II. In addition, a new focus on market risk management limits the Value-at-Risk models to positions clearly tied to market negotiation and valuation; it leaves the balance to considerations of expected income and capital value. In addition, the functions of the Board of Directors, the Risk Committee and the Risk Management Unit are defined with greater precision.

Credit Portfolio Qualification

To guarantee healthy bank practices, a new note on qualification and provisioning of the credit portfolio of credit institutions (universal and development banks), which up-dates, confirms and compiles the various regulations has been published. The regulation considers changes to permit credit institutions to adjust their assigned financing qualification, taking into account supporting guarantees, be they real or personal. Internal methodologies for the consumption credit portfolio have been expanded and now coincide with lending, housing and commercial methodologies. It includes new mechanisms to qualify and provide credit to states and municipalities and their decentralized organisms and to recognize more specifically the risk level assigned by the qualifying agencies and the specifics of the guarantees.

Capital Requirements for Banking Institutions

Rules to determine capital requirements were also reformed based on innovation and dynamism in the financial system. This constitutes one of the most important pillars of financial regulation and supervision and its adequate calibration is of special importance.

In this sense, the reform responds to the very dynamism of the credit institutions’ operations. This refers to a series of specific valuation mechanisms to determine the sensitiveness of the positions taken by the intermediaries in the face of current variations of the interest rates in a
maturity horizon. For example, this includes derivatives that permit the adequate
determination of capital requirements by market risks under current market conditions.

Another important change was to adapt the deduction of deferred taxes so that they are
computed as part of the institutions’ capital basis, up to 10 percent, in accordance with
international practice. Likewise, the principals of assets and liabilities administration have
been incorporated, such as the treatment of lending insurance to determine weights and credit
risk.

It is important to note that these reforms represent the platform from which to implement the
New Basel Capital Accord.

External Auditors

The development of financial markets is based on the confidence of the participants and
transparency in operations and available information. With this proposal, the framework to
establish the offices for external audits that serve banking institutions has been reviewed.
These constitute an additional indispensable element to improve public confidence in the
information.

It should be stressed that, likewise, specific guidelines on autonomy, to avoid conflict of
interest for the office and the individual auditor, have been included. This includes, in
particular, the provision of additional services by the members of the audit team. The reports
required of the audit associate were substituted by a proposal that these reports be of use for
the institutions.

Internal Controls

In terms of internal controls, the rules were improved and adapted to current international
standards and extends them to development banks. These rules had been limited to universal
banks. The project strengthens the functions of the comptroller and internal audit and
establishes the responsibilities, functions and authorities of the audit committee, the senior
management and the board of directors. In addition, it requires development and improvement
of information systems.

Prudential rules for credit

The prudential credit rules up-date and standardize the regulation of the credit process for
universal and development banks. Similarly, institutions are expected to establish policies and
procedures to identify, measure and limit risk, establishing, in effect, policies and procedures
of credit. These rules expect that, to reach an adequate development of credit activity, the
organization and the personnel who participate in the credit process, have clearly defined
responsibilities, functions and authorities.

Securities Market

The securities market is one of the most dynamic sectors in the world. However, in Mexico, it
has not developed to its full potential. Considering the size of our economy, the number of
businesses with shares listed in the stock market is low, as is the level of market capitalization
and business liquidity. It is notable that Latin America only captures 1 percent of world capital
risk flows and Mexico only captures 10 percent of those resources.

To create an adequate institutional framework that encourages the growth of the stock market,
legislation has been reformed at various times to improve transparency, strengthen investor
confidence and deepen the mechanisms that provide adequate protection to the public’s interests. Based on these beginnings, it will be possible to continue developing the market’s infrastructure. In addition, a series of adjustments of the fiscal law have been completed, and eliminate distortions that limit the development of investment vehicles in the stock market.

The Equities Market Law

The Equities Market Law, in place since 1975, was modernized through a number of reforms and, importantly, with the reform of June, 2001. Included in this reform are: (i) recognition of minority shareholders’ rights; (ii) introduction of minimum good governance practices of the issuing company; (iii) limits to the offering of non-voting shares; (iv) central counterparties to increase liquidity; (v) substitution of the systems of registration of shares and approval of public offering based on merit with a system that prefers transparency of information.

Despite the progress accomplished with the 2001 reform, it was necessary to conduct an integrated review of the stock market legislation, and to conform our legislation to that of the best international standards, within the particular confines of our own legal system. To that end, work has progressed on a new Stock Market Law. This new law was approved by the Congress in December, 2005 and contains the following provisions:

- Promote access of mid-sized business to the stock market. This is understood in its largest sense, so that these businesses will voluntarily adopt good governance practices and adequate minority stock holders rights.
- Consolidate the rules for the publicly registered companies, whose shares are listed on the stock market, to adjust their organization and functioning based on the modernization of structure and responsibilities.
- Update the applicable normative framework for stock market intermediaries (brokerage firms) and the other participating financial entities, such as stock exchanges, security depository institutions, central counterparties, companies that manage securities operations, price providers and securities rating companies.
- Modernize crime and sanctions regulations
- Redefine functions and capacities of the financial authorities, to avoid duplication and redundancy in the process of authorization and supervision of the market participants.

Trusts for infrastructure and real estate

The work of the Trusts for Infrastructure and Real Estate (Fideicomiso de Infraestructura y Bienes Raíces-FIBRAS) is part of the effort by authorities to strengthen the property development through the financial sector. The main objectives of the FIBRAS are: (i) democratize the real estate investment market by giving access to the market to the investing public; (ii) untie investment in real estate, giving them the liquidity they do not normally have; (iii) develop the real estate market; and (iv) promote a new type of asset class in the stock market, to diversify risk.

The FIBRAS will permit financing through the issuing of Certificates of Participation (CPs) in the public financial markets or in private offerings. The investors in these certificates will participate in an aliquot part of the real estate of the trust. The value of the certificates will be directly related to the value of the real estate and with the income they generate.
The FIBRAS are real estate trusts, fiscally transparent for income and assets. The trust does not pay taxes nor does it make deductions; this means that it avoids double taxation and that the owners of the CPs pay according to their individual situations. The trust is required to transfer its profits to the investors, who accumulate earnings and pay taxes according to their fiscal identities (physical person, moral person, foreign resident, national pension fund, foreign pension fund).

The legal framework of the FIBRAS is found in Articles 223 and 224 of the Income Tax Law. These articles were introduced in January, 2004 and revised in December, 2005.

Capital Risk Market

The capital risk market provides businesses with the financial resources for new projects and growth. The market is an intermediate stage between bank credit and the debt and capital market of the stock exchange. The financing of risk capital avoids the leveraging that eliminates flexibility for investment projects. In addition, participation in risk promotes technology transfer and the formalization of businesses.

In a number of countries, risk capital has been a fundamental source to finance new projects and for business growth in diverse industries—particularly in high tech industries. The developing countries, it has permitted the deepening of the financial system and has become an important support for economic growth.

With the introduction of the “S.A. Promotora de Inversiones” (SAPI), unlisted businesses can send a signal to potential investors that their rights will be respected, increasing the demand for private and risk capital investment projects.

For its part, the Government has produced legislation to create a flexible investment vehicle that efficiently intermediates between supply and demand. In December, 2005, the Congress approved the inclusion of Articles 227 and 228 in the income tax law. These Articles provide for fiscal transparency in risk capital investment. This means that risk capital investment funds can be established in Mexico at competitive costs and thereby encourage this type of financing for productive activities.

Public Debt Market

During the current Administration, management of public debt has been consolidated not only as a basic element in macroeconomic and financial stability, but also as an instrument to promote development of the national financial system. The main objective of the public debt policy has been to capture the necessary resources to meet current obligations and financial needs under the most favorable conditions possible for the medium and long term with prudent risk levels.

In general the present Administration’s strategy to manage liabilities has follow three basic approaches:

- The public deficit has been completely financed with internal debt.
- Internal financing has been accomplished in an orderly manner through long term fixed rate instruments.
- Net financing in the local market has created an external environment that permits a proactive policy to improve the conditions of public liabilities denominated in foreign currency.
These approaches have resulted in a more suitable mix of internal and external debt, reducing the relative importance of liabilities denominated in foreign currency and the vulnerability of public finances to external impacts and exchange rate changes.

Similarly, the policies have resulted in a robust and diversified internal debt structure. The development of a local market and the creation of a long-term yield curve in national currency through regular issuance of nominal fixed rate instruments of three, five, seven, ten and twenty years has been of particular importance. Presently, nominal fixed rate instruments with terms of more than one year represent more than 47 percent of government securities in circulation. This compares favorably with 14.5 percent at the end of 2000.

The development of a deep local liquid market has also permitted the Government to advance on a third approach by facilitating external credit operations to obtain refinancing resources in foreign currency under favorable conditions of cost and terms and not capture net resources. At present, the debt associated with the difficult restructuring process of the 1980s has been almost entirely canceled. This has avoided the expiry of large amounts of public debt. It has also resulted in current-value savings of public debt.

Evidently, these results have been significant for general economic development and for the establishment of efficient national financial markets in particular. In addition, these results have permitted the Federal Government to establish the basis for public credit management in line with the best international practices.

4. Support of the World Bank

Our commitment to a decisive reform program of the financial system is tied to this synopsis. We consider that the World Bank’s support has been and will continue to be valuable tool in this reform phase. The proposed Loan fits within the framework of the support loans in the financial sector that the Bank has recently been developing. These include technical assistance operations, and loans that support reform in specific sectors. This program has resulted in a profitable dialogue with the Bank. It has also contributed to the achievement of significant advances in financial sector reform.

The Under Secretary
## ANNEX 2: OPERATION POLICY MATRIX

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<td><strong>I. STRENGTHEN MARKET INTEGRITY AND PRUDENTIAL REGULATION</strong></td>
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<tr>
<td><em>Enhance corporate governance and minority shareholder rights of firms participating in the capital markets</em> through the enactment of a new Securities Markets Law, published on December 30, 2005, establishing the role and duties of the management and boards of listed companies, as well as applicable sanctions.</td>
<td><em>Create a transparent bank resolution mechanism</em> through the submission to the Legislature of legal reforms (Miscelénea) creating a new banking resolution mechanism</td>
<td><em>All banks operating at capital adequacy ratios above minimum international standards</em></td>
</tr>
<tr>
<td><em>Strengthen prudential regulations and risk management in the banking sector</em> through the issuance by Comisión Nacional Bancaria y de Valores (CNBV) of: (a) Regulation (Disposición) dated April 27, 2005 defining standards for external auditors and credit institutions in relation to the provision of external auditing services; (b) Circular dated December 3, 2004 defining capital adequacy-based early warning indicators to trigger prompt corrective actions; (c) Circular dated July 1, 2004 establishing corporate governance requirements for integrated risk management of credit institutions; (d) Regulation (Disposición) dated July 5, 2005 strengthening credit management practices for credit institutions; and (e) Circular dated August 20, 2004 establishing risk-based loan classification and provisioning rules for credit institutions.</td>
<td><em>Enhance banking solvency rules</em> through the issuance by SHCP of a set of resolutions that: (a) aligns the regulatory capital requirements of development banks with those of commercial banks; (b) improves the quality of regulatory capital by reducing the amount of deferred taxes that can be counted as capital; (c) eliminates distortions deriving from current market risk capital rules; and (d) defines lower regulatory capital requirements for insured mortgages</td>
<td><em>Increased capitalization of the equity market</em></td>
</tr>
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<td><em>Enhance market disclosure and transparency</em> through the issuance by CNBV of: (a) Regulation (Disposición) dated April 27, 2005 establishing financial reporting requirements for financial group holding companies that are subject to supervision by CNBV; and (b) Regulation (Resolución) dated April 27, 2005 that modifies and harmonizes the disclosure of financial information by credit institutions.</td>
<td><em>Increase market transparency and integrity</em> through the issuance by CNBV of circulars (a) requiring an ethics code for rating agencies; (b) preventing conflicts of interest for financial analysts; and (c) through the issuance by SHCP of an ethics code for public debt market makers</td>
<td><em>Least-cost banking resolution mechanism in operation and used if necessary</em></td>
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## II. INCREASE DEPTH, ACCESS, AND DIVERSIFICATION OF FINANCING
### Actions for Board Approval

- **Enhance access to the capital markets** through the enactment of a new Securities Markets Law, published on December 30, 2005 that (a) creates a new corporate vehicle, Sociedad Anónima Promotora de Inversión, SAPI, to facilitate stock market listing; and (b) rationalizes minimum capital requirements for securities brokers to foster the entrance of new participants.
- **Increase the role of the capital markets in the supply of credit** through the approval by the Legislature of an amendment, published on November 30, 2005, of articles 2 and 103 of the Law on Credit Institutions allowing enterprises to tap capital markets in order to fund their credit activities.

### Indicative Triggers for Second Programmatic Loan

- **Enhance the financial infrastructure for private sector participation in housing finance** by (a) creating the legal framework for private sector provision of mortgage default insurance (MI) and financial guarantees for mortgage-backed securities (MBS); and (b) amending the Organic Law of Sociedad Hipotecaria Federal (SHF) to improve SHF’s corporate governance structure and enable it to segregate the capital that backs mortgage default insurance for lower- and middle-income families.
- **Promote the development of infrastructure bonds and other private and public securities** through the introduction of financial insurance for listed securities

### Program Outcomes

- Increased levels of private debt issuance in the capital markets
- Increased levels of new private debt issuers particularly in the mid-sized company range
- Private insurers offering MI and financial guarantees for MBS in competition with SHF
- Sofoles tap capital markets directly for funding without SHF support
- Increased private sector mortgage lending

### III. Promote Diversified Investment Instruments

- **Enable better investment strategies and competition in the pensions industry** through (a) Enactment by the Legislature of an Amendment to the Ley de los Sistemas de Ahorros para el Retiro dated January 11, 2005 permitting the transfer of assets to lower cost Añores without losing seniority discounts; (b) issuance by Comisión Nacional de sistemas de Ahorros para el Retiro (CONSAR) of amendments to Circular 15-12 dated February 1, September 22 and October 27, 2005 to make more flexible the investment regime of private pensions funds and allow better alignment with workers’ risk preferences; and (c) issuance by CONSAR of Circular 28-11 (July 19, 2005) and 22-10 (August 1, 2005) increasing cost transparency and lowering switching transaction costs for contributors.
- **Increase the range of investment vehicles in the capital markets** through the: (a) issuance by SHCP of oficio 305-11/2004, dated October 18, 2004 establishing rules allowing the creation of strips of public debt (i.e., allowing the separation and reassembly of public debt bonds into their interest and principal payment coupons) and subsequent implementation thereof by BdM; (b) issuance, by BdM of circular

- **Enable better Investment strategies and competitions in the pensions industry** through the finalization of studies on additional flexibility of SHF-ORES investment regimes and disclosure of investment strategies and returns
- **Increase the range of investment vehicles for more effective risk management** through the issuance by SHCP and CENV of regulations extending the framework to use derivatives to other intermediaries such as mutual funds and insurance companies

- Continued decrease in private pensions funds management costs with increased returns performance with respect to benchmarks
- Entry into the market of additional private pension funds administrators
- MexDex turnover increases by at least 20 percent
- Increase liquidity of public debt secondary markets
<table>
<thead>
<tr>
<th>ACTIONS FOR BOARD APPROVAL</th>
<th>INDICATIVE TRIGGERS FOR SECOND PROGRAMMATIC LOAN</th>
<th>PROGRAM OUTCOMES</th>
</tr>
</thead>
<tbody>
<tr>
<td>No.1/2004 dated June 7, 2004, (as amended on September 23, 2005) establishing the regulatory framework and operational rules for securities lending; (c) issuance by SHCP and BdM of circular No.13/2005, dated June 30, 2005, establishing rules aiming at increasing secondary market activity by reducing auctions’ ownership concentration; and (d) issuance by SHCP of the following regulations and approvals to promote greater activity by investors in Mexico’s organized derivatives exchange and to widen the range of derivatives instruments: (i) Fifth Modification to the miscellaneous fiscal resolution of 2005 dated October 12, 2005; (ii) updates, dated May 14, 2004, and January 4, 2005, to the derivative exchange regulations; and (iii) approvals by SHCP for new derivatives instruments issued in March 10, 2004, December 23, 2004, March 9, 2005 and August 18, 2005</td>
<td></td>
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</table>
IMF Executive Board Concludes 2005 Article IV Consultation with Mexico

On November 9, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Mexico.

Background

The economic recovery that began in mid-2003 has continued, though at a slower pace in 2005. A broad-based expansion of economic activity in 2004, driven by a rebound of private consumption and private investment, took growth up to 4.4 percent. The economic recovery was accompanied by a boost to confidence, capacity utilization, and formal employment. In the first semester of 2005, growth slowed to 2.8 percent, reflecting several sector-specific developments, including a soft patch in U.S. industrial production. The most recent indicators point to a strengthening of activity in the third quarter of this year.

After rising through November 2004, inflation has come down significantly in 2005, approaching the Bank of Mexico's 3 percent inflation target. The 12-month headline inflation rate peaked at 5.4 percent in November 2004, but has declined thereafter, to 3.1 percent in the first half of October 2005. Core inflation also has come down, to 3.2 percent.

After tightening monetary policy since early 2004, the Bank of Mexico (BoM) signaled an end to its monetary tightening cycle in June 2005, and began to reverse that tightening in August. The firming of monetary conditions in this cycle was substantial—with the overnight interbank interest rate rising from less than 5 percent in early 2004 to 9 3/4 percent by spring 2005. Since August, rates have come down to 9 percent, as the BoM has signaled 25 basis point cuts in the desired floor interest rate, in each of August, September, and October. From early 2004, the BoM has taken a number of steps to enhance its communication with markets, including signaling a desired minimum level of interest rates—yet maintaining the corto instrument (the borrowed reserves objective).

The fiscal accounts improved in 2004 on the strength of rising oil revenues and restraint of current expenditures. The authorities achieved their target for the traditional deficit, 0.3 percent of GDP, and the

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36 Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.
broadly-defined deficit (the augmented deficit) narrowed to 2 percent of GDP, from 3.1 percent in 2003. Rising oil revenue helped finance an increase in capital expenditure, particularly in the oil sector. Gross public debt declined to 46.5 percent of GDP, in part through the write-off of some of the bank restructuring debt.

In 2005, oil revenues are rising again, but their impact on the broader deficit is being more than offset by a deterioration in the non-oil fiscal balance. Staff project that the traditional deficit will narrow slightly, to 0.2 percent of GDP in 2005, while the augmented deficit widens to 2.3 percent of GDP. Oil income for the year is projected to be up by about ½ percentage point of GDP from 2004 (and about 1 percentage point over budget projections). It is expected that almost all of this unbudgeted revenue will go to compensate for shortfalls in non-oil revenue, and toward transfers for additional investment spending by PEMEX and the states, as implied by the budget law, with a small part going to the oil stabilization fund and reduction of the traditional budget deficit.

The external current account deficit has remained modest, with a continued rise in oil exports and household remittances compensating for some widening of the non-oil trade deficit. With the recovery of economic activity in 2004 and 2005, imports of investment and especially consumer goods grew strongly, while weak auto exports to the U.S. and enhanced competition from China and other countries, slowed non-oil exports.

Mexican financial markets have recently performed strongly, as have other emerging markets. Sovereign bond spreads have continued to decline, recently to less than 150 basis points. At end-October, the stock market was up more than 75 percent (in domestic currency terms) since end-2003, with much of that gain coming since April of this year. The peso also has tended to strengthen this year though giving up some of its gains since August. The BoM has continued to abstain from market purchases of foreign exchange, but rising foreign exchange receipts from the state-owned oil company have pushed NIR upward. NIR reached US$61 billion by end 2004, about 4½ months of Mexico’s imports and 1.6 times its short-term external liabilities; at October 28, 2005, NIR was US$62.3 billion.

The authorities have taken further steps to strengthen the public finances. The average maturity of the domestic debt of the federal government was extended to 3.1 years by June 2005, up from 2.6 years in early 2004. Exposure to currency depreciation has declined further as the public sector’s annual foreign exchange earnings from oil now exceed US$30 billion, against interest payments on its foreign debt of US$9 billion. Furthermore, at mid-year the authorities announced that the federal government had accumulated enough foreign currency liquidity to allow it to forego any external bond issues through 2007.

Executive Board Assessment

Executive Directors commended the Mexican authorities for the improvements they had made in economic policies, institutions and structures over the last decade, which have contributed to greater macroeconomic stability and reduced financial vulnerability. Fiscal policy has earned broad credibility, with a track record of achieving the annual deficit targets, and a prudent monetary policy has established a low-inflation environment. A series of reforms has strengthened the financial sector and boosted its development. Directors welcomed that economic policy making is taking place in a setting of greater inclusiveness and transparency in government. The challenge ahead will be to launch a new round of structural reforms that will enhance the economy's efficiency and competitiveness and ensure the transition to a more rapid growth path, while entrenching the considerable progress that has already been made in economic policy design and implementation.

Concerning fiscal policy, Directors commended the authorities for achieving declining annual targets for the fiscal deficit, reducing the public debt ratio, and improving the debt structure, and they encouraged them to continue their efforts. At the same time, Directors noted that the overall fiscal balance has been benefiting increasingly from rising world oil prices, and that a reversal of oil prices could complicate fiscal policy if expenditures could not be reduced quickly. Most Directors urged the authorities to avoid a further widening of the non-oil fiscal deficit in 2006. A few Directors recommended monitoring closely the increase in spending by the state governments.

Directors supported Mexico's intention to implement a medium-term budget framework, with the objectives of reducing public debt further, strengthening the public finances, limiting vulnerability to oil revenue fluctuations, and allocating resources efficiently to essential investments, especially in the oil and social
sectors. Noting the important share of oil revenues in total government revenues, Directors also encouraged the authorities to take measures over the medium term to strengthen the tax system and broaden its base, including by bringing more of the economy into the formal sector. Directors considered that the current high oil prices make it more important than ever to ensure that the operations and investments of the state-owned oil company (PEMEX) are effective.

Directors agreed that the monetary tightening of 2004 and early 2005 had been necessary to contain the rise in inflation and reverse inflation expectations. They were reassured that headline and core inflation are now close to the 3 percent target. With inflation expectations also moving down in recent months, the improved inflation outlook has allowed the Bank of Mexico to begin gradually loosening its policy stance. Directors recommended that the Bank continue to proceed cautiously in this direction, noting that inflation expectations have not yet converged to the 3 percent inflation target.

Directors welcomed the changes in the operational framework of monetary policy since early 2004. The Bank of Mexico's steps to refocus and sharpen its policy statements, provide an indication of its estimate of inflation for the current year, and shift toward defining policy changes through signalling a minimum level of interest rates have enhanced communication and the market's understanding of monetary policy objectives. Some Directors suggested that the authorities make public inflation forecasts for both the current year and a somewhat longer horizon, and adopt fully and explicitly an interest rate policy instrument.

Directors considered that Mexico has been well served by its floating exchange rate regime. External competitiveness appears to be broadly adequate at present, as reflected in the sustainable balance of payments position.

Directors welcomed the considerable progress made in strengthening and reforming the financial sector and capital markets and reducing potential vulnerabilities, setting the stage for an environment conducive to economic growth. Commercial banks appear to be well capitalized, profitable, and provisioned against nonperforming loans. Directors were encouraged that bank credit has begun to expand after a long period of stagnation. They noted the efforts to further enhance financial sector supervision.

Directors expressed disappointment with the slow pace of structural reforms in recent years in spite of the authorities' commitment to move forward in this area. At the same time, they supported the authorities' emphasis on implementing small-scale reforms to improve structural competitiveness in specific sectors. Nevertheless, Directors emphasized that to confront Mexico's external competitiveness, productivity, and growth challenges effectively in the future, more thoroughgoing structural reforms will be indispensable, including in the energy and telecommunications sectors, the labor market, the judicial system, the tax system, and the regulatory and business environment. In that light, Directors were encouraged that there is a growing popular understanding of the need to implement an ambitious structural reform agenda. They advised the authorities to continue to stand ready to move ahead quickly to implement these reforms at the appropriate juncture.

<table>
<thead>
<tr>
<th>Mexico: Selected Economic and Financial Indicators 1/</th>
</tr>
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</table>

<table>
<thead>
<tr>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
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<td>National accounts and prices</td>
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<tr>
<td>Real GDP</td>
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<td>0.0</td>
<td>0.8</td>
<td>1.4</td>
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<tr>
<td>Real GDP per capita 2/</td>
<td>5.1</td>
<td>-1.5</td>
<td>-0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Gross domestic investment (in percent of GDP)</td>
<td>23.7</td>
<td>20.9</td>
<td>20.6</td>
<td>20.6</td>
</tr>
<tr>
<td>Gross national savings (in percent of GDP)</td>
<td>20.5</td>
<td>18.0</td>
<td>18.6</td>
<td>19.2</td>
</tr>
<tr>
<td>Consumer price index (end period)</td>
<td>9.0</td>
<td>4.4</td>
<td>5.7</td>
<td>4.0</td>
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| External sector |

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<table>
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<tr>
<th></th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
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</thead>
<tbody>
<tr>
<td>Exports, f.o.b. 3/</td>
<td>21.5</td>
<td>-3.1</td>
<td>0.6</td>
<td>3.9</td>
<td>13.8</td>
</tr>
<tr>
<td>Imports, f.o.b. 4/</td>
<td>23.1</td>
<td>-1.7</td>
<td>-1.3</td>
<td>1.9</td>
<td>15.8</td>
</tr>
<tr>
<td>External current account balance (in percent of GDP)</td>
<td>-3.2</td>
<td>-2.8</td>
<td>-2.1</td>
<td>-1.3</td>
<td>-1.1</td>
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<tr>
<td>Change in net international reserves (end of period, billions of U.S. dollars)</td>
<td>2.8</td>
<td>7.3</td>
<td>7.1</td>
<td>9.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Outstanding external debt (in percent of GDP)</td>
<td>28.3</td>
<td>26.1</td>
<td>25.2</td>
<td>25.9</td>
<td>23.5</td>
</tr>
<tr>
<td>Total debt service ratio 5/ (in percent of exports of goods, services, and transfers)</td>
<td>44.8</td>
<td>38.3</td>
<td>29.9</td>
<td>31.1</td>
<td>31.5</td>
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<tr>
<td>Nonfinancial public sector (in percent of GDP)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Augmented overall balance</td>
<td>-3.7</td>
<td>-3.6</td>
<td>-3.4</td>
<td>-3.1</td>
<td>-2.0</td>
</tr>
<tr>
<td>Traditional overall balance</td>
<td>-1.1</td>
<td>-0.7</td>
<td>-1.2</td>
<td>-0.6</td>
<td>-0.3</td>
</tr>
<tr>
<td>Gross augmented public sector debt</td>
<td>49.3</td>
<td>47.9</td>
<td>49.7</td>
<td>50.0</td>
<td>46.5</td>
</tr>
<tr>
<td>Net augmented public sector debt</td>
<td>42.2</td>
<td>41.7</td>
<td>43.6</td>
<td>44.0</td>
<td>41.2</td>
</tr>
<tr>
<td>Money and credit</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monetary base</td>
<td>10.7</td>
<td>8.0</td>
<td>17.0</td>
<td>15.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Broad money (M4a)</td>
<td>12.9</td>
<td>16.0</td>
<td>10.8</td>
<td>13.5</td>
<td>12.6</td>
</tr>
<tr>
<td>Treasury bill rate (28-day cetes, in percent, annual average)</td>
<td>15.3</td>
<td>11.2</td>
<td>7.1</td>
<td>6.2</td>
<td>6.8</td>
</tr>
</tbody>
</table>

Sources: National Institute of Statistics and Geography; Bank of Mexico; and Ministry of Finance and Public Credit; and IMF staff estimates.
1/ Methodological differences mean that the figures in this table may differ from those published by the authorities.
2/ Fund staff estimates.
3/ Exports net of maquila sector imports.
4/ Excludes maquila sector imports.
5/ Public and private sectors.
ANNEX 4: COUNTRY AT A GLANCE

Mexico at a glance

POVERTY and SOCIAL

<table>
<thead>
<tr>
<th></th>
<th>Mexico</th>
<th>Latin America &amp; Carib.</th>
<th>Upper-middle-income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population, mid-year (millions)</td>
<td>103.8</td>
<td>541</td>
<td>576</td>
</tr>
<tr>
<td>GNI per capita (Atlas method, US$)</td>
<td>6,790</td>
<td>3,600</td>
<td>4,770</td>
</tr>
<tr>
<td>GNI (Atlas method, US$ billions)</td>
<td>704.9</td>
<td>1,848</td>
<td>2,748</td>
</tr>
<tr>
<td>Average annual growth, 1999-04</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Population (%)</td>
<td>1.4</td>
<td>1.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Labor force (%)</td>
<td>2.5</td>
<td>0.2</td>
<td>-0.9</td>
</tr>
<tr>
<td>Most recent estimate (latest year available, 1998-04)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poverty (% of population below national poverty line)</td>
<td>18.0</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Urban population (% of total population)</td>
<td>75.0</td>
<td>77.0</td>
<td>72.0</td>
</tr>
<tr>
<td>Life expectancy at birth (years)</td>
<td>74.0</td>
<td>71.0</td>
<td>69.0</td>
</tr>
<tr>
<td>Infant mortality (per 1,000 live births)</td>
<td>23.0</td>
<td>28.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Child malnutrition (% of children under 5)</td>
<td>6.0</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Access to an improved water source (% of population)</td>
<td>91.0</td>
<td>89.0</td>
<td>93.0</td>
</tr>
<tr>
<td>Literacy (% of population age 15+)</td>
<td>92.0</td>
<td>89.0</td>
<td>91.0</td>
</tr>
<tr>
<td>Gross primary enrollment (% of school-age population)</td>
<td>110.0</td>
<td>123.0</td>
<td>106.0</td>
</tr>
<tr>
<td>Male</td>
<td>111.0</td>
<td>126.0</td>
<td>108.0</td>
</tr>
<tr>
<td>Female</td>
<td>110.0</td>
<td>122.0</td>
<td>106.0</td>
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</table>

KEY ECONOMIC RATIOS and LONG-TERM TRENDS

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<tr>
<th></th>
<th>1984</th>
<th>1994</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (US$ billions)</td>
<td>175.8</td>
<td>421.7</td>
<td>639.1</td>
<td>676.5</td>
</tr>
<tr>
<td>Gross capital formation/GDP</td>
<td>19.9</td>
<td>21.9</td>
<td>20.6</td>
<td>21.3</td>
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<tr>
<td>Exports of goods and services/GDP</td>
<td>17.4</td>
<td>18.8</td>
<td>27.9</td>
<td>30.1</td>
</tr>
<tr>
<td>Gross domestic savings/GDP</td>
<td>27.7</td>
<td>17.1</td>
<td>19.0</td>
<td>19.9</td>
</tr>
<tr>
<td>Gross national savings/GDP</td>
<td>22.7</td>
<td>14.9</td>
<td>19.3</td>
<td>20.8</td>
</tr>
<tr>
<td>Current account balance/GDP</td>
<td>2.4</td>
<td>-7.0</td>
<td>-1.3</td>
<td>-1.1</td>
</tr>
<tr>
<td>Interest payments/GDP</td>
<td>6.4</td>
<td>2.1</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Total debt/GDP</td>
<td>64.0</td>
<td>32.9</td>
<td>25.4</td>
<td>24.6</td>
</tr>
<tr>
<td>Total debt service/exports</td>
<td>45.1</td>
<td>25.7</td>
<td>17.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Present value of debt/GDP</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Present value of debt-service/GDP</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
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</tbody>
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**STRUCTURE of the ECONOMY**

<table>
<thead>
<tr>
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<th>1994</th>
<th>2003</th>
<th>2004</th>
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<tbody>
<tr>
<td>Agriculture (%)</td>
<td>9.4</td>
<td>6.0</td>
<td>3.9</td>
<td>4.1</td>
</tr>
<tr>
<td>Industry (%)</td>
<td>34.9</td>
<td>25.8</td>
<td>25.8</td>
<td>26.4</td>
</tr>
<tr>
<td>Manufacturing (%)</td>
<td>22.7</td>
<td>18.7</td>
<td>18.0</td>
<td>18.1</td>
</tr>
<tr>
<td>Services (%)</td>
<td>55.7</td>
<td>67.2</td>
<td>70.3</td>
<td>69.5</td>
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<tr>
<td>Household final consumption expenditure</td>
<td>63.1</td>
<td>71.4</td>
<td>68.6</td>
<td>66.5</td>
</tr>
<tr>
<td>General govt final consumption expenditure</td>
<td>9.2</td>
<td>11.5</td>
<td>12.4</td>
<td>11.7</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>9.6</td>
<td>21.6</td>
<td>29.5</td>
<td>31.9</td>
</tr>
</tbody>
</table>

**Growth of capital and GDP (%)**

Note: 2004 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.
### PRICES and GOVERNMENT FINANCE

#### Domestic prices (% change)

#### Government finance (% of GDP, includes current grants)
- Overall surplus/deficit: 1964 = -6.4, 1994 = -0.3, 2003 = -0.7, 2004 = -0.3

### TRADE

#### (US$ millions)

#### Export price index (2000=100)

#### Import price index (2000=100)

#### Terms of trade (2000=100)

### BALANCE of PAYMENTS (US$ millions)

#### Exports of goods and services
- 1984 = 33,926, 1994 = 71,184, 2003 = 177,299, 2004 = 201,911

#### Imports of goods and services

#### Resource balance

#### Net income
- 1984 = 10,498, 1994 = -12,082, 2003 = 1,461, 2004 = 2,678

#### Net current transfers

#### Current account balance

#### Changes in net reserves

### EXTERNAL DEBT and RESOURCE FLOWS (US$ millions)

#### Total debt outstanding and disbursed

#### IBRD

#### IDA
- 1984 = 0, 1994 = 0, 2003 = 0, 2004 = 0

#### Total debt service

#### IBRD
- 1984 = 485, 1994 = 1,989, 2003 = 1,972, 2004 = 2,499

#### IDA
- 1984 = 0, 1994 = 0, 2003 = 0, 2004 = 0

#### Composition of net resource flows
- Portfolio equity (net inflows): 1984 = 0, 1994 = 4,084, 2003 = 0, 2004 = 0

#### World Bank program
- Principal repayments: 1984 = 253, 1994 = 1,065, 2003 = 1,369, 2004 = 1,976

### Development Economics 1/17/06

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### ANNEX 5: MEXICO – OPERATIONS PORTFOLIO (IBRD/IDA) AND GRANTS

#### As Of Date 01/06/2006

**Closed Projects**

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<th>IBRD/IDA</th>
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</tr>
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<tbody>
<tr>
<td>Active</td>
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<tr>
<td>Disbursed (Active)</td>
<td>823.3</td>
</tr>
<tr>
<td>of which has been repaid</td>
<td>38.0</td>
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<tr>
<td>Total Disbursed (Closed)</td>
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<tr>
<td>of which has been repaid</td>
<td>242432.4</td>
</tr>
<tr>
<td>Total Disbursed (Active + Closed)</td>
<td>329502.5</td>
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<tr>
<td>of which has been repaid</td>
<td>245958.5</td>
</tr>
<tr>
<td>Total Undisbursed (Active)</td>
<td>1527.0</td>
</tr>
<tr>
<td>Total Undisbursed (Closed)</td>
<td>0.0</td>
</tr>
<tr>
<td>Total Undisbursed (Active + Closed)</td>
<td>1527.0</td>
</tr>
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</table>

#### Active Projects

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ANNEX 7: ANALYTICAL SOURCES

Aguilera, Nelly and César Velásquez. *Are there economies of scale in the pension fund managers industry? A semiparametric approach.* Mimeo. 2005


BBVA Bancomer. *Mexico - Servicio de Estudios Economicos: Tercer Trimestre 2005*


Instituto Mexicano para la Competitividad. *Situación de la Competitividad de México 2004*


Latinwatch. *Servicio de Estudios Economicos Tercer Trimestre 2005.* BBVA


MAP SECTION