

Mexico: Detailed Assessment of Observance of Basel Core Principles

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International Monetary Fund
Washington, D.C.

FINANCIAL SECTOR ASSESSMENT PROGRAM

MEXICO

BASEL CORE PRINCIPLES

DETAILED ASSESSMENT OF
OBSERVANCE

MARCH 2012

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

THE WORLD BANK
FINANCIAL SECTOR VICE PRESIDENCY
LAC REGION VICE PRESIDENCY

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EXECUTIVE SUMMARY

The effectiveness of banking supervision in Mexico has helped to reduce the impact of the global financial crisis on the financial sector. The Comision Nacional Bancaria y de Valores (CNBV) has achieved a fundamental step forward in implementing a complete Pillar I capital adequacy regime that is consistent with the Basel Committee standards. Capital ratios have remained strong and above the regulatory minimum, supported by a rigorously applied forward-looking loan provisioning regime. The CNBV has successfully supervised adherence to the above two crucial regimes and developed robust means to quantify and monitor key risk measures.

Since the last FSAP Update in 2006, the CNBV has made steady progress in advancing a major internal reorganization. Its supervisory culture is now much more risk focused. Its internal organization visualizes supervision according to institutional, group, and risk dimensions. Systemic supervision is being set up. Progress is also noticeable in the practices applied by the CNBV. The professionalism and quality of its management, and of the staff dedicated to supervision, are outstanding. It has put in place rich offsite systems for supervision and is implementing changes toward a risk-based approach. However, crucial challenges remain ahead to preserve and to project forward what has already been achieved.

Important institutional issues outside the control of senior management in the CNBV threaten the sustainability of the above achievements. These issues constrain the ratings assigned by the assessors to several principles. The autonomy, the authority, and the resources of the CNBV remain limited. The CNBV is still an agent of the Executive, with 10 out of 13 positions in the Board being under the control of the Executive (Secretaria de Hacienda y Credito Publico, SHCP). In addition, most of the CNBV's key decisions¹ belong to its Board. The Board needs to provide more leadership to the CNVB, as required for a modern supervisory agency. The lack of autonomy in funding its activities and in providing more competitive salaries is eroding the key element of supervision: **its people**. High staff turnover related to below-market salaries has been a particular concern for maintaining the quality of supervision and institutional continuity. Headcount seems excessive, but management cannot flexibly restructure the agency (due in part to unionized civil service staff) to meet its needs and make better use of its decreasing budgetary resources. There is also a proliferation of new institutions to supervise and an ever-increasing universe of compliance requirements that make CNBV's workload particularly heavy.

¹ Per the count made by the assessors, 31 key decisions belong to the CNBV's Board without delegation, and an additional 12 decisions require consultation with the Banco de Mexico (BoM).

There is no appropriate statute covering the terms of service for CNBV's senior management and legal protection for its staff. Members of its senior management team do not have a fixed term contract and there are no specific rules for their removal. In addition, no specific legal protection is given to CNBV's managers and supervisory staff for the decisions taken in good faith. This, together with the lack of flexibility and budget aligned to its increasing needs, constrains the effectiveness of the CNBV. Moreover, in a civil code environment, it is easier to take appropriate measures (either external action or an official reprimand) on the basis of noncompliance rather than mere judgment, as a responsible response to risk accumulation. There is no way forward to resolve these issues without making CNBV more independent operationally and providing further flexibility to its management.²

Pillar 2 of the capital adequacy regime remains to be adopted, including publication of CNBV's supervisory review process and associated standards. The strategic decision to adopt Basel II and a more risk-based approach to supervision makes it critical to resolve the issues discussed on autonomy and resources. Until now, the CNBV has focused on implementing the quantification of Pillar 1 risks and has advanced several internal elements of its supervisory review process under Pillar 2. However, several supervisory practices and associated standards deserve attention to complete Pillar 2 and the effectiveness of the risk-based approach being adopted. These issues include:

- The institutions need to be mandated to perform an internal capital adequacy assessment process (ICAAP) to determine how much capital they need going forward and the strategies and means to obtain that capital and keep it aligned to their risk profile;³
- The CNBV needs to make public its supervisory review and evaluation process (SREP) to build upon the ICAAP and to determine the sufficiency of Pillar 1 and Pillar 2 risk capital estimated by bank management, including whether and how to require additional capital;⁴
- The standards to implement Pillar 2 have to be improved or completed for liquidity risk (soon to be adopted), and for concentration and interest rate risks. Further attention needs to be given to the treatment of risks from association with broader

² These issues explain the materially noncompliant rating assigned to CP1.

³ The lack of a mandated ICAAP explains the largely compliant rating assigned to CP7 on risk management, and to CP19 on supervisory approach.

⁴ The lack of a complete internal SREP and its publication explains the largely compliant rating assigned to CP19 on supervisory approach.

mixed-activity conglomerates, which some Mexican banks and financial groups are members of;⁵

- CNBV should design and implement a supervisory cycle to cover in-depth all significant activities and central control functions of institutions and groups. This assessment should prompt a re-assessment of the workload associated with these tasks, to estimate and to secure anticipated staff resources in terms of number and seniority/experience;⁶
- Compliance with regulation is not sufficient to maintain financial stability. The CNBV needs to pursue strategies directed at reducing the risk profile of adversely rated institutions, as well as to respond to the lack of progress by their Boards and senior managers in addressing CNBV's concerns. Progress in implementing these strategies provides the basis for judging the overall performance and effectiveness of supervision following an objective quality assurance process;⁶
- The criteria and procedures, including risk metrics, used internally to assess risk and conduct inspections need integration and standardization among the CNBV's internal units. In particular, more guidance is needed, as well as risk benchmarks, to evaluate business models and the effectiveness of management and controls, as the best forward-looking indicators of risk;⁶ and
- CNBV needs to strengthen the basis for enforcing qualitative issues related to sound and safe practices. It also needs to make Boards aware of their fiduciary responsibilities in ensuring adherence to such practices and of the seriousness of breaches of regulatory compliance.⁷ Once that has been achieved, the CNBV will have reached its risk-based destination.

Further actions are recommended to strengthen a robust regime for 'downward' consolidated supervision of banking groups. There are 25 financial groups regulated by the SHCP being supervised by the CNBV. Asymmetries in the regulations across financial sub-sectors have been evaluated and need now to be addressed. The CNBV should be given powers to regulate all financial groups where banks are significant members. Prudential regulation, especially risk limits, and risk governance and management standards should be

⁵ The lack of complete regulations, and of risk management and supervisory standards, for these risks explains the largely compliant ratings assigned to CP14 on liquidity risk, CP16 on interest rate risk, CP19 on supervisory approach, and CP24 on consolidated supervision. Moreover, issues identified in CP10 on large exposures and CP11 on related party lending limits need further consideration.

⁶ These items explain the largely compliant ratings assigned to CP19 and to CP23.

⁷ This, and further aspects discussed in this assessment, explain the largely compliant rating assigned to CP23 on remedial actions.

extended to the level of the holding company in regulated groups. More importantly, mixed-activity groups that combine banking and other financial activities with commercial activities have to be regulated, providing effective powers to the CNBV to assess and resolve risks to banking and other financial activities from inter-group transactions.⁸ These actions will complete current consolidated supervision practices, reinforcing the CNBV's authority to practice 'upward group' consolidated supervision.

The assessment found other areas where the regulatory and supervisory framework should be further improved. Anti-money laundering (AML) supervision has been substantially strengthened. However, challenges remain and key decisions need to be made to bring Mexico to a higher level of compliance with international standards. The use of enforcement should become more focused in responding to substantive issues rather than reacting solely to breaches of compliance. Moreover, whilst operational risk is well regulated, its supervision is not yet fully operational and needs to be performed more systematically at both macro and solo levels, including the systematic development of risk indicators.⁹

Like for other risks, the assessors believe that there is a general need to provide further guidance to the industry regarding how the CNBV expects institutions to implement the mandated prudential standards in practice. Such guidance would constitute a clear communication of the supervisory process and of how the CNBV intends to strengthen its response to changing risk profiles. This will complete the CNBV's new approach that judiciously combines elements of compliance, safety and soundness, and risk-based consolidated supervision.

⁸ These issues discussed in the report of assessment constrain to largely compliant the ratings assigned to CP24 on consolidated supervision.

⁹ These issues explain the largely compliant ratings assigned to CP18 on AML, CP23 on enforcement, and the materially noncompliant rating to CP15 on operational risk.

I. GENERAL

1. **This detailed assessment of the current state of implementation of the Basel Core Principles in Mexico has been completed as part of a Financial Sector Assessment Program update undertaken jointly by the International Monetary Fund and the World Bank.** The assessment was conducted in September 2011 to update the 2006 assessment.¹⁰ It reflects the banking supervision practices of the country as of end-July 2011. The ratings assigned during this assessment are not necessarily directly comparable to the ones assigned using the pre-2006 BCP Methodology. Moreover, the bar to measure the effectiveness of a supervisory framework was raised following the recent financial crisis.

A. Information and Methodology Used for Assessment

2. **The assessment is based on several sources:** (i) a self-assessment in August 2011 by the country authorities, including written answers to an exhaustive questionnaire; (ii) detailed interviews with staff from the relevant national agencies, including the CNBV, the central bank of Mexico (BoM), the SHCP, and the Financial Intelligence Unit (UIF); (iii) relevant laws, directives, circulars and guidelines, which constitute the regulatory framework; (iv) relevant official pronouncements and other documentation on the supervisory framework; (v) primary evidence on the nature and extent of the supervisory practices; (vi) sundry information on the structure and development of the country's financial sector, and more specifically, the country's banking sector; and (vii) meetings with selected banks, auditing firms, and rating agencies.

3. **The assessment was performed in accordance with the guidelines set out in the Core Principles Methodology,¹¹ and assessed compliance with the “essential” criteria only.** Inter alia, the guidelines require that the assessments be based on the legal and other documentary evidence, in combination with the work of the supervisory authority and evidence of effective implementation of the core principles in the banking sector. Accordingly, in addition to gaining an understanding and insight into the regulatory and supervisory frameworks, the assessors also verified the application of the key elements of these frameworks, by gaining access to original evidence pertaining to onsite and offsite supervision. The assessment of the fulfillment of the Core Principles is not, and is not intended to be, an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the Core Principles are seen as minimum standards.

¹⁰ The assessment was conducted from September 7 to September 21, 2011 by Pierre-Laurent Chatain of the World Bank and Joaquín Gutiérrez García of the IMF.

¹¹ Issued by the Basel Committee, October 2006.

4. **The assessment of compliance with each principle is made on a qualitative basis. A four-part assessment system is used: compliant; largely compliant; materially noncompliant; and noncompliant.** To achieve a “compliant” assessment, all essential criteria generally must be met without any significant deficiencies, including evidence of effective implementation. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that principle. A “materially noncompliant” assessment is given when the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance, but substantive progress had been made. A “noncompliant” assessment is given when no substantive progress toward compliance has been achieved.

5. **The assessors enjoyed excellent cooperation with their counterparts, and received all the information required.** The team extends its thanks to the staff of the various institutions visited and very particularly to the staff of the CNBV for their participation in the process, their hospitality, and the frankness and the accessibility provided at all times.

B. Previous FSAP BCP Assessment

6. **Progress in implementing the recommendations made during the FSAP Update in 2006 varies in line with the efforts made to adopt the Basel II capital regime.** At that time, there were recommendations to strengthen compliance with the essential conditions of six core principles. The following paragraphs summarize progress achieved to date as presented to the assessors (Box 1).

- ***Core principle 1 on objectives, autonomy, powers, and resources:*** The opinion of the assessors is that the issues reported by the FSAP 2006 Update have not been effectively resolved. Moreover, there was some deterioration in regard to some of the issues (see CP1). The issues affecting autonomy, budgetary independence, and delegation of powers continue to constrain the ratings granted in this FSAP Update. Among other changes to the Ley de las Instituciones de Credito (LIC), licensing and de-licensing powers were transferred in 2008 from SHCP to the CNBV. However, the Board of the CNBV retains the final approval power. The assessors believe that, given the fact that SHCP nominates 10 out of 13 of the members of the Board, this transfer is more a formality than a substantive delegation of SHCP’s powers to the CNBV. As referred to in CP1 (2), the assessors noted at least 31 key supervisory decisions where the actual decision making authority belongs to the Board of the CNBV rather than to the senior management of the agency.
- ***Core principle 5 on investment criteria:*** The previous FSAP Update recommendation has been addressed in many respects. In 2008, the power to approve major acquisitions in banks was transferred from the SHCP to the CNBV. The assessors believe that this reform has been a major step forward. However, it would have been

better if the CNBV had been provided with full autonomy by not requiring the favourable and binding opinion of the BoM for any transfer of ownership exceeding 20 percent.

- ***Core principle 10 on connected lending:*** The recommendations made in 2006 have not been fully implemented as suggested. The Executive has not succeeded in amending the LIC to reduce the maximum 50 percent aggregated lending limit with related parties and bring it closer to international standards. CNBV senior management introduced by regulation in 2011 an aggregated 25 percent lending limit with relevant related parties with a 10-year phase-in period. Amounts in excess of this are to be deducted from Tier 1 capital.

Box 1. Actions Undertaken to Implement Recommendations of the 2006 FSAP Update

- Realignment of powers from SHCP to CNBV (authorization and licensing procedures, authorization for the transfer of significant ownership and for investments—major acquisitions—by banks in nonfinancial companies, ancillary services providers).
- A new regulatory deduction from TIER1 capital regarding credits to Relevant Related Parties in excess of 25 percent from said capital. This deduction applies to credits granted to persons who possess (directly or indirectly) at least 20 percent of a bank’s shares, be it on an individual or collective basis.
- Regarding Principle 10 “Connected lending,” on January 27, 2011, Accounting Standard C-3 “Partes relacionadas” (Related parties)—issued by CNBV—was updated and is now convergent to IAS 24 “Related Party Disclosures” issued by the International Accounting Standards Board.
- Regarding Principle 20 “Consolidated supervision,” during 2010 and 2011 CNBV developed the “Consolidated and risk based supervision” project in order to evaluate the convenience of standardizing the regulation applicable to banks with that applicable to other financial entities that can be part of their financial group. As a result, it was considered that the external auditors regulation applicable to mutual funds asset managers (*sociedades operadoras de sociedades de inversion*) should be taken to the bank standard.

- ***Core principle 20 on consolidated supervision:*** The CNBV confirms that the powers for licensing and de-licensing individual institutions have been transferred from the SHCP to the Board of the CNBV (see substantive comments above for CP1). However, powers to license groups and regulate holding companies to extend consolidated regulation to a full financial group remain under the authority of the SHCP. Moreover, during this FSAP 2011 update, the assessors foresaw clear risks to the banking sector from broader unregulated mixed-activity groups, which is an issue needing serious consideration (see CP24);

- **Core principle 22 on remedial measures:** The deposit insurance scheme has been modernized and better aligned with international standards. Mexico is still lacking a legal framework for bank liquidation. There is also a need to establish a framework and operational guidelines for the resolution of financial groups.
- **Core principle 23 on global consolidated supervision:** The legislation suggested to empower the CNBV to supervise parallel banks has not been enacted. New regulations for data processing and outsourcing have been adopted. However, all issues related to implementing ‘upward’ supervision of mixed-activity and horizontal groups persist (see CP24).

Institutional and market structure overview

Macroeconomic background

7. **Banking supervision is performed against a backdrop of a sound macroeconomic policy framework that has limited the fallout from the crisis.** After a steep fall in output in 2009 owing to its close trade linkages with the United States, Mexico experienced a broad-based recovery, with a resurgence of manufacturing exports as well as renewed strength of consumption. The authorities employed a wide range of countercyclical policies, with the central bank loosening monetary policy while the government applied a careful fiscal stimulus (3 percent of GDP).

8. **Other important policies were also implemented.** These included foreign-exchange interventions (the first since September 1998) to control the pace of depreciation of the peso, the use of an FX swap agreement with the U.S. Federal Reserve, an FCL from the IMF to backstop net international reserves, and an additional liquidity facility allowing a broader range of eligible collateral for emergency liquidity support. In response to the surge in capital flows to emerging markets, the exchange rate appreciated by about 10 percent, yet significantly less than some other emerging markets. The record of sound macroeconomic policies is reflected in low inflation—below 4 percent per annum—and sound balance sheets: net public debt stands at around 40 percent of GDP in 2011, and household borrowing is about 20 percent of disposable income. As a result, Mexico has maintained its investment grade, further bolstering its resilience to shocks.

9. **The policy response also relied on macro- and micro-prudential instruments.** These included (i) a tightening of related-party lending for banks, which—given the large presence of foreign banks in Mexico—sought to gradually reduce the risk that foreign-owned banks would drain liquidity from domestic subsidiaries and add to the credit contraction; (ii) the introduction of forward-looking loan-loss provisioning for all the retail segments; (iii) a tightening of corporate disclosure on derivative positions, following large losses by the corporate sector; and (iv) the ongoing expansion of the regulatory perimeter to cover mortgage providers that faced significant liquidity problems and losses. The Bank of Mexico tightened its foreign exchange liquidity coefficient, with a view to raising the cost of bank

borrowing abroad in foreign exchange to fund lending in pesos and diminish the attractiveness of using Mexican banks as counterparties in carry-trade.

10. **Despite significant structural reforms, Mexico's growth has remained low, and the financial system shallow.** Between 1985 and 2008, the annual average growth in per capita GDP amounted to 1.1 percent. Low growth is partly attributed to poorly functioning credit markets, a high degree of informality in the economy, and significant market distortions related to lack of competition. Mexico also scores high on corruption indices, and the legal system is not considered efficient. Measures of financial depth point to low financial intermediation, with credit to GDP well below peer emerging market economies, at about 25 percent of GDP at end-2010. Mexico's dependence on oil exports has been in steady decline, although the budget has become more reliant on oil revenues.

11. **The main risk factors for the Mexican financial system are linked to global and domestic developments.** A slowdown of the U.S. industrial production would have an adverse effect on domestic economic activity and, in turn, on the demand for credit and the quality of loan portfolios. Also, adverse developments in the oil market could result in increased borrowing requirements by the public sector, with crowding-out effects. Although progress was made in extending the maturity and duration of government domestic debt, it remains relatively short term and vulnerable to a tightening of global liquidity and sharp increases in interest rates, which could lead to increased volatility in the financial system. Moreover, Mexico may also be affected by a global increase in risk aversion associated with financial distress, as well as spillovers from the global crisis, given the large presence of U.S. and Spanish banks in the financial system.

Financial sector structure

12. **Mexico's financial system is small and concentrated, with seven banks accounting for more than 80 percent of the system's assets.** Financial intermediation and credit to the private sector are among the lowest in Latin America and well below other emerging markets of comparable income. At end-September 2011, there were 42 banks (bancos multiples), commonly divided into the following sub-groups: (i) 7 large banks, 5 of which are subsidiaries of foreign banks; (ii) 9 banks focused on consumer lending; (iii) 15 corporate banks; and (iv) 11 investment banks.

13. **Other components of the financial system include:** (i) public development institutions involved, inter alia, in housing and agricultural finance (6 public development banks, 7 public development trusts and funds, and 4 development agencies)—these agencies account for roughly one-third of all lending; (ii) mutual funds (a total of 534 funds managed by 63 mutual fund managers are in operation at end-July 2011); (iii) one stock exchange and its broker-dealer members; (iv) savings and loans institutions and credit unions; (v) insurance companies; (vi) pension fund administrators—over 70 percent of the contributions are managed by the six largest companies (and more than a third managed by two administrators

affiliated with the two largest banks); private pension funds now hold assets in excess of 12 percent of GDP; and (vii) other institutions, including non-deposit-taking credit institutions (Sofoles, Sofomes), deposit warehouses, leasing and factoring firms, and credit bureaus.

14. **There are 25 financial groups, in which a holding company manages several financial entities, usually including one bank.** The largest are involved in virtually all financial business (banking, insurance, asset and fund management, brokerage, and pension fund administration). This may raise conglomeration issues (i.e., large banks with an insurance company, pension fund, brokerage house, etc.) that might lead to product bundling with nontransparent cross-subsidies, deterring entry and competition. More importantly, several banks are members of broader mixed-activity groups that combine banking with commercial activities and still need to be regulated and supervised to mitigate association risks.

15. **The banking system appears to be sound and profitable, and it has strengthened considerably in recent years.** The financial sector was not seriously affected by the crisis. Private banks appear well capitalized, with a system-wide risk-weighted capital asset ratio of 15.6 percent as of May 2011, with Tier I capital of 13.6 percent. Profitability declined sharply in 2008–2009, but has recovered more recently with the improvement in loan quality, a pickup in credit growth, and rapid declines in provisions and write-offs. Following the crisis, banks have become more selective in their provision of credit cards, and outstanding balances and the number and credit limits of cards were drastically cut for the higher risk categories. Bank credit to the private sector has been pro-cyclical, but liquidity seems adequate. The loan-to-deposit ratio is moderate, and banks keep about one-third of their total assets invested in government securities.

16. **Improvements in risk management have taken place.** Markets for derivatives (both over-the-counter (OTC) and exchange traded) have grown significantly, allowing for better management of market risks. Banks also benefit from a broad and stable domestic deposit base, with little reliance on wholesale funds or lines of credit from parent banks. However, medium-sized and small banks appear to be much less liquid. Risk management practices in systemically important commercial banks have strengthened substantially, supported by internal models from reputable specialized vendors and the headquarters of foreign banks (where applicable). However, the 2008–09 large credit card losses suggest that potential credit risk and control gaps may remain.

Supervisory environment

17. **The regulatory regime in Mexico consists of various regulatory agencies, with some overlapping mandates.** The CNBV is the banking and securities regulator, CONSAR the pension regulator, IPAB the deposit insurance agency, and the CNSF the insurance regulator. Payment system oversight is handled by the Bank of Mexico (BoM), which also

has roles in bank licensing, capital and liquidity prudential regulation, and derivatives. Foreign exchange policy is decided by the Foreign Exchange Commission—a body comprising the SHCP and BoM. In 2010, the authorities created the Financial Stability Council (FSC)—a cross-agency council chaired by the Minister of Finance with representatives from the BoM, CNBV, CNSF, CONSAR, and IPAB. The Ministry of Finance (SHCP) authorizes financial groups, and has a dominant presence on the governing Boards of the other agencies, except the Bank of Mexico, which is independent.

18. **Legal and institutional weaknesses continue to hamper financial development, despite progress in this area.** Mexico has passed key reforms, including a Unified Registry for Movable Collateral, and reforms of the Law on Bankruptcy and the Commercial Code. However, remaining weaknesses include relatively weak property rights, a complex and unreliable insolvency and creditors' rights framework, an inefficient and corrupt judicial system, and insufficient transparency in financial information. These factors increase bank risks and raise the loss-given default, increasing bank spreads and restricting access, especially to small and medium-size enterprises.

19. **In addition, improvements in credit bureaus and risk modeling have allowed banks, vendors, and other suppliers to better assess credit risks.** However, costs of realizing collateral remain high, including for registration and because of regional discrepancies in cadastres and registries. Although the framework has improved sufficiently so that banks are confident about eventually collecting their collateral, it can still take several years to work through all the processes, and many banks prefer to write-off the debt, especially for small debtors, compensating for this by increasing the rates on loans.

20. **Regarding insolvency, only 428 bankruptcy cases have been filed through February 2011 since the Commercial Bankruptcy Law was passed in 2000.** Although the process has been improved and the legislation follows international good practice, the process is slow, the courts and judges need to improve, and debtors can use multiple layers of appeal to slow the judicial process further. Debtors also have little incentive to cooperate, since the system is not set up to help companies emerge from insolvency (such as by providing debtor-in-possession financing), and it is difficult to fully discharge debts through partial payment. Creditors also have little incentive to participate; those with guarantees prefer to execute their claims individually, and those without guarantees find the probability of payment too low. Given these difficulties, it appears that many smaller firms liquidate outside a formal process, which often results in the creditors closest to the debtor being paid off first.

C. Principle-by-Principle Assessment

21. **This assessment has been completed against both essential and additional criteria.** The description and comments touch on the additional criteria where viewed

appropriate by the assessment team. However, the level of implementation of the additional criteria has not affected the overall assessment of each core principle.

Table 1. Mexico: Summary of Compliance with the Basel Core Principles

Core Principle	C ^{1/}	LC ^{2/}	MNC ^{3/}	NC ^{4/}	N/A ^{5/}
1. Objectives, Independence, Powers, etcetera			X		
1.1 Responsibilities and Objectives		X			
1.2 Independence, Accountability, Transparency				X	
1.3 Legal Framework	X				
1.4 Legal Powers	X				
1.5 Legal Protection				X	
1.6 Cooperation	X				
2. Permissible Activities	X				
3. Licensing Criteria	X				
4. Transfer of Significant Ownership	X				
5. Major Acquisitions	X				
6. Capital Adequacy	X				
7. Risk Management Process		X			
8. Credit Risk	X				
9. Problem Assets, Provisions, and Reserves	X				
10. Large Exposure Limits		X			
11. Exposures to Related Parties		X			
12. Country and Transfer Risks		X			
13. Market Risks	X				
14. Liquidity Risk		X			
15. Operational Risk			X		
16. Interest Rate Risk in the Banking Book		X			
17. Internal Control and Audit	X				
18. Abuse of Financial Services		X			
19. Supervisory Approach		X			
20. Supervisory Techniques	X				
21. Supervisory Reporting	X				
22. Accounting and Disclosure	X				
23. Corrective and Supervisor's Remedial Powers		X			
24. Consolidated Supervision		X			
25. Home-Host Relationships	X				
Totals (For the 25 principles)	13	10	2	0	
Totals (For the 6 sub-components of BCP1)	3	1	0	2	

1/ C: Compliant.

2/ LC: Largely compliant.

3/ MNC: Materially noncompliant.

4/ NC: Noncompliant.

5/ NA: Not applicable.

Table 2. Mexico: Detailed Assessment of Compliance with the Basel Core Principles

Principle 1	Objectives, autonomy, powers, and resources. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Assessment	Materially Noncompliant
Principle 1(1)	Responsibilities and objectives. An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.
Summary description and findings re principle 1(1)	
Essential criteria	
EC1	Laws are in place for banking, and for the authority (each of the authorities) involved in banking supervision. The responsibilities and objectives of each of the authorities are clearly defined and publicly disclosed.
Description and findings re EC1	<p>Articles 3 to 8 of the LIC govern the activities of the banking and credit institutions and define the powers and responsibilities of the Mexican regulatory authorities, including licensing and supervision, as well as enforcement powers and bank resolution.</p> <p>CNBV's law defines its objectives and functions, as well as its internal organization, the composition and role of its Board of Directors, and the functions of its president. Article 18 establishes its budgetary resources and Article 20 the regime applicable to its employees.</p> <p>The official policies for supervision determined by the CNBV were approved in January 2005 by an ordinance ("Reglamento de Supervision") of the President of the United Mexican States.</p> <p>In addition, the central bank (BoM, or BoM) law also gives certain regulatory powers to the BoM.</p> <p>Finally, the Instituto para la Protección del Ahorro Bancario (IPAB) law governs deposit insurance and its role in resolving failing banks.</p> <p>These laws and CNBV's ordinance, as well as the set of regulations enacted by the CNBV for its implementation by the industry, are very comprehensive and available for public consultation on the websites of the CNBV, the BoM, and the SHCP.</p>
EC 2	The laws and supporting regulations provide a framework of minimum prudential standards that banks must meet.

Description and findings re EC2	<p>Article 98 (Bis) of the LIC governs the general obligation of banking institutions regarding the observance of prudential regulations. It also establishes CNBV's regulatory powers. Using these powers, the CNBV issues and amends periodically a broad set of regulations, which have been compiled in the "Unified Banking Circular" (CUB) and cover all relevant prudential matters.</p> <p>The Law on Financial Groups (LAF) regulates mixed-financial conglomerates. It empowers the SHCP (see CP24) to request the relevant information in order to authorize the registration of the leading financial holding company.</p> <p>With the exception of the obligation of institutions to undertake their internal capital adequacy assessment process (ICAAP) and certain observations noted by the assessors in other CPs, the set of laws and supporting regulations fulfill the requirements of this EC.</p> <p>As a key element of the fiduciary duties and responsibilities of directors serving on the Boards of credit institutions, they must follow sound and safe practices, including respecting risk management and control regulations. But these responsibilities are not explicitly indicated in the LIC; rather, they are enunciated in the secondary regulations issued by the CNBV (notably, the CUB).</p> <p>The assessors believe that this might have consequences regarding the enforceability of the directors' legal responsibilities in the event of breaches of prudential regulations, and most notably for failing to properly ensure the adoption and enforcement of sound risk management and control systems in their institutions. Currently, these breaches would be treated as an administrative infraction rather than as a criminal offense. The latter carries more severe consequences, which could act as a deterrent for failing to follow sound risk governance practices.</p> <p>Accordingly, and given that a risk based approach to supervision is predicated on a low tolerance level toward inadequate risk management and ineffective controls, the assessors strongly recommend to the authorities to consider a review of existing legislation (amending the LIC). The gravest breaches of the duties and responsibilities of directors should be treated as a punishable criminal offense.</p>
EC3	Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.
Description and findings re EC3	<p>The LIC has been modified 13 times since 2005 to update a variety of principles, including the procedures to resolve failed institutions, improve legal protection, implement Basel II, and develop a framework for cooperation with other local and foreign supervisors.</p> <p>The CNBV's regulatory norms have been continuously updated to ensure that they remain effective and relevant to the changing economic environment and regulatory practices.</p> <p>The CNBV does not have the power to submit legislative amendments to parliament. This power rests with the executive branch through the SHCP. The support of the SHCP representatives serving on the Board of the CNBV for legitimate legislative changes is of the utmost importance. During 2010, the political process failed to endorse the changes proposed by the CNBV to amend the aggregate lending limit for related parties set in the LIC Article 73 Bis, which is capped at 50 percent of Tier 1 capital. This is the main reason for the assessors' rating of CP11 as largely compliant.</p>
EC4	The supervisor confirms that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

Description and findings re EC4	The Commission makes publicly available on its website a broad range of statistical information and indicators regarding the financial condition and performance of the institutions under its supervision, both on an individual and system-wide basis.
Additional criteria	
AC1	In determining supervisory programs and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks.
Description and findings re AC1	<p>The CNBV established in 2008 an internal committee (Supervisory Group) that performs as an internal forum for discussion and decision making. The members of this group are the president of the CNBV, all the vice-presidents, and general directors of supervision.</p> <p>The Supervisory Group meets every two weeks in order to: (1) review the risk-profiles of all supervised entities; (2) establish and review supervisory priorities; (3) design the Annual Inspection Program; (4) set standardized internal criteria; (5) discuss relevant cases of supervised entities; and (6) analyze systemically important issues. The frequency of inspections and other supervisory activities, as well as the allocation of supervisory resources, follow the risk profile of the institutions according to a new risk-based supervisory process summarized in a risk matrix adopted in 2007 and 2008.</p> <p>The CNBV pays special attention to assessing institutions and trends that might pose a significant risk to the banking system as a whole (see CP19).</p>
Assessment of Principle 1(1)	Largely Compliant
Comments	<p>The opinion of the assessors is that compliance with the essential and additional criteria of this CP is largely achieved, but it can be reinforced by implementing the following actions:</p> <p>Complete the legal framework to implement risk based supervision by explicitly stating in the LIC:</p> <ul style="list-style-type: none"> a) the fiduciary role and responsibilities of directors to effectively implement all risk governance and control regulations enacted by CNBV; and b) the obligations of the Boards of credit institutions to adopt an ICAAP (see CP7); <p>It is essential to obtain the support of CNBV's Board of Directors, notably those representing the government, for the legal reforms proposed by CNBV's senior management.</p>
Principle 1(2).	Independence, accountability and transparency. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties.
Summary description and findings re principle 1(1)	
Essential criteria	
EC1	The operational independence, accountability and governance structures of each supervisory authority are prescribed by law and publicly disclosed. There is, in practice, no evidence of government or industry interference which compromises the operational independence of each authority, or in each authority's ability to obtain and

	<p>deploy the resources needed to carry out its mandate. The head(s) of the supervisory authority can be removed from office during his (their) term only for reasons specified in law. The reason(s) for removal should be publicly disclosed.</p>
Description and findings re EC1	<p>CNBV's governance, powers, accountability and supervisory authority are derived from its law. Being part of the Federal Government, the CNBV is subject to surveillance and control by the Secretariat of Civil Service ('Secretaría de la Función Pública' - SFP).</p> <p>The CNBV is a decentralized body of the 'Secretaria de Hacienda y Credito Publico' (SHCP), with formal technical autonomy and executive powers (CNBV's Law, Article 1).</p> <p>CNBV's Board has 13 members, of which the SHCP has direct authority to nominate or remove 10 members at its discretion, including the President of the Commission.</p> <p>By Law, the president of the CNBV is appointed by the SHCP, and its vice-presidents and general directors are appointed by the Board upon the president's nomination.</p> <p>The length of the term of office of the president, vice-presidents and directors of the CNBV is not specifically stated; nor are the reasons for their removal stated in the law. The reasons for removal need not be publicly disclosed.</p> <p>Regarding the CNBV's de facto independence, the assessors note that, in spite of recent efforts to transfer the powers for licensing to the CNBV, most of its key decisions as supervisor require approval by the Board, which leaves the decisions of the CNBV open to influence by other policy goals.</p> <p>The assessors note that in 31 cases the CNBV senior management has taken major decisions in line with the LIC, but these have needed subsequent approval by CNBV's Board, including 12 cases where the opinion or concurrence of the BoM has also been required.</p>
EC2	<p>The supervisor publishes objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives.</p>
Description and findings re EC2	<p>CNBV's objectives are defined in its law (Article 2) and guide its overall operations. The CNBV publishes an annual report of its activities and is held accountable through the oversight powers of the General Audit of the SHCP and the SFP.</p> <p>The CNBV would like to make public to the industry its supervisory review and evaluation process (SREP), as well as the core criteria that will guide its activities and key decisions. This should include the response and escalation regime that the CNBV intends to follow in order to reduce the risk profile of the institutions going forward, before adopting formal enforcement and resolution measures.</p>
EC3	<p>The supervisory authority and its staff have credibility based on their professionalism and integrity.</p>
Description and findings re EC3	<p>CNBV's staff has continued to gain credibility among market participants based on high professionalism, competence, and integrity. There is agreement that CNBV's capacity has improved notably in recent years, although more experience and training in supervisory functions are still needed.</p> <p>Market participants expect to receive further detailed guidance regarding the expectations of the CNBV for risk governance (e.g., risk appetite), as well as to understand better the detailed criteria applied in reaching a judgment about the effectiveness and adequacy of certain risk management processes. Participants would like to see all the elements of Basel II implemented before moving to the implementation of the Basel III reforms.</p>

EC4	<p>The supervisor is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes:</p> <ul style="list-style-type: none"> • A budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised; • Salary scales that allow it to attract and retain qualified staff; • The ability to commission outside experts with the necessary professional skills and independence and subject to necessary confidentiality restrictions to conduct supervisory tasks; • A training budget and program that provides regular training opportunities for staff; • A budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups; and • A travel budget that allows appropriate on-site work. 																																																
Description and findings re EC4	<p>The SHCP determines the annual budget of the CNBV according to Article 16, XI of its Law. This determination is made within the envelope communicated by the SHCP to the CNBV. Such budget is not necessarily aligned with the actual needs of the Commission.</p> <p>A supervisory fee is levied every year on the supervised institutions, as determined by the SHCP. Such fee is calculated based on the total assets of each institution. The basis for calculating the fee does not yet take into account the particular risk profile of each institution, which, as currently evaluated by the CNBV, identifies the difficulties associated with and the intensity of supervision actually required for the various institutions.</p> <p>The SHCP receives directly the proceeds collected from the fees levied and allocates to the CNBV between 70 and 80 percent of the total fees collected to cover the CNBV's overall current and investment expenses. However, the budget assigned is very inflexible, as it must be applied to the various categories of expenses approved ex-ante by the SHCP. CNBV's senior management does not have budgetary discretion to re-allocate the budget to changing and possibly new urgent needs throughout the year.</p> <div data-bbox="456 1430 1019 1656" style="border: 1px solid black; padding: 5px;"> <p style="text-align: center;">Box – Selected indicators</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left;">CNBV Indicators</th> <th style="text-align: center;">2006</th> <th style="text-align: center;">2007</th> <th style="text-align: center;">2008</th> <th style="text-align: center;">2009</th> <th style="text-align: center;">2010</th> </tr> </thead> <tbody> <tr> <td>Budget to Total Assets</td> <td style="text-align: center;">0.021%</td> <td style="text-align: center;">0.017%</td> <td style="text-align: center;">0.017%</td> <td style="text-align: center;">0.017%</td> <td style="text-align: center;">0.016%</td> </tr> <tr> <td>Expenses to Total Assets</td> <td style="text-align: center;">0.005%</td> <td style="text-align: center;">0.003%</td> <td style="text-align: center;">0.005%</td> <td style="text-align: center;">0.006%</td> <td style="text-align: center;">0.006%</td> </tr> <tr> <td>Salaries to Total Assets</td> <td style="text-align: center;">0.016%</td> <td style="text-align: center;">0.014%</td> <td style="text-align: center;">0.011%</td> <td style="text-align: center;">0.011%</td> <td style="text-align: center;">0.010%</td> </tr> <tr> <td>Salaries to Budget</td> <td style="text-align: center;">77.2%</td> <td style="text-align: center;">82.6%</td> <td style="text-align: center;">67.8%</td> <td style="text-align: center;">64.5%</td> <td style="text-align: center;">65.0%</td> </tr> <tr> <td>Salaries to Staff Headcount (1)</td> <td style="text-align: center;">0.67803</td> <td style="text-align: center;">0.624727</td> <td style="text-align: center;">0.593373</td> <td style="text-align: center;">0.540918</td> <td style="text-align: center;">0.576738</td> </tr> <tr> <td>Total assets to Headcount (1)</td> <td style="text-align: center;">4,150</td> <td style="text-align: center;">4,469</td> <td style="text-align: center;">5,184</td> <td style="text-align: center;">4,803</td> <td style="text-align: center;">5,578</td> </tr> <tr> <td>(1) in mill. of MXP</td> <td></td> <td></td> <td></td> <td></td> <td></td> </tr> </tbody> </table> </div> <p>Currently, the budget allocated by the SHCP to the CNBV is not sufficient to cover the latter's operational needs. In particular, the budget is insufficient to attract, train, and retain the high-quality staff required to face the challenges of operating a modern supervisory agency (see Box of Selected Indicators). Salaries have remained frozen for the last 7-8 years for professional staff. As a consequence, the salary gap with the private sector has risen and the turnover of senior staff increased in 2010 (see table). CNBV Board members from BoM have shared this concern in Board meetings and with the FSAP mission.</p>	CNBV Indicators	2006	2007	2008	2009	2010	Budget to Total Assets	0.021%	0.017%	0.017%	0.017%	0.016%	Expenses to Total Assets	0.005%	0.003%	0.005%	0.006%	0.006%	Salaries to Total Assets	0.016%	0.014%	0.011%	0.011%	0.010%	Salaries to Budget	77.2%	82.6%	67.8%	64.5%	65.0%	Salaries to Staff Headcount (1)	0.67803	0.624727	0.593373	0.540918	0.576738	Total assets to Headcount (1)	4,150	4,469	5,184	4,803	5,578	(1) in mill. of MXP					
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Number of staff Leaving the CNBV 1/					
Positions	2007	2008	2009	2010	Total
Vice-presidents	3	3	0	0	6
General managers	1	4	2	4	11
Deputy general-managers	12	6	2	6	26
Heads of areas	3	5	1	5	14
Deputy heads of areas	33	31	9	15	88
Inspectors and specialists	56	20	20	14	110
Total	108	69	34	44	255

1/Further staff left in 2011, including three vice-presidents.

Article 20 of the CNBV's Law prevents the agency from operating an incentive based system or from increasing salaries at the discretion of its senior management since its budgetary regime prevents this. It follows the same budget rules of other de-concentrated federal agencies. The execution of the budget is pre-determined, confined to specific approved items since, as a general rule, the expense categories cannot be modified e.g., expenses are tagged from origin by the SHCP and cannot be reallocated at the discretion of senior management in CNBV. At times, SHCP limits the execution of the budget already allocated to the CNBV by limiting the number of new hires to approved staff positions.

Since April 2003, the 'Ley del Servicio Profesional en la Administración Pública Federal' has brought the CNBV under the Federal Civil Service that constitutes the framework for the hiring and removal of staff. The law covers positions ranging from section chief to Director General. This further limits the autonomy of the CNBV to flexibly manage its human resources, provide early retirement to low performers, as well as better align compensation to a more modern and incentive based formula that combines level of responsibility, seniority, and performance.

Training is provided regularly by the CNBV and every employee has the right and duty to engage in at least 40 hours per year of training, a level that is currently met. Moreover, computers and equipment are available and replaced on a regular basis in accordance with their obsolescence and institutional needs. The CNBV needs to have further flexibility to operate a comprehensive training curriculum to enhance the skills of its professional staff.

The travel budget regulation is determined also by the SHCP through the SFP, within the guidelines applicable to the Federal Government. The travel budget has remained flat since December 2007 and is set at the minimum necessary due to the austerity policy established by the Mexican President. Because of this, travel budgets within the Mexican territory are very limited and insufficient. For international travel, budget availability is less restrictive.

	<p>It should be pointed out that the Federal Government procurement rules apply to the CNBV, creating significant delays in purchasing equipment and hiring consultants. Also, accepting grants is subject to SHCP approval.</p> <p>Overall, to achieve the objectives of this EC, the CNBV should have autonomy to fund its activities and to reallocate its budget based on its own priorities, only subject to the prior approval of its governing Board.</p>
Additional criteria	
AC1	The head(s) of the supervisory authority is (are) appointed for a minimum term.
Description and findings re AC1	<p>the president and vice-presidents of the CNBV are not appointed for a specific term. The Secretary of Finance can remove them without specific reasons (CNBV's Law Article 14). In addition, CNBV senior staff, such as directors, can be removed at the discretion of the president of the CNBV, which may undermine the independence of their technical work.</p> <p>The assessors believe that the length of the appointments and the reasons for removal from office should be clearly stated. CNBV should ideally have a regime similar to the one applied to the BoM. Removal from office should be based solely on a reasoned and 'just case', and approved by a committee of 'peers', rather than at the discretion of the CNBV's president, and submitted for approval by the Board. Removal of the president and vice-presidents before the expiration of their terms of appointment should always involve consultations with BoM and be notified to parliament.</p>
Assessment of Principle 1(2)	Noncompliant.
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP has not been achieved. Compliance must therefore be strengthened as soon as possible, to mitigate the risks of regulatory capture and avoid political pressure, by implementing the following actions:</p> <ul style="list-style-type: none"> • Amend CNBV's law to provide fixed terms of appointment for its more senior staff: president and vice-president, similar to those currently applied at the BoM; • Include in the amendment an explicit 'just case' justification for the removal of CNBV's senior managers, conditional upon the approval of two-thirds of the members of CNBV's Board, excluding the member under question, who shall cast their votes by ballot; • Require that the reasons for removal be communicated to parliament and be made public; • Review the distribution of powers and decision making between the Board of the CNBV, the BoM, and the agency to ensure de facto independence in the supervisory process. <p>With respect to CNBV's resources, there appear to be a number of unresolved issues. The assessors are not confident that there is a full understanding by CNBV's Board of the complexities, incremental development, and demanding workload and resources needed to adopt a fully-fledged Basel II risk-based approach to regulation and supervision.</p> <p>The assessors' impression is that the policy followed has been not to increase CNBV's resources, even when that would have been desirable and justifiable, for financial (fiscal) stability reasons.</p>

	<p>Assessors were not in a position to conduct a detailed analysis, but their strong sense is that additional resources for prudential supervision (in quality and quantity) are required.</p> <p>Assessors recognize that some of this could be funded from enhanced efficiency in CNBV's existing processes. However, to achieve these efficiencies, senior management at CNBV must be endowed with the autonomy to execute them, once approved by the Board, with full flexibility, including removal of noncontributing staff.</p> <p>Such additional resources are essential to enable the CNBV to (i) implement the planned enhancements well; (ii) deal with a number of recommendations in this assessment such as more proactive in-depth reviews of key risk areas along a mandated multi-year supervisory cycle; and (iii) implement the new approach to systemic supervision that is being developed.</p> <p>The CNBV needs to conduct a rigorous analysis and justification of its needs, as well as of possible synergies to be achieved internally and vis-à-vis BoM, where there might be some duplication of tasks. Potentially, as part of reorganization, the pros and cons of a merger with some other commissions should be examined. This will help to accelerate the implementation already started by CNBV of a full financial sector group risk based consolidated supervision.</p> <p>The CNBV's Board is ultimately responsible for ensuring that the CNBV is able to resource its activities adequately. The assessors feel that this is not taking place as it should.</p> <p>Assessors were not in a position to conduct a detailed analysis of the governance practices and processes followed by CNBV's Board. However, from the review of its minutes, the assessors believe that more activism by the Board, more diligence, and more frequent deliberation by all its directors, as well as the presence of directors with stronger financial professional backgrounds to guide and assist the Commission, are conditions sine-qua-non for the success of the changes being implemented by its management team. It is not sufficient for the Board to meet once every two months for one and a half hours. Consideration should be given to the appointment of external independent directors with sufficient dedication to the tasks of the Board.</p> <p>The assessors believe that there are clear grounds and an urgency to:</p> <ul style="list-style-type: none"> • Estimate transparently the current and anticipated workload in the CNBV; • Align its budget and salaries to current needs to stop staff attrition; • Provide an explicit mandate to its Sr. management to reshuffle the staff structure, including powers and funding to implement early retirement and transfer of service programs.
Principle 1(3)	Legal framework. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Summary description and findings re principle 1(1)	
Essential criteria	

EC1	The law identifies the authority (or authorities) responsible for granting and withdrawing banking licenses.
Description and findings re EC1	Legal powers for licensing and revocation of licenses previously rested with the SHCP, but were transferred in 2008 to the CNBV. In practice, the approval of the SHCP is required in making these decisions, making the transfer of powers to the CNBV more a formality than an effective delegation. The assessors note that the use of the powers listed in the LIC necessitate the approval of CNBV's Board, and in several instances, also extensive consultations with BoM (see CP1(2)).
EC2	The law empowers the supervisor to set prudential rules (without changing laws). The supervisor consults publicly and in a timely way on proposed changes, as appropriate.
Description and findings re EC2	<p>The LIC establishes the need for, and gives the CNBV powers to, issue the prudential secondary regulations required to supervise the banking system effectively, and these are continually updated. The provisions of the LIC are purposely general in order to allow for flexibility in the drafting of regulations by CNBV.</p> <p>The CNBV has the appropriate authority to set, update, and change the prudential regulations without requiring changes to the law. There is a public entity responsible for the public disclosure and consultation of regulatory proposals (COFEMER).</p> <p>In addition, the CNBV regularly consults and discusses regulatory proposals with the industry in order to anticipate potential areas of opportunity and to receive industry feedback.</p>
EC3	The law or regulations empower the supervisor to obtain information from the banks and banking groups in the form and frequency it deems necessary.
Description and findings re EC3	<p>Article 97 of the LIC grants powers to the financial authorities, including CNBV, to request information from supervised institutions and allows for information sharing among the authorities. This power is deemed sufficient and is exercised without any restrictions.</p> <p>Notwithstanding, a quid-pro-quo similar regime of information exchange from other Mexican financial Commissions (CONSAR and CNFS) toward the CNBV is not possible, since their confidentiality regime does not allow them to do so.</p>
Assessment of Principle 1(3)	Compliant
Comments	<p>The opinion of the assessors is that compliance with the essential conditions of this CP has been achieved and may be further enhanced by implementing the following action:</p> <ul style="list-style-type: none"> Amend the confidentiality provisions of other Mexican supervisory agencies (CNSF and CONSAR) to the same standards as currently applied to the CNBV.
Principle 1(4)	Legal powers. A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.
Summary description and findings re principle 1(4)	
Essential criteria	
EC1	The law and regulations enable the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations

	<p>permit the supervisor to apply qualitative judgment in safeguarding the safety and soundness of the banks within its jurisdiction.</p>
<p>Description and findings re EC1</p>	<p>The CNBV believes that prudential laws and regulations provide enough room and points of reference for supervisors to exert their substantive judgment and apply qualitative criteria in discharging their duties.</p> <p>The law and regulations focus on the safety and soundness of banks. It encompasses regulation for their capital adequacy, and creation of reserves for the risks undertaken. It also contemplates fines and different kinds of sanctions for different types of misconduct. The CNBV believes that prudential regulation adds to the comprehensiveness of the regulation in Mexico. This prudential regulation provides qualitative elements that complement the quantitative knowledge of the supervisor of a given entity.</p> <p>In practice, the assessors have not been presented with clear evidence that the CNBV has ever acted on the basis of circumstances that are not related to a lack of compliance with quantitative regulations, such as those cases where the conduct of the Board and senior management could be enforced by reference to best practices. Acting on qualitative judgments is difficult for the CNBV.</p> <p>The assessors recommend that the CNBV publicly adopt all the risk-based papers of the Basel Committee on risk management and supervision as a public set of guidelines. This would include compiling a list of unsafe, unsound, and imprudent governance and risk management practices deemed unacceptable and, therefore, subject to prompt remedial action under the CUB.</p>
EC2	<p>The supervisor has full access to banks' Board, management, staff, and records in order to review compliance with internal rules and limits as well as external laws and regulations.</p>
<p>Description and findings re EC2</p>	<p>CNBV Law (Article 19) establishes that banks are obligated to provide data, reports and all the information that CNBV requires, besides allowing access to their facilities.</p>
EC3	<p>When, in a supervisor's judgment, a bank is not complying with laws or regulations or it is or is likely to be engaged in unsafe and unsound practices, the supervisor has the power to:</p> <ul style="list-style-type: none"> - take (and/or require a bank to take) prompt remedial action; and - Impose a range of sanctions (including the revocation of the banking license).
<p>Description and findings re EC3</p>	<p>Article 134 BIS of the LIC empowers the CNBV to order 'standard' corrective actions or additional corrective actions, according to the capitalization level of a bank.</p> <p>One ground for withdrawing the banking license is the inability to meet the minimum capital requirement (LIC Art. 28, V); several other remedial or corrective actions are established by law and regulations relating to the prompt corrective actions regime.</p> <p>The assessors believe that these are hard-wired triggers for escalation that do not incorporate 'qualitative' deviations from sound and safe practices, such as to operate without proper and reliable control systems, including poor risk management and governance practices, which, among other qualitative aspects, provide the best early warning indication of problems ahead.</p>
Assessment of Principle 1(4)	<p>Compliant</p>
<p>Comments</p>	<p>The opinion of the assessors is that compliance with the essential conditions of this CP has been achieved and may be further enhanced by implementing the following actions:</p>

	<ul style="list-style-type: none"> • Compile a list imprudent practices (“unsafe and unsound”) resulting in serious deviations from internal governance practices expected from directors and managers (see CP23).
	<ul style="list-style-type: none"> • Categorize substantive deviations as enforceable breaches under the LIC and the most serious systematic and repetitive deviations as criminal offenses (see EC2 in above Principle 1(1)).
Principle 1(5)	Legal protection. A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Summary description and findings re Principle 1(5)	
Essential criteria	
EC1	The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.
Description and findings re EC1	In the opinion of the assessors there is not an appropriate provision in the LIC nor in the Law of the CNBV to provide adequate legal protection to the CNBV and its staff as required in this EC, including after termination of the period of service in the CNBV for actions taken and/or omissions made in good faith while still in active service.
EC2	The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.
Description and findings re EC2	<p>Article 21 of the CNBV’s law establishes that the Commission shall provide legal assistance and defense to the members of its Board and other public officers serving in the Commission when performing their supervisory duties according to their responsibilities. This assistance is extended to the individuals nominated by the CNBV to intervene a problem institution. The assistance shall be provided based on the resources approved by the Board of the CNBV, subject to reimbursement in case of judicial ruling against the individual. The SHCP shall establish the mechanisms and find the resources to cover the costs involved.</p> <p>Such mechanism is still not in operation and fully funded.</p>
Assessment of Principle 1(5)	Noncompliant
Comments	<p>The opinion of the assessors is that compliance with the essential conditions of this CP has not been achieved. Compliance must therefore be strengthened, as soon as possible, to mitigate risks of frivolous actions by third parties, by implementing the following measures:</p> <ul style="list-style-type: none"> • The staff of the agency may be criminally prosecuted only if the Federal Department of Justice approves it, based on a prima facie assessment of the evidence; • Consequently, the law of the CNBV should be amended to ensure that no civil liability claim may be addressed directly against its members, and claims should be brought against the United States of Mexico first; • If a member of the CNBV has caused a loss intentionally or through gross negligence to a third party, the latter should have recourse against that member,

	<ul style="list-style-type: none"> including cases of bad faith or intentionally damaging acts; in such cases the supervisor can be held liable. SHCP should approve a mechanism to fund ex-ante legal support interventions, including enacting the detailed rules for implementation with appropriate delegation to the CNBV.
Principle 1(6)	Cooperation. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Summary description and findings re Principle 1(6)	
Essential criteria	
EC1	Arrangements, formal or informal, are in place for cooperation and information sharing between all domestic authorities with responsibility for the soundness of the financial system, and there is evidence that these arrangements work in practice, where necessary.
Description and findings re EC1	<p>The Mexican Financial System Stability Council involves all the relevant authorities that share responsibility in the financial oversight and systemic stability.</p> <p>As for the supervision of the banking institutions, Article 97 of LIC provides for the exchange of information (including confidential information) among the SHCP, the BoM, the CNBV, the Commission for the Pension System (CONSAR), the Institute for the Protection of Bank Savings (IPAB), and the National Commission for the Protection of Users of Financial Services (CONDUSEF).</p> <p>In addition to the above, there are a suite of MOUs signed between the CNBV and other financial authorities for supervisory purposes:</p> <ul style="list-style-type: none"> MOU signed in 2000 for information exchange among the SHCP, BoM, CNBV, and IPAB; MOU signed in September 2007 between the CNBV and IPAB to establish the conditions under which IPAB may request CNBV assistance in verifying the proper management of deposit-insurance-covered liabilities and obtaining necessary information; MOU signed in October 2008 between the CNBV and BoM to facilitate stronger coordination in information sharing and joint examinations between the two institutions. The CNBV and CONDUSEF are in the process of negotiating an MOU.
EC2	Arrangements, formal or informal, are in place, where relevant, for cooperation and information sharing with foreign financial sector supervisors of banks and banking groups of material interest to the home or host supervisor, and there is evidence that these arrangements work in practice, where necessary.
Description and findings re EC2	The CNBV has signed MOUs with foreign authorities to share relevant information. In addition, it can conduct joint examinations of banks with foreign regulators in foreign territories, just as foreign authorities are able to do in Mexico (see CP25).
EC3	The supervisor may provide confidential information to another domestic or foreign financial sector supervisor. The supervisor is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used

	only for supervisory purposes and will be treated as confidential by the receiving party. The supervisor receiving confidential information from other supervisors is also required to take reasonable steps to ensure that the confidential information will be used only for supervisory purposes and will be treated as confidential.
Description and findings re EC3	Article 117 Bis of the LIC establishes that the CNBV has the power to provide foreign authorities with the information they may require for the purposes of their supervision. If the information required is protected by banking secrecy, the CNBV must require a reciprocity agreement to ensure that the information will be treated with due confidentiality.
EC4	The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.
Description and findings re EC4	The aforementioned Article 117 Bis also provides for the denial of an information request to CNBV (or the withdrawal of previously granted information) by a foreign authority when the request deviates from the relevant information exchange agreement, if it would be used for a different purpose to the one originally claimed or if it is opposed to public order or national security. Article 117 defines the entities and the procedure through which different judicial authorities and auditing bodies may require information from the CNBV; CNBV may not disseminate sensitive information other than in those cases mentioned therein.
Assessment of principle 1(6)	Compliant
Comments	
Principle 2	Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word “bank” in names should be controlled as far as possible.
Summary description and findings re Principle 2	The Mexican regime for permissible activities of institutions that are licensed and subject to supervision is clearly defined in the law and the use of the word “bank” in names is properly controlled. In practice, however, Mexican authorities are confronting situations where nonlicensed entities are illegally capturing deposits from the public. The authorities pay particular attention to preventing illegal deposit-taking: there are several provisions in the LIC dealing with the prohibition of the unlicensed taking of deposits from the public. Sanctions for such activities include fines and imprisonment, as specified in Art. 111 of the LIC. It is difficult to evaluate the magnitude of the problem. On July 25, 2011, the CNBV published a list of 14 entities that were collecting deposits from the public without proper authorization and outside the supervisory umbrella of CNBV. Another 39 entities had been identified earlier. Some of these are clearly misleading their customers by improperly using the name “bank,” e.g., <i>Instituto de Banca y Ahorro</i> , <i>Interbanc</i> , <i>Capitalbank</i> , <i>Inverban SA</i> . The authorities have issued warnings not to carry out transactions with these entities; according to CNBV, several initiatives are under review to sanction these entities and their managers.
Essential criteria	
EC1	The term “bank” is clearly defined in laws or regulations.
Description and findings re EC1	Art. 2 of the LIC stipulates that bank and credit services are provided by credit institutions only. According to the Mexican banking law, credit institutions are either multiple-purpose banking institutions (Instituciones de banca múltiple) or development banks (Instituciones de banca de desarrollo) and their permissible activities are clearly defined in Art. 46 (see below).

EC2	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.
Description and findings re EC2	<p>Permissible activities of credit institutions are outlined in Art. 2 and 46 of the LIC. There are 28 activities that banks can engage in, notably: (i) deposit-taking activities; (ii) issuing bonds; (iii) contract credits; (iv) issuing credit cards; (v) granting any type of loans; and (vi) acting as custodians. As stated in Art. 46 Bis of the LIC, other types of activities not listed in Art 46 should be approved by the CNBV. The BoM (BoM) Circular 2019 also defines activities for supervised banks. In addition, LIC Art. 106 identifies the categories of activities that are prohibited.</p> <p>At the time of licensing, CNBV specifies activities from the above-mentioned list that the aspiring bank can carry out at the time of licensing; any additional activities or changes in scope of business require CNBV approval. Banks are explicitly required to specify in their chart of incorporation the list of activities that they are allowed to undertake. New products and innovations also require CNBV approval, as well as any changes in the terms and conditions of these products.</p>
EC3	The use of the word “bank” and any derivations such as “banking” in a name is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
Description and findings re EC3	<p>As observed in the previous 2001 and 2006 BCP assessments, Art. 105 of the LIC restricts the use of the word “bank” to “credit institutions,” which are, according to Art. 2 of the LIC, multiple-purpose banking institutions and development banks. The use of the word “bank” in contravention of the law is punished by the CNBV by administrative sanctions consisting of fines ranging from 100 to 5000 times the so-called UDI—6,000 to 300,000 pesos (Art. 107 and 108 Bis 1). Furthermore, the CNBV can order the administrative suspension of the activity as long as the misleading name has not been changed. There are no provisions in the law that requires explicitly that any illegal gains be confiscated. The LIC also specifically prohibits the unapproved use of related words such as “banking” and “saving.”</p> <p>Even though the LIC contains adequate administrative and criminal provisions to protect the general public from being abused by illegal “banking” entities, in practice many cases of the illegal use of the word “bank” have been detected. Illegal use of the name “bank” is a matter of concern in Mexico. As indicated above, CNBV has disclosed a list of 53 companies that have been found collecting deposits without authorization, some of which contain the word “bank” in their name. The case of <i>Capitalbank</i>, located in Tijuana is interesting in this respect. Capitalbank was renamed Capital Institute, a savings and loan company that offered deposit certificates with very high returns (12 percent yields with a maturity of 90 days and 18 percent with a maturity of 3 years). Neither Capitalbank nor Capital Institute were licensed by the CNBV. The CNBV is taking this issue seriously and the Legal department has a dedicated team that liaises with the enforcement authorities.</p>
EC4	The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks.
Description and findings re EC4	Pursuant to Art. 2 of the LIC, the taking of deposits from the public (<i>captación de recursos del público</i>) is restricted to credit institutions. In Art. 103, the LIC stipulates that individuals or legal entities are prohibited from taking—directly or indirectly—deposits from the public except those that are listed in the same article: (i) credit institutions; (ii) financial intermediaries properly authorized; (iii) savings and loan (S&L) cooperatives; and (iv) associations and companies that collect funds from their own members. In other words, only supervised financial institutions, i.e., banks and

	<p>SOCAPS (S&L cooperatives) can take deposits, while the SOFIPOS (noncoop S&L) are allowed to take deposits under their own law (<i>Ley de Ahorro y Crédito Popular</i>).</p> <p>Taking deposits from the public without being properly authorized by the CNBV is an offense and can lead to administrative sanctions (e.g., fines ranging from 30,000 to 3 million pesos) and criminal punishment consisting of jail time ranging from 5 years to 15 years (LIC, Art. 111).</p>
EC5	The supervisory or licensing authority publishes, and keeps current, a list of licensed banks and branches of foreign banks operating within its jurisdiction.
Description and findings re EC5	<p>As set forth in Art. 8 of the LIC, all bank licenses granted by the competent authorities are made public in an official legal journal (<i>Diario Oficial de la Federación</i>). Besides, the CNBV keeps current a list of licensed banks and branches of foreign banks operating in Mexico (<i>Padrón de Entidades Supervisadas</i>). The list is available on line on the CNBV website (www.cnbv.gob.mx/bancos/). Moreover, every bank that has been licensed is required to register the license in the Commercial Public Registry. (Art. 46 Bis).</p> <p>CNBV also published in July 2011 a list of entities that (i) do not belong to the financial system; (ii) are not supervised by CNBV; and (iii) are not authorized to collect deposits. This list also contains a statement exhorting the public not to enter into business with these entities.</p>
Assessment of Principle 2	Compliant
Comments	<p>The legal regime for permissible activities as set forth in the LIC complies with BCP #2. The LIC lays out in detail the procedures and processes to be followed by the licensing agency. CNBV has the legal powers to regulate, supervise and enforce permissible activities.</p> <p>Several initiatives have been taken to address the issue of unlicensed entities that are still collecting funds from the public. On the regulatory side, the creation of a new type of banking license, called “banco de nicho,” requiring lighter requirements (notably for minimum capital) aims to offer a legal framework to these entities with limited scope. However, no <i>banco de nicho</i> type of license has been issued as of today. On the enforcement front, CNBV has established and made public a list of unlicensed entities that are illegally operating in the country. Assessors were told that prosecution cases are pending. The authorities are encouraged to continue pursuing those entities that are abusing the general public. In this regard, CNBV has engaged with the judiciary to proceed with criminal prosecutions.</p>
Principle 3	Licensing criteria. The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Summary description and findings re Principle 3	The licensing mechanism for banks changed significantly in 2008. At the time of the 2006 FSAP, the licensing authority for banks rested with the SHCP while the CNBV was vested with the power to license intermediaries in the securities area. In the wake of the assessment, the decision was made to reassign most of the regulatory powers held by the Finance Ministry to CNBV, including the authority to issue and withdraw licenses for banks and bank subsidiaries, and to set prudential regulations.

	<p>In addition, CNBV has been granted other responsibilities—such as assessing ownership changes in, and investments by, banks—that were previously also under SHCP authority.</p> <p>Pursuant to the new regime that took effect in June 2008, the organization and operation of a universal banking institution requires authorization by the Federal Government [through the National Banking and Securities Commission (CNBV)] and the favorable opinion of the Bank of Mexico. That is, the approval of the Central Bank is necessary to grant authorization. Nevertheless, the CNBV has sufficient discretionary power to deny such authorization. Thus, the authorization or the denial of the organization and operation of a banking institution belongs to the Governing Board, its supreme decision-making body. Besides CNBV officials, Board directors are representatives from the different authorities of the Mexican financial system, such as the Ministry of Finance, the Bank of Mexico (BoM), <i>Comisión Nacional de Seguros y Finanzas</i> (CNSF, Insurance Commission) and <i>Comisión Nacional del Sistema de Ahorro para el Retiro</i> (CONSAR, Pensions Commission). It is noteworthy that CNBV has issued only one license under its new licensing capacity, to a bureau de change that has been converted into a bank.</p> <p>Although the licensing authority for banking institutions has been shifted from the Finance Ministry to CNBV, the licensing authority for financial holding companies remains with the Ministry.</p> <p>The operating plans, business strategy and projected financial statements are among the documents that are presented when requesting a bank license. These documents are examined by CNBV during the authorization process to determine the viability of the proposed institution. The fit-and-proper test of directors and managers includes skills, moral suitability, experience in relevant financial activities and no adverse regulatory determination or poor credit record. Some improvements in the current requirements would, however, be desirable (supporting evidence for lack of criminal records and origin of funds).</p>
Essential criteria	
EC1	<p>The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisory authority are not the same, the supervisor has the right to have its views considered on each specific application. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed institution.</p>
Description and findings re EC1	<p>The Ministry of Finance and Public Credit (<i>Secretaría de Hacienda y Crédito Público</i>-SHCP) is no longer in charge of granting banking licenses. At the time of the 2006 FSAP, SHCP was empowered to license credit institutions while CNBV's role was limited to supervision. With amendments to the banking law in February 2008, CNBV now approves and revokes licenses to banking organizations, including the subsidiaries of foreign financial institutions. It is noteworthy that granting the license requires prior approval from CNBV's Board and a favorable opinion from the <i>Banco de México</i>. Since the last evaluation, two applications for commercial banking licenses have been received, both from domestic entities. One had a favorable response and the other is still in process.</p>
EC2	<p>The licensing authority has the power to set criteria for licensing banks. These may be based on criteria set in laws or regulations.</p>

Description and findings re EC2	<p>The LIC establishes the criteria and requirements for licensing banks (Art. 8-10). Additional details are contained in the <i>Circular Única de Bancos</i> (CUB) issued by CNBV (Articles 336-337 Bis, annexes 53-54). For this purpose the CNBV receives information on the proposed entity, including the draft articles of incorporation, the list of planned activities, the list of aspiring managers with their personal information, income statements for individuals and financial statements for legal entities, as well as the source of paid-in capital. The CNBV also receives the list of shareholders revealing the names of the individuals that directly or indirectly would own shares in the proposed institution. Further information is also required to ensure that the proposed business plan is realistic and sustainable. To this end, the applicant has to submit information on the projected activities and provide an analysis of the financial viability of the bank. Details on internal controls, IT system, and internal organization and administration are also required.</p> <p>The bank is also required to obtain written approval from CNBV before starting its operations. The bank has 30 days to start operating; otherwise, CNBV can revoke the license. An on-site visit is carried out to ensure that all conditions are met.</p> <p>As indicated by CNBV, there is no licensing manual <i>per se</i>, but there is an internal procedure for processing and analyzing new applications as well as a list of documentation and information that must be submitted along with the application for authorization. In order to verify compliance with the above requirements, information and supporting documentation received from the applicant are shared with all relevant departments of the CNBV (supervision, legal, AML and systems) and Banco de México, who in turn will express a technical opinion on the application.</p> <p>For each application, an Authorization Committee is also set up, whose purpose is to review the opinions issued by the competent CNBV departments. This Committee is made up of representatives from the Secretariat of Finance, Banco de México, and the CNBV. The Committee's opinion on the eligibility of the applicants is then submitted to the Board of Governors for final approval.</p>
EC3	The criteria for issuing licenses are consistent with those applied in ongoing supervision.
Description and findings re EC3	The licensing criteria mainly include requirements for bank shareholders, Board members and senior managers, capital, organizational structure, risk management and internal control policies and procedures, business venues, etc. These criteria are consistent with those applied in ongoing supervision (capital requirements, fit-and-proper tests, internal controls, etc.). At any stage of the licensing process, the supervisory agency has the unrestricted right to request the applicant to provide any information considered relevant.
EC4	The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.
Description and findings re EC4	Adequate legal basis for rejecting applications is provided by Art. 8 of the LIC with the explicit right of refusal by CNBV if it is not satisfied with the merits of the application. To the extent that licensing and informational requirements are not met, the CNBV can reject applications. Moreover, Art. 25 of the LIC empowers the CNBV to remove (<i>remoción</i>) or suspend from 3 months to 5 years Board members, directors, and senior management when authorities believe that interested parties no longer meet fit-and-proper requisites. In the same vein and additionally, CNBV can ban the same persons from holding any other type of position or responsibility within the Mexican financial system (Art. 25).

EC5	The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.
Description and findings re EC5	<p>In assessing the request for a license, the authorities make an assessment of the applicant's organization and management layout. To this end, CNBV is guided by the LIC, Art. 10, which defines the requirements to be met regarding the organization, management, and legal structure to be fulfilled in establishing a bank. These include Articles of Association, having qualified directors and senior managers, sound organization and management systems, good corporate governance structures, and risk management systems. Further, additional information is required such as the names of shareholders, the proposed amount of capital contributions and shares, a declaration of good standing, and relevant documents of the shareholders who intend to hold 2 percent or more of the proposed capital.</p> <p>In the case of a foreign bank, CNBV examines materials on organizational structures of the shareholder or its wider group, the list of main shareholders, and overseas offices and affiliates.</p>
EC6	The licensing authority identifies and determines the suitability of major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure and the sources of initial capital.
Description and findings re EC6	<p>The CNBV verifies the financial status and creditworthiness of the shareholders and other persons that may exert significant influence. According to Annex 53 of the LIC, aspiring shareholders that plan to hold 2 percent or more of the capital are subject to the following requirements: they should disclose all assets (property, bank accounts, securities) and liabilities along with their personal data (address, profession, professional background, citizenship, etc.). In addition, they should provide indications about the origin of their resources. Additional documents are also required such as a copy of the applicant's ID, diplomas and credit history. For a legal entity, copies of financial statements are also needed. However, Annex 53 does not refer to criminal records. Moreover, Annex 54 of the LIC subjects applicants to certify that (i) they have a good credit history; (ii) they have not been found guilty of serious violations of the financial laws in Mexico or abroad; and (iii) they have not been prosecuted for criminal acts and sentenced to more than one year in prison (<i>delito doloso</i>). However, there is no specific provision requiring the submission of supporting documents, e.g., a certificate proving the absence of a criminal record (e.g., <i>certificado de antecedentes criminales</i>).</p> <p>In addition, with regard to the particular issue of ML/TF, the licensing department of the CNBV requests the opinion of the AML/CFT department on the adequacy of the internal AML manuals submitted by the incumbent. A detailed analysis is made in this regard.</p> <p>Assessors could not find explicit reference in the LIC or regulations to the ultimate beneficial owners and the transparency of the ownership structure of the bank and its wider group, with the exception of annex 53 of the CUB. According to it, information should be given about individuals who are the ultimate beneficial owner of legal persons as well as trustees (<i>fideicomisos</i>) who will hold 10 percent or more of the capital of the bank. During the mission, the assessors observed that in one case reviewed, a description of the shareholding structure was provided with the names of individuals. This case was a simple one; assessors were not in a position to access other files involving banks with a much more complex shareholding structure.</p>

	<p>The 2008 regulatory changes also vested in the CNBV the power to approve changes in ownership structure as well as major acquisitions and investments of banking institutions, in consultation with the BoM.</p> <p>The CNBV is empowered to conduct investigations to determine the primary source of initial capital. Annex 53 of the CUB requires the applicant to provide details about assets (<i>relacion patrimonial</i>) including property, securities, and bank account balances; moreover, documents should be submitted to support the application, such as a copy of IDs, reports from two credit agencies, and academic records. There is no explicit obligation to provide supporting documents that could help CNBV services to determine more accurately the origin of funds. The assessors were told that such verification is performed during the licensing process.</p>
EC7	A minimum initial capital amount is stipulated for all banks.
Description and findings re EC7	<p>A minimum initial capital amount is established in Article 9 of the LIC as stipulated for all banks in Art. 19 of the banking law. Banks interested in operating in Mexico must apply for a “multiple-service” bank license, which implies a minimum capital requirement of approximately US\$30 million (90 million <i>unidades de inversión</i>—UDIs—Mexico’s inflation-adjusted index).</p> <p>Since 2008, and following congressional approval, a new type of license for niche banking has been promoted. The capital requirement for a niche banking license is considerably less: 40 percent of the capital requirement for a multiple-service license or roughly US\$12 million.</p>
EC8	The licensing authority, at authorization, evaluates proposed directors and senior management as to expertise and integrity (fit-and-proper test), and any potential for conflicts of interest. The fit-and-proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.
Description and findings re EC8	<p>Under the LIC, fit-and-proper requirements are specified in Art. 10, 22-24. CNBV assesses the technical suitability of the members of the Board of Directors (<i>Consejeros</i>) and senior management in terms of their experience in the financial sector. Members of the Board and senior management should have relevant knowledge and experience in financial, legal, and administrative matters, and possess sound technical skills. Furthermore, they should meet the requirements for moral suitability (<i>honorabilidad</i>). The LIC also subjects directors and senior management to a series of incompatibility tests. For example, they cannot act as director if they have been declared bankrupt or if they have been excluded from engaging in commerce or holding a position in the financial system.</p> <p>Pursuant to LIC, Art. 25, the CNBV is empowered to remove Board members managers, directors, and persons with power of attorney, as well as suspend from 3 months up to 5 years the abovementioned persons, when it deems they are lacking the necessary technical skills, good standing or when they do not meet the required eligibility criteria.</p>
EC9	The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.

Description and findings re EC9	<p>Art. 10 of the LIC requires applicants to submit a set of information that will help CNBV evaluate the potential strategic, operational, control and risk management capabilities of the candidate. CNBV will review the following:</p> <p>(i) the strategic plan (<i>Plan general de funcionamiento</i>), which should include the objectives and mission of the institution, its strategies, product development plans, initial plan for opening offices, the outfitting of the installations and information systems (in this regard, CNBV places special attention on the integrity of the information);</p> <p>(ii) the organization plan that includes the corporate structure, the organization chart, and internal control mechanisms; and</p> <p>(iii) general policies and procedures in different areas, including for taking deposits and granting credit, as well as for profit-sharing.</p> <p>It is worth noting that Art. 10 does not contain explicit references to the detection and prevention of criminal activities. In practice, however, CNBV assesses the honorability and suitability of incumbents (including their credit history) but there is no particular obligation to ensure that an appropriate mechanism to detect and prevent criminal activities is in place.</p>
EC10	<p>The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.</p>
Description and findings re EC10	<p>Pursuant to Art. 10 of the LIC, applicants must present a general plan for the operations of the proposed bank, one item of which is a financial viability study. CNBV reviews the feasibility study and requires that it include an analysis of market prospects, a description of the business strategy and plans, projections on assets and liabilities, earnings, liquidity, capital adequacy, return on assets, and return on equity.</p>
EC11	<p>In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.</p>
Description and findings re EC11	<p>The financial regulatory laws permit the entry of non-Mexican financial groups and financial intermediaries, through Mexican subsidiaries, to engage in various activities in the Mexican financial system, including banking, securities, and insurance activities. In fact, foreign banks mainly from G7 jurisdictions are operating in the country and hold a central place in the Mexican financial sector.</p> <p>The LIC, in Article 45 (A to N), stipulates that authorization to operate as a foreign bank in Mexico is granted by the CNBV. In practice, CNBV requires confirmation that there is no objection from the home regulatory authorities and evaluates whether cross-border activities are under their effective consolidated supervision (See CP 25). The assessors could not see examples of correspondence exchanged with cross-border supervisors in this regard.</p>
EC12	<p>If the licensing, or supervisory, authority determines that the license was based on false information, the license can be revoked.</p>
Description and findings re EC12	<p>If the presentation of false or deceiving information is established after the authorization has been granted, the authorization will not be revoked. As explained by CNBV, once granted, the subsequent discovery of deficiencies would not lead to revocation. In its Article 28, the LIC stipulates very clearly the different circumstances</p>

	that can lead to the revocation of the license and there is no reference to the situation of false information. However, as explained by the Mexican authorities, the fact that the application requirements are not only to be met at the inception of the bank, but rather consistently upheld throughout the bank's operation as part of the regular supervisory and regulatory regime, banks deviating from said standards would face remedial action and, eventually, dissolution.
EC13	The Board, collectively, must have a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.
Description and findings re EC13	CNBV evaluates the competences of individual directors against the criteria mentioned in CP 8. However, it does not conduct an assessment of the Board collectively to ensure that it has a sound knowledge of the types of activities the bank intends to pursue and the associated risks. Evidence of such assessment could not be found in the files reviewed by the assessors.
Essential criteria	
AC1	The assessment of the application includes the ability of the shareholder to supply additional financial support, if needed.
Description and findings re AC1	During the process of licensing, an analysis of the financial soundness of the applicant is done. There is no explicit assessment of the ability of the shareholder to supply additional support, if needed.
AC2	The licensing or supervisory authority has policies and processes in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met.
Description and findings re AC2	The CNBV is responsible for the supervision of new entrants to monitor their progress in meeting their business and strategic goals, and to determine whether the supervisory requirements outlined in the license approval are being met. The assessors discussed the licensing process with those responsible and are satisfied that it is working in practice.
Assessment of Principle 3	Compliant
Comments	<p>The CNBV may wish to consider the following recommendations:</p> <ul style="list-style-type: none"> • Obtain more autonomy in the decision making process. The new licensing regime has been conceived to provide CNBV with a full range of licensing, regulatory, and supervisory powers. However, the fact that a license requires the binding favorable opinion of BoM may undermine CNBV's discretionary power. The assessors were told that CNBV has to deny authorization if the BoM expresses a negative opinion. As a result, the supervisory agency does not seem to have exclusive authority to license banks. BoM, as lender of last resort and authority overseeing the operation of the payment systems, feels its opinion should be binding. • Supplement the fit-and-proper mechanisms with additional criteria. The mechanisms for the fit-and-proper test are well processed within the CNBV. The Department for Authorization makes several inquiries to other competent units to undertake further checks and investigations, in particular to the "department of offenses and sanctions (<i>Dirección General de Delitos y Sanciones</i>). In turn, all units communicate to the department of authorization their findings (by means of a formal letter). BCP assessors are of the view that a few aspects could be strengthened. The LIC in its Art. 10, 23 and 24 stipulates that aspiring directors,

	<p>senior managers, and members of the Board should have sufficient “honorability.” The assessors could not find in the regulations a clear definition of the concept of “honorability.” In addition, annex 54 of the CUB requires incumbent directors to submit a <i>bona fide</i> letter confirming that aspiring directors are complying <i>with all</i> requirements, including a good credit history and the absence of criminal sanctions (<i>proceso penal por delito doloso</i>) punished by jail time of more than <i>one year</i>. <i>However, there is no</i> obligation requiring applicants to provide proof of the absence of a criminal record.</p> <p>The same reasoning also applies to the sources of initial capital. As per Annex 53 and 54 of the CUB, applicants should disclose their assets by filling in a specific form; however, there is no specific obligation to submit additional documents or evidence to support such disclosure. In one file reviewed by the assessors, the description of the origin of funds appeared rather vague, without substantial evidence.</p> <ul style="list-style-type: none"> • Define more clearly the concept of ultimate beneficiary owner (UBO). The LIC does not contain an explicit definition of a UBO, i.e., the natural person in a chain of interposed companies that controls the voting power of a share, even in cases when the representative does not have title documents or is not registered as the owner of the shares or property, but simply claims such ownership rights by holding the title as only a trustee, i.e., it is a beneficiary under a trust, or is the true shareholder as opposed to a nominee shareholder. UBOs are not directed to disclose their true identities (neither as per the mandate of the LIC, nor through by-laws), including revealing the identity of their related parties to the Board of the bank they are shareholders of. Accordingly, beneficial owners through one or more trustees, legal representatives, agents, and other intermediaries, including custodians, might hide their identity, including the final identity of possible related parties. • Explore the possibility of stating explicitly that access to a bank license will not be granted to candidates under suspicion of money laundering. • Allow explicitly in the law that the CNBV may revoke a license if it was granted on the basis of false information.
Principle 4	Transfer of significant ownership. The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
Summary description and findings re Principle 4	<p>At the time of the 2006 BCP report, significant changes in ownership or controlling interests had to be approved by the SHCP. In 2008, LIC was amended to provide the CNBV with the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties. In this process, the CNBV imposes the same managerial and shareholder standards as it does for new authorizations outlined under CP 3.</p> <p>Pursuant to LIC Art. 17, transfers that lead to a shareholder achieving a 5 percent share or more in a financial institution have to be approved by CNBV. In addition, the applicant must submit personal information, income or financial statements over the last three years, and any information that establishes his honorability, credit history and business records. The CNBV can make inquiries of any public or private entity, or domestic or foreign authority about the applicant’s personal and business records.</p> <p>BoM’s opinion is required for all transfers of significant ownership. For an acquisition achieving, directly or indirectly, a 5 percent share or more, BoM’s opinion is mandatory but not binding. BoM’s opinion is binding for transfers that lead to a shareholder</p>

	<p>achieving 20 percent or more. In that case, a favorable opinion from the BoM is required. In this regard, in the assessors' view, the fact that CNBV is bound by the opinion of the Central Bank when an acquisition exceeds a specified benchmark undermines CNBV's discretionary power.</p>
	<p>The LIC requires the disclosure of information on intended equity holdings, and submission of statements to the effect that potential investors comply with the relevant requirements and are not impeded from acting as shareholders of the bank. In the case of legal persons, they must provide the identities of their 10 principal shareholders; with the provision that in the case of these being other legal persons, trusts or other investment vehicles, the direct or indirect investments of physical persons in these must be disclosed until the ultimate beneficiary owners of said participations are identified. (LIC: 17, CUB: 336, annexes 53 y 54).</p> <p>The LIC grants power to CNBV to prevent the beneficial ownership of any shares in a bank that were acquired in contravention of the banking laws. In particular, the LIC provides penalties for any changes in ownership that do not meet the criteria comparable to those used at the authorization stage.</p> <p>According to the CUB, Art. 207, banks are required to submit twice a year a report with the list of all shareholders above the 5 percent threshold, indicating the number and types of shares, according to a format included in the regulation.</p>
Essential criteria	
EC1	Laws or regulations contain clear definitions of "significant" ownership and "controlling interest."
Description and findings re EC1	Art. 17 of the LIC has an implicit definition of <i>significant ownership</i> , applicable when an individual or a legal entity, directly or indirectly, acquires 5 percent of the paid-in capital of a bank. The same Article 17 stipulates that when an individual or a group of persons plans to acquire 20 percent and above of the paid-in capital or plans to obtain control over the institution, approval by the CNBV is also required. The concepts of "control" and "group of persons" can be found in Art. 22 Bis and are broadly defined.
EC2	There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
Description and findings re EC2	<p>CNBV's notification or approval is required when changes in ownership or controlling interest are above a certain threshold. Any individual who wishes to purchase equities representing more than 2 percent of the paid-in capital of a bank must notify such purchase to the CNBV (Art. 14 of the LIC) within three working days following the transaction. Any acquisition or pledge above 5 percent of the equity capital of a bank requires the formal approval of the CNBV, which will take into consideration the opinion of BoM (Art. 17). In that case, the applicant will have to meet the criteria used for approving new banks as set forth in Art. 10, paragraph II. If the acquisition represents 20 percent or more of the paid-in capital, it will also require (i) CNBV clearance; and (ii) the "favorable" opinion of BoM.</p> <p>In addition, applicants have to meet not only the criteria set out in Art. 10, paragraph II, but also provide further details defined in LIC Articles 22 Bis-II on (i) the persons who will take control of the bank; (ii) the business plan; and (iii) all relevant information on the organization, administration and internal controls of the applicant. According to the</p>

	terms of Art. 17, section IV, entities shall be required to document all information that may be required by the CNBV in accordance with the terms and conditions it may establish.
EC3	The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.
Description and findings re EC3	In the previous FSAP, the team's recommendation was to enhance CNBV's participation in the review and authorization of changes in significant ownership or controlling interests that was being carried out by SHCP; there has been some improvement in this regard. The CNBV's capacity to object to any proposal for a change in significant ownership is implicitly contemplated in Art. 17, according to which the Commission has the "discretionary" power to grant its approval. One can infer from this that the CNBV can also deny an authorization if it considers that the potential shareholder does not meet the moral and solvency requirements established in the LIC.
EC4	The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert a controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.
Description and findings re EC4	Banks are required to prepare and send twice a year to the CNBV a report on the integration of capital, which includes the names and other relevant data of the shareholders, including the percentage of their participation in relation to the whole capital. Mexican banking regulation incorporates the expression "beneficial owners", although not as a formally defined concept (see the section on comments below). In the case of legal persons, they must disclose the identity of the 10 principal shareholders. In the case of these being other legal persons, a trust (<i>fideicomisos</i>) or other vehicle, the applicant should disclose the identity of the UBOs of said participations. (LIC: 17, CUB: 336, annexes 53 y 54).
EC5	The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.
Description and findings re EC5	According to LIC Art. 18, transfers of shares that aim to take control over a bank are void if CNBV's formal and previous approval has not been obtained. In addition, as set forth in Art. 108, the violation of any of the provisions of Art. 17 through the purchase of shares without CNBV's previous consent is subject to administrative sanctions (e.g., a fine equivalent to up to 15,000 days of salaries).
Additional criteria	
AC1	Laws and regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.
Description and findings re AC1	The assessors could not find such a requirement in the Mexican regime.
Assessment of Principle 4	Compliant
Comments	The 2008 reform has been an important improvement. The authorities may wish to consider the following comments to make the process even stronger:

- Provide the CNBV with more autonomy in the decision making process. CNBV does not enjoy full autonomy to approve the transfer of significant ownership. As explained above, it has to obtain the favorable opinion of BoM for transfer of ownership exceeding 20 percent. As a result, in case of negative opinion from the central bank, CNBV cannot proceed if it has a diverging view. The discretionary power of CNBV is exercised only when BoM issues a favorable opinion and the CNBV has a negative opinion. In that particular circumstance, CNBV can decide not to proceed if legal criteria are not met. Both cases, however, have never materialized.
- Supplement the fit-and-proper mechanisms with additional criteria. The process to verify the fit-and-proper requirements for BCP 4 are the same as those applied for opening a bank. As discussed in BCP 3, the assessors are inclined to think that the current processes could be complemented with additional requirements, particularly given the current local Mexican context (see BCP 18). According to the CUB (annexes 53 and 54), applicants who wish to take a significant or a controlling participation in a bank are required to provide information about their financial condition, assets and liabilities, and creditworthiness, among others. As far as their honorability is concerned, a *bona fide* declaration is made by means of a standardized letter in which applicants claim that they have never been indicted for offenses punishable by jail time of more than one year. The applicant is not required, however, to produce supporting evidence. CNBV told the assessors that further investigation is done by the Direction of Offenses. It would be good to have in the licensing file a trace of such inquiries and their results.

In the same spirit, it would be useful to keep in the files evidence that applicants have not been subject to suspicious transaction reporting. In this regard, CNBV asks the AML department to run several tests. It is suggested that an explicit document (from the Financial Intelligence Unit [FIU]) be kept on file so as to remove any doubt that there is no suspicious transaction report (STR) on money laundering/terrorist financing and no investigation regarding aspiring shareholders. Additionally, the authorities may wish to explore the possibility of including in the LIC a provision that either explicitly restricts the exercise of voting rights on investment-related matters by shareholders under suspicion of money laundering, or expressly prohibits such shareholders from injecting new resources into the institution with the intention of acquiring a significant share of its capital.

Regarding the origin of funds used for the acquisition of shares, there is a specific heading in the standardized form in which applicants have to indicate the origin of funds (personal resources or "others"). Annex 53 does not require further documentation (see BCP 3). Assessors were told that CNBV can request additional information from the internal revenue service (SAT) or the judiciary (*Procuracion de Justicia*), but the assessors could not verify whether this is a common practice.

In light of the above, the authorities may wish to consider formalizing the methods for processing a request for the transfer of significant ownership with a clear and broader list of supporting documents to be submitted (*mapa de proceso*).

- Promote a clearer definition of UBO. As already observed in CP3, a better definition of the concept of Ultimate Beneficial Owner would be desirable. There is no definition of such a concept, either in the LIC or in the CUB, with the exception of annex 53, which contains a footnote that requires a legal entity

	wishing to acquire a significant participation to disclose the identity of their shareholders, including individuals who are the UBOs. Beyond the mere declaration, the assessors could not find in the files evidence of a deeper investigation by CNBV in this regard, particularly for complex shareholding structures.
Principle 5	Major acquisitions. The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Summary description and findings re Principle 5	At the time of the 2006 FSAP, the SHCP was reviewing and approving major acquisitions or investments by banks, although the CNBV was providing its opinion on each request, which the SHCP historically followed. The situation improved in 2008 through a legal reform that transferred the power to review major acquisitions or investments from the SHCP to the CNBV.
Essential criteria	
EC1	Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval.
Description and findings re EC1	Limits on investments by banking institutions in nonfinancial firms are established in Article 75 of the LIC. For investments representing between 5 percent and 15 percent of paid-in-capital, the securities cannot be held for longer than three years without CNBV approval. If a majority of the members of a bank's Board of Directors decide to hold the investment for a longer period, the approval of the CNBV is required. Approval by the CNBV (with the nonbinding opinion of BoM) is required for investments that are more than 15 percent of a company's paid-in capital and for investments that are to be kept for longer than three years. The sum of a bank's investments in nonfinancial institutions shall not exceed 5 percent of the bank's deposit base. Article 88 of the LIC states that all investments in, and acquisitions of, companies that provide ancillary services require approval by the CNBV. Pursuant to Article 89 of the LIC, all investments in financial companies registered abroad, regardless of their amount, also require approval by the Commission. For the assessors, it is not clear whether CNBV gets a formal "no objection" from the home supervisor.
EC2	Laws or regulations provide criteria by which to judge individual proposals.
Description and findings re EC2	The LIC establishes clear criteria by which to judge individual proposals. The criteria are the amount and nature of the investment and the holding period; in order to exceed the initial limits described above, special approval by CNBV is needed. The law establishes that CNBV may allow investments for larger stakes or longer periods if the companies being invested in are developing long maturity projects or are carrying out development activities.
EC3	Consistent with licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision.
Description and findings re EC3	Investments in foreign financial institutions are regulated by Article 89 of LIC, and require previous CNBV approval. The article also stipulates that when a Mexican bank

	<p>owns at least 51 percent of the foreign financial institution's capital or has control over its Board or management, the Mexican bank shall ensure that the foreign institution adheres to the applicable foreign regulations and to the rules that Mexican financial authorities deem appropriate.</p> <p>Art. 89, paragraph 3 also stipulates the type of institutions in which Mexican banks are allowed to invest abroad.</p> <p>The same articles require applicants to provide indications on policies designed by the bank to resolve possible conflicts of interest that their conduct of operations with the public may cause.</p> <p>The procedure laid down in the LIC does not provide a framework through which the supervisor can ensure that no excessive risks are undertaken or that consolidated supervision is not hindered. In practice, however, the CNBV pays attention to these issues during the examination of the projected investment.</p>
EC4	The supervisor determines that the bank has, from the outset, adequate financial and organizational resources to handle the acquisition/investment.
Description and findings re EC4	As indicated by the CNBV, banks may carry out relatively small investments for relatively small periods of time; when the investments are to be kept for longer periods or involve the acquisition of financial entities abroad, CNBV authorization is required. The competent department in the CNBV analyzes the proposal to determine if the bank has adequate financial and organizational resources on the basis of documents provided by the applicant; it can reject the application if it is not satisfied with the proposal. CNBV has developed an internal procedure for processing and analyzing major acquisition applications, as well as a list of documentation and information that must be submitted along with the application.
EC5	Laws and regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.
Description and findings re EC5	Assessors could not find provisions where a notification after the acquisition applies.
EC6	The supervisor is aware of the risks that nonbanking activities can pose to a banking group, and has the means to take action to mitigate those risks.
Description and findings re EC6	Paragraph 6 of Article 75 requires banks to diversify their acquisitions as stipulated in LIC Art. 51, and in particular with respect to the rule of diversification of risks. Besides, such acquisitions or investments are subject to prudential measures or requirements as defined by the CNBV. As indicated by CNBV, any deviation from this requires supervisory assessment and approval.
Additional criteria	
AC1	When a bank wishes to acquire a significant holding in a financial institution in another country, the supervisor should take into consideration the quality of supervision in that country and its own ability to exercise supervision on a consolidated basis.
Description and findings re AC1	<p>Art. 89 of the LIC allows banks to acquire—directly or indirectly—participation in the capital of financial institutions located abroad. In that case, a previous authorization from the CNBV is required and the nonbinding opinion of BoM is sought. If CNBV deems the quality of the supervisory regime in the host country questionable, it can (i) deny the acquisition; or (ii) subject it to additional conditions.</p> <p>If equity participation abroad is considered to have the potential to reduce a bank's capital or significantly increase its risk profile, for example owing to the investee's</p>

	business, it is not clear whether CNBV may insist on remedial actions and/or recommend to host authorities that they take remedial action to address the situation. Such remedial action could include, for example, divestment of related equity participation or suspension of part or all of the subsidiary business.
Assessment re Principle 5	Compliant
Comments	In the 2006 FSAP, it was pointed out that responsibility for the review of a bank's investment should rest with CNBV and not with SHCP, or at a minimum CNBV should be consulted before the purchase was authorized. Since the 2008 LIC reforms, SHCP powers on this matter have been transferred to the Commission (see LIC Art. 75, 88 and 89).
Principle 6	Capital adequacy. Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
Summary description and findings re Principle 6	
Essential criteria	
EC1	Laws and regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio (CAR). Laws, regulations or the supervisor define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
Description and findings re EC1	<p>As currently regulated, the capital adequacy regime for banking in Mexico is in transition toward full implementation of the regime endorsed by the BCBS under its Basel II framework. The CNBV is also considering the adoption of some components of the Basel III framework, as well as full implementation of the Pillar 2 of the former Basel II regime (see CP7 and CP19).</p> <p>Article 50 of the LIC, and the Articles 2 (Bis) to 2 (Bis 119) of the main banking circular (CUB), mandate banking institutions to operate with a minimum net CAR equivalent to 8 percent of the sum of their equivalent risk-weighted assets for credit risk, market risk, and operational risk.</p> <p>At the time of the assessment, only one subsidiary of an international bank operating in Mexico had authorization from the CNBV to calculate capital under the IRB method for one segment of its loan portfolio. All other banking institutions calculate risk-weighted assets applying standardized methods for credit, market and operational risks (basic indicator).</p> <p>The market risk capital charge under the standardized approach incorporates a charge for market risk in the full banking book (see CP13). This charge is calculated applying standard VaR based coefficients to that broader book. This charge approximates a charge for interest rate risk in the banking book. On average, the latter charge amounts to about the same amount that would be required for market risk in the trading book.</p>

	<p>Since the introduction in 2007 of the current capital regime, risk-weighted assets for credit risks have not experienced any abnormal fluctuation denoting artificial reduction of risk-weighted assets for credit risk to accommodate the new charge for operational risk under the basic indicator.</p> <p>This confirms the opinion of the assessors that the current capital regime, as implemented by the CNBV in the CUB, has not used national discretion options to reduce capital charges applied to retail segments.</p> <p>In practice, given the thresholds of undercapitalization established by Article 220 (Fifth Title, Chapter I on Early Warnings) of the CUB, institutions are required to operate above the 10 percent level to remain outside the scope of the prompt corrective actions applicable to the second category of under-capitalized banks (CP23).</p> <p>The institutions send monthly to the BoM the information necessary to calculate their CAR. The BoM performs such calculation and forwards the CARs to the CNBV every month. The CNBV makes public the CAR reported by banks and the category to which they are graded (see above Article 222).</p> <p>This practice creates peer pressure to operate well above the 10 percent level indicated in the previous paragraph. There is also an informal indication that dividend distribution is permitted only when institutions operate at or above the 12 percent CAR level. The banking system was operating with an average CAR of over 15.5 percent as of May 2011.</p> <p>As of June 2011, all commercial banking institutions were classified in category I since they were all operating with a reported CAR above the 12 percent level, according to the list made public by the CNBV on its website per mandate of Article 221 of the CUB. Thirty out of 42 banks are reporting a CAR above 15 percent, and only five banks are reporting less than 13 percent.</p> <p>Articles 2 (Bis 5) to 2 (Bis 9) of the CUB define the components of 'net capital' consistent with the Basel II standards, composed of two segments: (1) 'base capital' (87.3 percent contribution to total net capital); and (2) 'complementary capital' (12.7 percent contribution to total net capital).</p> <p>Base capital must be equal to or exceed 50 percent of the combined net capital. Since December 2005, the contribution of average base and complementary capital to net capital has been 90.6 percent and 9.4 percent, respectively. As of May 2011, the contribution was 87.3 percent for base capital, and 12.7 percent for complementary capital.</p> <p>The definition and the components of base capital include equity capital, retained earnings, other capital contributions, as well as a very small number of eligible capitalization instruments authorized as per Article 64 of the CUB. All these elements of base capital are reported net of provisioning deficits and a very complete set of capital deductions fully aligned to those required under the new Basel III framework. These deductions, which include all unconsolidated participations in subsidiaries at a solo bank level, represent about 10 percent of the total eligible instruments included in the base capital.</p> <p>Subject to strict conditions set in Article 64 of the LIC, and the eligibility criteria required by Articles 2 (Bis 6) and 134 of the CUB, these capitalization instruments include voluntary and obligatory convertible instruments, and nonconvertible. Based on all the above considerations, the assessors conclude, without time for more</p>
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analysis, that the current capital adequacy regime as implemented by the CNBV in the CUB is consistent with international practices. nonpreferred instruments where the cancellation of interest and debt service can be decided by the institution per explicit contractual clauses. As of May 2011, eligible debt instruments computed as base capital contributed only 4.6 percent of the total base capital reported by banking institutions.

Given the deductions included in base capital (14 percent of all other eligible base capital instruments) and the contribution of equity shares and retained earnings in the base capital (above 100 percent before deductions), the assessors conclude that the quality of base capital is high and sound. As currently defined, base capital is a direct comparable measure to Tier 1 capital under the new Basel III regime.

As of May 2011, pure capital instruments and retained earnings, net of mandatory deductions, represented for the whole Mexican banking institutions 12.1 percent of the sum of all risk-weighted assets. On average, since December 2005, the same relationship has been 13 percent.

As indicated above, the CNBV has been prudent in using its national discretion. It has maintained a minimum standardized risk weight of 75 percent for household mortgages. It has maintained a 100 percent risk weight for the segment of small and medium enterprises. It has applied a 125 percent risk weight for past due loans.

However, it has kept a zero risk weight for OECD countries' sovereign debt and their central banks rather than mapping them to external ratings. This last risk weight does not segregate local from foreign currency. Moreover, it calculates capital charges for counterparty credit risk based on current exposures rather than using the equivalent average expected exposure for derivative instruments. Accordingly, Mexican debt in foreign currency attracts currently a zero risk weight capital charge. The assessors have not quantified the effect of these differences from the Basel II regime.

Except for the latter deviations from the Basel II regime, all other aspects applicable to risk weights appear to the assessors consistent with the latter capital regime.

As of May 2011 (and on average since December 2005), the structure of metrics for reported capital adequacy and risk-weighted assets (RWA) under current regulations for all 42 banking institutions, as calculated by the assessors, were as follows:

- (1) Net equity to total un-weighted total assets: 10.2 percent (average of 9.7 percent);
- (2) Reported eligible capital instruments to RWA: 15.6 percent (average of 16.3 percent);
- (3) Base capital (Tier Capital 1) to RWA: 12.1 percent (average of 13 percent);
- (4) Sum of RWA to un-weighted total assets: 67.4 percent (average of 60.1 percent);
- (5) Contribution of credit risk to total RWA: 55.2 percent (average of 62.1 percent);
- (6) Contribution of market risk to total RWA: 22.1 percent (average of 31.5 percent);
- (7) Contribution of operational risk to total RWA: 22.6 percent (average of 5.4 percent);
- (8) Contribution of the RWA of loans to credit RWA: 73 percent (average of 71 percent).

	The CNBV is being requested to approve more advanced methods to calculate capital, and the assessors encourage the CNBV to maintain the same level of commitment.
EC2	At least for internationally active banks, the definition of capital, the method of calculation and the ratio required are not lower than those established in the applicable Basel requirement.
Description and findings re EC2	Per the above discussion, as worded in CNBV regulations and implemented in practice, current capital adequacy regulations appear fully aligned with applicable Basel requirements.
EC3	The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures.
Description and findings re EC3	Article 2 (Bis 117) of the CUB provides explicit powers to the CNBV to require individual banking institutions to operate with a CAR above the minimum capital, subject to the binding opinion of the BoM. This power has not yet been publicly used.
EC4	The required capital ratio reflects the risk profile of individual banks. Both on-balance sheet and off-balance sheet risks are included.
Description and findings re EC4	All assets and off-balance sheet assets are currently part of the calculations required to determine the risk-weighted assets, including charges for credit risk, market risk and operational risk. Subject to comments above in the EC1, all banks follow standardized approaches to calculate RWA for the three risks.
EC5	Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, laws and regulations in a particular jurisdiction may set higher capital adequacy standards than the applicable Basel requirements.
Description and findings re EC5	In practice, the CNBV has required banking institutions to operate above the minimum 8 percent CAR. As described above in EC1, institutions must operate above 10 percent to avoid falling into the prompt corrective actions foreseen in Article 220 of the CUB (Fifth Title, Chapter I on Early Warnings). In practice, a minimum CAR of 12 percent is suggested for institutions willing to distribute dividends. In practice, using peer pressure through the monthly publication of the CAR reported for all the banks, commercial banks tend to operate above the 15 percent CAR level (see EC1 above).
EC6	Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
Description and findings re EC6	By means of the prompt corrective actions instituted in Articles 225 to 237 of the CUB (Fifth Title, Chapter I on Early Warnings), the CNBV has established an objective regime of early intervention (see CP23).
EC7	Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.
Description and findings re AC7	The use of internal models for determining capital charges for credit risk is well regulated by Articles 2 (Bis 65) to Article 2 (Bis 95) of the CUB. The regulatory standards and conditions are consistent with the requirements promoted under the Basel II regime. A number of annexes specify the relevant conditions for estimation of inputs, length of data series, calibration, validation and back-testing, including Annex 01-L 18P that

	<p>specifies requirements for the IRB foundation methods, and Annex 01-M 15P that specifies requirements for the IRB advanced methods.</p> <p>The CNBV has powers to order amendments, to extend parallel runs, to suspend and to apply standardized methods, as well as to revoke its approval of internal assessments per the following articles of the CUB: Art. 2 (Bis 66 II paragraph 2); 2 (Bis 68 last paragraph); 2 (Bis 72 and 88); and 2 (Bis 97). Given the small number of IRB approved methods, these powers have still not been used in practice.</p>
Additional criteria	
AC1	For non-internationally active banks, the definition of capital, the method of calculation and the capital required are broadly consistent with the principles of applicable Basel requirements relevant to internationally active banks.
Description and findings re AC1	The definition of capital and the methods of calculations are the same regardless of the type of banking institution and were found to be consistent with the applicable Basel requirements as discussed in EC1 above.
AC2	For non-internationally active banks and their holding companies, capital adequacy ratios are calculated and applied in a manner generally consistent with the applicable Basel requirement, as set forth in the footnote to the Principle.
Description and findings re AC2	The same as EC1 above. Capital adequacy for regulated holding companies follows a building block approach, where the capital needs of the latter companies must be equal to or higher than the sum of the capital needs of the members of the group, as per their respective financial sector regime, including any existing deficits.
AC3	The supervisor has the power to require banks to adopt a forward-looking approach to capital management and set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect.
Description and findings re AC3	<p>Such power is implicit in the CUB, which requires banking institutions to be stress tested for individual risks (credit, market and liquidity) as discussed in other CPs and in CP7.</p> <p>The new amendments under discussion with the industry (see CP14 on liquidity risk) will add to the CUB the need for banks' Boards to provide an explicit statement of their risk appetite and the corresponding risk management measures, taking into consideration the results of formal stress test exercises.</p> <p>The obligation to factor stress tests into the internal capital adequacy assessment process, as required under Pillar 2 of Basel II, will need to be made more explicit in the amendments being discussed with the industry (see CP14 and CP19).</p>
AC4	The supervisor requires adequate distribution of capital within different entities of the banking group according to the allocation of risks.
Description and findings re AC4	<p>The CNBV confirmed to the assessors that such an explicit legal requirement is not yet available in the CUB.</p> <p>In practice, the regime for deductions instituted in Article 2 (Bis 7) of the CUB achieves indirectly this purpose, by ensuring that capital excess in one entity is not used to compensate for capital needs in another entity of the group. Moreover, as part of its offsite analysis of financial groups, the CNBV monitors this condition, taking into account the still low contribution to regulated financial groups of their nonbank financial entities.</p>

	The assessors have suggested amendments to the LAF, which provides powers to the SHCP for regulating holding companies. These amendments can be utilized in the banking laws to explicitly require the adequate distribution of capital resources across a group.
AC5	The supervisor may require an individual bank or banking group to maintain capital above the minimum to ensure that individual banks or banking groups are operating with the appropriate level of capital.
Description and findings re AC5	The CNBV has powers to satisfy this additional condition provided under Article 2 (Bis 117). In addition, Article 2 (Bis 97) provides similar powers. Further powers will be necessary per amendment of the LAF (see CP24) to elevate the referred powers to the level of the holding companies regulated by the SHCP, including to unregulated mixed-activity holding companies placed above the regulated financial groups (see CP24).
Assessment re principle 6	Compliant
Comments	<p>Since 2005, the CNBV has advanced decisively and with sound rigor the regulatory and supervisory framework necessary to conform to the requirements of the capital adequacy regime promoted by the BCBS under the Basel II capital regime. In addition, the CNBV has put in place explicit and implicit mechanisms to encourage institutions to operate with higher capital than the Basel minimum requirements. The assessors would like to praise the progress achieved to date.</p> <p>The following actions, as suggested by the assessors in the corresponding CP, will further support the implementation of this principle:</p> <ul style="list-style-type: none"> • Implement fully the Pillar 2 approach and the use of stress testing to set capital buffers (CP7); • Mandate institutions to operate an internal capital adequacy assessment process (ICAAP); • Explicitly adopt metrics to require capital for concentration and other risks under Pillar 2 (CP7); • Amend the capital rules for counterparty credit risk to consider the equivalent expected exposure for derivative instruments rather than the current market value of a contract.
Principle 7	Risk management process. Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
Summary description and findings re Principle 7	
Essential criteria	
EC1	Individual banks and banking groups are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. The supervisor determines that these processes are adequate

	<p>for the size and nature of the activities of the bank and the banking group and are periodically adjusted in the light of the changing risk profile of the bank or banking group and external market developments. If the supervisor determines that the risk management processes are inadequate, it has the power to require a bank or banking group to strengthen them.</p>
<p>Description and findings re EC1</p>	<p>The responsibilities of directors and officers in ensuring conformity with risk management standards are regulated in the CUB (secondary legislation), though not explicitly indicated in the LIC (primary legislation). This situation could have implications in terms of enforcing their fiduciary responsibilities in observing the risk management standards mandated by the CUB and treating breaches of the risk management rules as a penal offense in the most egregious cases. The enforceability of these responsibilities is a crucial cornerstone elsewhere for effectively implementing risk based supervision (See CP 1(1) EC3).</p> <p>The CUB specifies the role and responsibilities of the Board and senior management (Articles 68 and 69) regarding risk governance and management. These articles require the establishment of a risk committee (Article 70) made up of at least two directors, the general manager, and the heads of risk management and internal audit. Banks are directed to establish a risk management unit (Article 71). The independent nature of the directors serving in this committee is not specified by the CUB. The general composition of the Board as a whole, as established by Article 22 of the LIC, consists of at least 5 to 15 members, of whom at least 25 percent must be independent.</p> <p>The CNBV is aware of the need to adopt 'proportionality' criteria and procedures to differentiate between less and more complex institutions regarding internal governance and risk management standards. This interpretation is left to the judgment of supervisors, as reflected in their respective expectations regarding compliance with the current regulations.</p> <p>Bank Boards are required to review, at least annually, the risk limits and the overall objectives and policies for risk management (Article 69).</p> <p>The reform being prepared to adopt the new liquidity risk standards promoted by the BCBS (see CP14) will fully align the prevailing regulations that govern risk management with international standards. Among these reforms, there are three fundamental components that, once implemented, will reinforce the framework for risk management: (1) the requirement from directors to provide an explicit expression of their risk appetite; (2) the need for internal policies, risk measurement, and information systems to be unequivocally related to the latter risk expression; and (3) the obligation of directors to engage in more frequent and in-depth stress testing in order to fully incorporate a forward risk perspective to risk management.</p> <p>The assessors encourage senior management to use the opportunity of these reforms to fully institute all the components of Pillar 2 that have not still been adopted, including explicit reference to all Pillar 2 risks not captured under Pillar 1.</p> <p>Article 76 of the CUB requires an annual review by the internal audit unit of the risk management processes, including related risk management manuals and the validation of associated models and information systems. In addition, the institutions are required (Article 77) to perform a technical review every two years conforming to the scope of Annex 12 (which focuses on the integrity of risk data and modeling).</p>

	<p>Both reports are to be submitted to the Board of Directors and, subsequent to their approval, forwarded to the CNBV for the purposes of its supervisory processes.</p> <p>Article 78 of the CUB specifies the general aspects to be considered as part of the risk management processes in general. Articles 79 to 86 set out the detailed requirements for each of the core risks (credit, liquidity, market for both the trading and banking books, and operational risk), as discussed in each relevant CP in this document. Article 87 mandates appropriate risk management information and systems, and Article 88 sets out the adequate scope of related public disclosures.</p> <p>The requirements listed above apply to all the financial institutions within a regulated group under the supervision of the CNBV. However, the degree of convergence with the standards required of insurance and pension fund management companies is still evolving, as they are under the supervision of other sector supervisors (CNSF and CONSAR).</p> <p>In order to better communicate to the industry its expectations regarding the features of risk management that the CNBV expects to see in operation, including to share the manner in which it intends to supervise risk management processes, the Board of the CNBV would like to publish more detailed guidelines on best practices that are similar to applicable Basel Committee of Banking Supervisors (BCBS) documents.</p> <p>The powers of the CNBV to explicitly require strengthening of risk management processes are established in the CUB. The assessors were provided with examples of how these powers are being used in practice. There were no cases available for review where the CNBV had used its general powers to increase capital above the minimum required capital adequacy level.</p> <p>The assessors note that there are no standards for the risk management of regulated holding companies similar to those required of banks acting as parents in a banking group.</p>
EC2	<p>The supervisor confirms that banks and banking groups have appropriate risk management strategies that have been approved by the Board. The supervisor also confirms that the Board ensures that policies and processes for risk-taking are developed, appropriate limits are established, and senior management takes steps necessary to monitor and control all material risks consistent with the approved strategies.</p>
Description and findings re EC2	<p>The CNBV confirms the above conditions by two different means: (1) the annual risk focus inspections and the specialized inspections led by the CNBV risk focus supervisory process in operation since 2007 (see CEFER, CP19); and (2) the offsite review of the internal audit and the bi-annual review reports indicated in EC1 above.</p> <p>To support the assessment of risk management by the three institutional vice-presidencies responsible for the supervision of regulated institutions, the CNBV created in 2007 a fourth technical vice-presidency that supervises risk (see CP19), currently staffed with 203 supervisors. Sixty of these are responsible for data management and the financial analysis of institutions. The remaining 143 staff are specialized supervisors in: (a) IT and operational risk (60 specialists); (b) quantitative techniques, modeling and risk measurement (35 specialists); (c) risk governance of credit, market and liquidity risk (23 specialists); and (d) market conduct and sales practices (25 specialists). All of these supervisors have a good academic background and some experience, and the assessors found those with whom they interacted very knowledgeable.</p>

	<p>The combined work of both these four vice-presidencies provides the CNBV with the manpower to review onsite and quantify offsite implementation of the risk management regulations.</p> <p>Notably, CNBV is spearheading the implementation of robust risk measurement based on rich data warehoused by the CNBV, including the development of advanced approaches to credit and market risk measurement to review and challenge the estimations made by the institutions.</p> <p>The assessors note that there are no standards for supervising the risk management of regulated holding companies similar to those required of banks acting as parents in a banking group.</p>
EC3	<p>The supervisor determines that risk management strategies, policies, processes and limits are properly documented, reviewed and updated, communicated within the bank and banking group, and adhered to in practice. The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of and authorization by the appropriate level of management and the Board where necessary.</p>
Description and findings re EC3	<p>The CNBV determines proper documentation and adherence as per the above activities by means of its risk focus approach to supervision (see CEFER, CP19) with reasonable frequency and depth of coverage as per the rated risk profile of the institutions.</p> <p>Per Article 71 IV and V, the risk committee is bound to report to the Board exceptions to risk limits and implemented corrective actions. These are reviewed by the CNBV with reasonable frequency through the activities indicated in EC2 above.</p> <p>The three vice-presidencies that supervise institutions follow a detailed onsite procedure ('bitacora') to establish compliance with the provisions on risk management. This procedure explicitly directs supervisors to determine diligence by the Board in approving risk documentation and exceptions. The vice-presidency that supervises risk follows a procedure to evaluate the actual level of implementation of risk management activities.</p> <p>There are opportunities to make both procedures, which assess compliance with and substantive implementation of risk management practices, more consistent in their approach and to coordinate their rating criteria.</p> <p>The assessors note that standards for risk management need to be extended to regulated holding companies and made similar to those required of banks acting as parents in a banking group.</p>
EC4	<p>The supervisor determines that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. The supervisor also determines that senior management ensure that the risk management policies and processes are appropriate in the light of the bank's risk profile and business plan and that they are implemented effectively. This includes a requirement that senior management regularly reviews and understand the implications (and limitations) of the risk management information that it receives. The same requirement applies to the Board in relation to risk management information presented to it in a format suitable for Board oversight.</p>
Description and findings re EC4	<p>The CNBV still needs to provide the institutions with detailed guidance on its expectations regarding the scope and depth of their internal capital adequacy assessment programs (ICAAP).</p>

	<p>Besides the general requirement of Article 65, there is the need to (i) put in place explicit requirements for the Board and senior management to operate an ICAAP that explicitly relates risk assessments to capital needs, including the effect of stress testing scenarios; and (ii) develop a strategy to maintain capital adequacy at the envisaged level of risk going forward.</p> <p>The risk management unit is required by Article 74 VII of the CUB to calculate the capital risk requirements of the institution in order to comply with existing regulations on Pillar 1 capital, as currently regulated. Pillar 2 risks and the ICAAP remain to be implemented and related to the whole of the supervisory review process (see CP19).</p> <p>The CNBV requires (CUB Articles 76 and 77) from the Boards an annual audit and a bi-annual review of the risk management process. The latter is limited to the reliability of data and systems for estimating capital at risk as regulated. The Board must acknowledge both reports, which must be forwarded to the CNBV. This makes the Board responsible for reviewing and understanding the risk profile of their institution, but the approval of the risk appetite is not yet explicit. The information system supporting the risk management process is an integral part of both reviews.</p> <p>The CNBV determines, by means of the activities indicated in EC2 above, that the Board and senior management are aware of the reports prepared by the risk management and internal audit unit.</p>
EC5	<p>The supervisor determines that the banks have an internal process for assessing their overall capital adequacy in relation to their risk profile, and reviews and evaluates bank's internal capital adequacy assessments and strategies. The nature of the specific methodology used for this assessment will depend on the size, complexity and business strategy of a bank. Noncomplex banks may opt for a more qualitative approach to capital planning.</p>
Description and findings re EC5	<p>Article 65 of the CUB requires institutions to have in place mechanisms for ensuring that their activities are conducted in accordance with risk levels that are consistent with their respective capital.</p> <p>However, as indicated in EC above, there are no explicit regulatory requirements, including guidance for banks to operate an ICAAP, by which the Board determines its overall capital adequacy assessment and strategy. The amendments to the CUB for adopting the Basel III liquidity risk standards provide the opportunity to incorporate ICAAP into the Mexican regulatory regime for banking.</p> <p>Under Article 64 and 117 of the CUB, the CNBV may require a particular bank to operate with additional capital requirements. However, the grounds for requiring incremental capital do not explicitly include deficiencies in risk management processes.</p>
EC6	<p>Where banks and banking groups use models to measure components of risk, the supervisor determines that banks perform periodic and independent validation and testing of the models and systems.</p>
Description and findings re EC6	<p>The Articles 75 IV, 76 V and 76 VI of the CUB, respectively, require the risk management unit and the internal audit unit to prepare an annual review of models and systems, as well as to report findings to the risk management committee. In addition, Article 77 requires a bi-annual review of all technical aspects as per the contents of Annex 12, which includes the methodologies for risk measurement, models and data validation.</p> <p>Through the review of the annual audit report and the bi-annual report, including ad-hoc target onsite visits, the CNBV determines the adequacy and independence of</p>

	<p>model validation work. In addition, the quantitative risk experts of the Technical vice-presidency that supervises risk (see above EC2) review and validate data and models in the course of their activities.</p> <p>The assessors have been provided with examples of CNBV's responses to identified deficiencies, including its follow-up in regard to the remedial action taken by the Board and senior management of institutions.</p> <p>The assessors note that there are no standards for regulated holding companies comparable to those required of banks acting as a parent of a banking group.</p>
EC7	The supervisor determines that bank and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is satisfied that these reports are provided on a timely basis to the Board or senior management and reflect the bank's risk profile and capital needs.
Description and findings re EC7	<p>The determination of the adequacy of information systems is done annually by means of (i) the offsite review of the reports indicated in EC1; (ii) the annual risk focused inspection; and (iii) specialized onsite inspections.</p> <p>Since 2009, there have been about 45 targeted and annual risk focused inspections whose scope have included the information systems associated with risk management. The assessors have been presented with several cases, including cases of subsidiaries of foreign banks, where the CNBV has responded to deficiencies and related operational and system risks and initiated appropriate remedial action.</p> <p>The assessors note that there are no practices for supervising regulated holding companies similar to those applied to banks acting as a parent of a banking group.</p>
EC8	The supervisor determines that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board.
Description and findings re EC8	<p>Article 74 IX of the CUB requires the risk management unit to analyze and report to the risk committee any risk related to new products, services, and activities. Article 78 VII requires institutions to have in place an explicit process to approve new products and services, including the means and procedures for the risk management unit to identify, measure, monitor, control, and report risk associated with such new products, as well as to obtain appropriate legal advice.</p> <p>The CNBV is responsible for determining adherence to these requirements as per the practices discussed in EC1 to EC4. Apart from coverage under the annual inspections in 2009 and 2010 that focused on the processes for managing credit card activities, since 2010 the CNBV has conducted 19 target inspections where the process for approval of new products has been reviewed explicitly. This included a number of observations and suggestions to strengthen the segregation of duties and to improve the reporting of risks to the Board. The assessors have been provided with a sample of reports and observations that provides sufficient evidence to satisfy the requirements of this EC.</p>
EC9	The supervisor determines that banks and banking groups have risk evaluation, monitoring and control or mitigation functions with duties clearly segregated from risk-taking functions in the bank, and which report on risk exposures directly to senior management and the Board.
Description and findings re EC9	Among other requirements, Article 78 of the CUB requires institutions to have an appropriate organizational structure for their risk management activities. For such purposes, Article 73 of the CUB requires institutions to have an internal risk management unit that is independent from the business units and free of conflicts of

	<p>interest, and charged with a complete list of functions and responsibilities as per Articles 74 and 75 of the CUB. The risk management unit is responsible for reporting to the risk committee and forwarding a suite of periodic reports to this committee, to the business units, to senior management, and to the Board of Directors.</p> <p>The CNBV is responsible for determining adherence to these requirements as per the practices discussed in EC1 to EC4. As mentioned above, the CNBV has provided the assessors with examples of reports and observations regarding the coverage of this EC.</p> <p>Current regulations and risk management standards are only applicable to the banking level group. These regulations do not apply yet formally to the full financial group headed by a regulated holding company licensed by the SHCP. The Law on Financial Groups ('Ley de Agrupaciones Financieras' or LAF) should be amended in this respect.</p>
EC10	The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.
Description and findings re EC10	<p>Except for the regulations of Articles 79 to 86 of the CUB, the CNBV has not issued additional applicable standards.</p> <p>However, the CNBV is internally compiling the basic features of the diverse practices observed as part of its supervisory activity.</p> <p>The CNBV is aware of the need to (i) compile and develop more detailed benchmark standards to guide its supervisors, including advanced indicators; (ii) make a distinction between the standards required of large complex and simpler institutions; and (iii) disseminate to the industry more detailed evolving local and international practices and lessons.</p> <p>The decision to publicly endorse the standards for risk management and supervision of the Basel Committee is an alternative to speed up the process of communicating standards to the industry.</p>
Additional criteria	
AC1	The supervisor requires larger and more complex banks to have a dedicated unit(s) responsible for risk evaluation, monitoring and control or mitigation for material risk areas. The supervisor confirms that this unit (these units) is (are) subject to periodic review by the internal audit function.
Description and findings re AC1	All entities regardless of their size are required to have a dedicated risk management unit and to submit their risk management process and the responsible risk management unit to annual audit (see above EC1 to EC4).
AC2	The supervisor requires banks to conduct rigorous, forward-looking testing that identifies possible events or changes in market conditions that could adversely impact on the bank.
Description and findings re AC2	The CNBV requires the institutions to perform annual stress tests for the risk classes that have been regulated. The results of the stress test are cross-checked by the supervisors of the technical vice-presidency that supervises risk. As a result of the stress exercises performed, the CNBV has a reasonable assessment of the sensitivity of capital to stressed scenarios on credit and market risk. The stress tests performed are not formally integrated into the ICAAP for formal consideration so that the Boards can plan capital needs going forward.

AC3	The supervisor requires banks and banking groups to have in place appropriate policies and processes for assessing other material risks not directly addressed in the subsequent CPs, such as reputational and strategic risks.
Description and findings re AC3	Reputational and strategic risks are subject to specific regulatory standards under the assessment of the operational risk conducted by the CNBV. However, further guidance should be provided to supervisors and to the regulated institutions. Other Pillar 2 risks such as concentration and residual risks by association to broader mixed-activity groups should be also reviewed, including specific consideration within the supervisory review and evaluation process (see CP19).
Assessment of Principle 7	Largely Compliant
Comments	<p>The opinion of the assessors is that the following actions are necessary to reinforce compliance with the essential and additional conditions of this principle:</p> <ul style="list-style-type: none"> • Amend the LIC to mandate the risk governance duties and responsibilities of directors (EC1); • Adopt criteria and provide guidance for supervisors to apply the proportionality judgment to differentiate between large complex and more simpler business models (EC1); • Achieve better consistency between the inspection procedures used to assess compliance and substantive implementation of risk management practices, including the criteria for rating EC3; • Communicate explicit standards for directors to implement the internal capital adequacy assessment process (ICAAP) governing forward looking capital planning (EC5); • Amend the LAF to require consistent risk management standards at the group level, including for local holding companies and significant nonbanking institutions within a group (EC9); • Communicate more detailed standards of best observed risk management practice (EC10); and • Alternatively, publicly endorse the standards of the Basel Committee on each risk (EC10).
Principle 8	Credit risk. Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
Summary description and findings re Principle 8	
Essential criteria	
EC1	The supervisor determines, and periodically confirms, that a bank's Board approves, and periodically reviews, the credit risk management strategy and significant policies and processes for assuming, identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The supervisor also determines, and

	periodically confirms, that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.
Description and findings re EC1	<p>The CNBV determines periodically the suitability of credit risk management processes and applicable policies by means of: (1) the annual risk focus and specialized onsite inspections of the institution's activities; and (2) the evaluation of the annual reports issued by the risk management and internal audit units.</p> <p>Internal audit reports and opinions are reviewed periodically by the assigned supervisors from the institutional vice-presidencies, as well as by dedicated risk specialists from the technical vice-presidency. Associated work programs and working papers are reviewed ex-post by assigned supervisors during inspections as determined in the inspection work program.</p> <p>The administration records of the CNBV do not yet allow an estimation of the supervisory work applied to this area, since the current system only identifies allocation of work by institution per year rather than also by supervisory activity. The annual inspections are planned using MS Project Manager (MSPM). The project spreadsheets reviewed by the assessors indicate that a reasonable amount of time and staff was allocated to perform the required activities for the explicit and well-constructed work programs.</p> <p>CNBV could operate a comprehensive costing system by fully utilizing the features of MSPM, standardizing and codifying all relevant activities required across a supervisory cycle (see suggestions under CP19 and CP20), and entering into MSPM the actual work undertaken and any extensions granted.</p> <p>By this means, the CNBV could track the cost of supervision by downloading the planned and actual costs of each relevant onsite inspection and offsite activity into a database. This would also allow the CNBV to: (1) track the work load across a supervisory cycle; (2) identify functional activities and central functions not fully inspected across a cycle; (3) identify stress areas where the work load is insufficient or below average standard cost; and (4) estimate the current and anticipated work load and associated needs for varying degrees of depth and scope. Senior management will be better placed to involve the Board in discussing the trade-off between scope, extension and risk focus.</p> <p>Institutions report to the CNBV on credit risk activities by means of a suite of reports as indicated in CP9 and CP21. These reports are warehoused in the institutional systems of CNBV and utilized to elaborate a series of analytical reports and indicators that allow monitoring offsite a number of dimensions of credit risk concentration exposures (see CP 10 and 11). This includes a good panel of reports that facilitate support of offsite and onsite work, as well as a series of risk metrics at the transaction, borrower and portfolio level.</p> <p>The risk metrics commonly used are discussed in CP9. The CNBV would like to explicitly use the key metrics extracted from the system for rating the risk profile of the institutions, as a proxy 'entry note' for quantity risk, including as an early warning indicator.</p> <p>In practice, based on its annual inspection program, and considering the risk rate profiles of the activities for each credit segment, the CNBV ensures at least one target review of credit risk every year. For such a review, normally all credit segments are evaluated, including the credit risk processes associated with each segment, from strategy to policies and systems.</p>

	<p>The assessors have been given evidence of appropriate exceptions to the above inspection practices, such as when higher risks have been identified. Thus, initially planned work has been extended and, occasionally, unscheduled inspections have been triggered by offsite monitoring.</p> <p>Testing of compliance with bank approved policies is achieved through compilation of exceptions during transaction testing of individual loan files. In addition, using their respective procedures to evaluate compliance and assess effective implementation, the supervisors of the Institutional and the technical vice-presidencies evaluate actual credit risk management practices. Both procedures (evaluation of compliance and assessment of implementation) could be better integrated in practice.</p> <p>Onsite reviews are performed as per the procedures listed in the Institutional Manual of Supervision (MIS). The objectives, internal control questionnaires, review programs and reporting requirements of the MIS will need to be made consistent with the risk based approach to supervision, without reducing their scope and valuable detailed assessments. Control points to test the effectiveness and reliability of management and control systems should be better presented to supervisors, who should be provided with reasonable guidance to evaluate and provide an objective opinion on the subject.</p> <p>More importantly the two cultures of supervision that coexist today (condition-cum-compliance, versus risk based reliance on systems and controls) need to be carefully blended, since both are necessary depending on a concrete situation. Accordingly, the compliance review checklists (“bitacoras” de cumplimiento) used by the institutional vice-presidencies and the risk assessment procedures used by the technical vice-presidencies need coordination or integration.</p> <p>As a consequence of the review work performed, the CNBV initiates formal or informal actions, as the case might require. The assessors have been provided with examples where the CNBV requires institutions to remedy deficiencies noted in their credit risk management process. Follow-up of progress by the institutions in remedying the deficiencies noted is performed by a mix of onsite and offsite activities.</p>
EC2	<p>The supervisor requires, and periodically confirms, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:</p> <ul style="list-style-type: none"> - a well documented strategy and sound policies and processes for assuming credit risk; - well defined criteria and policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures; - effective credit administration policies and processes, including continued analysis of a borrower’s ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank’s activities or, at the least, with the asset grading system prescribed by the supervisor; - comprehensive policies and processes for reporting exposures on an ongoing basis; - comprehensive policies and processes for identifying problem assets; and

	<ul style="list-style-type: none"> - prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits, approvals and exceptions to limits.
Description and findings re EC2	<p>Appropriate requirements consistent with the essential conditions listed are mandated with reasonable scope and depth as per the following articles of the CUB:</p> <ul style="list-style-type: none"> • Article 78 that sets in place 10 basic principles regarding de-minimis expectations for risk management in terms of objectives, policies, limits and approvals; and, • Article 80 that sets in place 15 basic principles regarding de-minimis expectations for credit risk management. In addition, Chapter I, Articles 3 to 37, of the Second Title of the CUB, set in place detailed standards expected from institutions regarding their credit risk activities including: organization, phases, guidelines and policies, delegations and committees for credit approval, supporting infrastructure and controls, credit origination and analysis, loan administration, internal roles, responsibilities and delegations, loan recovery, and detail internal audit review aspects (Articles 30 to 32). <p>Moreover, Article 9 requires the risk committee or the audit committee to review the credit manual of the institution, in addition of the annual review work required from the risk management and audit units.</p> <p>Confirmation by the CNBV of compliance with the above requirements is performed according to the supervisory activities discussed in EC1 above.</p> <p>In addition, per Article 38, the CNBV is empowered to require additional provisions for individual loans which do not comply with regulation or internal policy, or depart from sound and safe banking practice. The assessors have been provided with a number of cases where these powers have been used to mitigate accumulation of risks.</p> <p>Current regulations appear very comprehensive to the assessors, including the level of sampling reviewed as per the inspection work programs that the assessors have reviewed. This good practice confirms the diligence with which effective implementation is evaluated.\</p> <p>The CNBV could consider compiling details of unacceptable practices deemed unsafe and unsound, which will be the subject of supervisory action. This could include providing institutions with further guidance regarding credit risk management and supervision, for example by publicly endorsing the various standards of the Basel Committee on the subject.</p>
EC3	<p>The supervisor requires, and periodically confirms, that banks make credit decisions free of conflicts of interest and on an arm's length basis.</p>
Description and findings re EC3	<p>Several Articles (3, 4, 8, 14, 17 and 19) of the Chapter I (Second Title) of the CUB specify that lending activities be conducted free of conflicts of interest.</p> <p>Article 73 VII (4th paragraph) of the LIC requires that all operations with related parties be entered into on terms and conditions no more favorable than similar operations entered into by an institution with the general public. However, there is no similar concept extended to nonrelated party loans.</p> <p>Confirmation by the CNBV is performed by means of reports provided regarding related party loans, which are cross-checked against the documentation provided by the credit risk committee or the Board, as applicable. This work is performed offsite, using certifications requested from the institutions by the Board and credit committees. Moreover, onsite review procedures include reviews of working papers during inspections to assess effective implementation.</p>

EC4	The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.
Description and findings re EC4	Article 19 of the CNBV's law provides the above authority. The CNBV confirms unfettered access as required by EC4, and no cases of the CNBV being denied full access to such information were reported to the assessors. For financial institutions incorporated abroad that are subsidiaries of Mexican parents, the CNBV performs onsite inspections together with local supervisors about every other year. An example has been discussed with the assessors.
Additional criteria	
AC1	The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.
Description and findings re AC1	Such a requirement is not explicitly made in the current regulations. However, Article 17 (Second Title, Chapter I) requires that the approval of loans to connected clients exceeding 10 percent of an institution's basic capital and having a tenor of more than one year be approved by officers not lower than the second level within the credit function. In practice, the assessors are informed that most institutions refer such level of exposure to the Board of Directors for approval.
AC2	The supervisor determines that banks have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. These processes should be commensurate with the size or complexity of the individual bank.
Description and findings re AC2	The regulations indicated in EC1 and EC2 above fully apply to counterparty credit risk and are inspected periodically following the current risk focus approach as part of the annual inspection program. During the current global crisis, the CNBV has dedicated additional efforts to monitor counterparty risk management practices, especially exposures between Mexican subsidiaries and their international parents. As part of these efforts, the CNBV lowered the limit on risk exposures to relevant related parties (see CP11).
AC3	The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit.
Description and findings re AC3	The CNBV performs this determination as per the activities discussed in EC1 above. For such purposes, its supervisors have access to and are required to access the two credit bureaus in operation. The supervisors are then required to leave a trail in each credit file that such information has been considered as part of the credit analysis of a borrower. The assessors had a general discussion on the scope and features of the credit bureaus. However, the assessors did not carry out any additional work on their operations.
Assessment of Principle 8	Compliant
Comments	The opinion of the assessors is that compliance with the conditions of this CP has been fully achieved. The following actions are suggested to enhance the effectiveness of implementation:

	<ul style="list-style-type: none"> • Achieve further consistency between the inspection procedures used to assess compliance and the procedures performed to assess substantive implementation of credit risk management practices, including the rating criteria (EC1). • Better integrate both assessments (compliance and implementation) with the already available risk metrics to rate the risk profile of credit activities and institutions (EC1), as discussed further in CP19. • Make public additional detailed guidance on credit risk management or publicly endorse the various standards promoted by the Basel Committee on the subject (EC3). • Elevate to Board level the approval of all large exposures (AC1). • Explicitly specify counterparty credit risk requirements (AC2). • Amend the LAF to require consistent credit risk management standards at the group level, including for local holding companies and significant nonbanking institutions within a group.
Principle 9	Problem assets, provisions and reserves. Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
Summary description and findings re Principle 9	
Essential criteria	
EC1	Laws, regulations or the supervisor require banks to formulate specific policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require periodic review by banks of their problem assets (at an individual level or at a portfolio level for credits with homogenous characteristics) and asset classification, provisioning and write-offs.
Description and findings re EC1	<p>The Mexican regulatory framework, including all relevant accounting aspects (recognition, valuation and loss provisioning) for financial instruments involving credit risk, such as loans and investment in securities, is fully placed under the authority of the CNBV.</p> <p>The assessors believe that the regulatory framework for granting and administering credit activities (see CP8), and for classifying loan quality and provisioning for loan losses (see below), is sound and very complete. The CNBV continuously updates and improves its rules, adapting them to the Mexican market. The framework is very broad and detailed. Accordingly, the observations and notes provided below are a very condensed summary.</p> <p>Article 65 of the LIC requires institutions to adopt and observe policies and procedures for managing credit risk, including problem loans. Article 76 of the LIC empowers the CNBV to regulate loan classification and provisioning.</p> <p>Four specific Chapters of the CUB require institutions to: (1) organize and control their lending operations, including reserving for problem loans (Chapter I, Articles 3 to 44); (2) properly maintain their credit files (Chapter II, Articles 45 to 64); (3) manage credit</p>

to 132) with a broad choice of approaches (see diagram below).

Articles 90 to 139 of the CUB establish the prudential rules that institutions must follow for loan classification and provisioning purposes.

Section B-6 of the annex 33 to the CUB on accounting provides core definitions regarding credit terms.

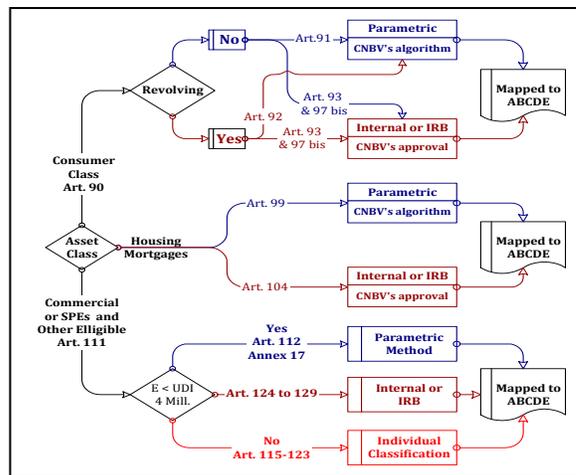
Article 207 of the LIC mandates a suite of 16 prudential reports on credit risk (A-0411 to H-0493) under the credit portfolio R04 Series.

Article 132 of the CUB requires quarterly provisioning of repossessed assets. It provides a dual schedule to phase in provisions, reaching full coverage in 30 months for moveable assets, and 5 years for real estate.

Series R-06 (quarterly report A-0611) shows the level of repossessed assets and their specific loss provisions. Section B-7 of annex 33 of CUB provides the applicable accounting criteria.

In addition, 14 annexes 13-A to 27 of the CUB promulgate additional guidelines and criteria for classification and debtor analysis, including the eligibility criteria that internal credit rating models need to fulfill for the CNBV's approval of more advanced provisioning methods.

Section B-6 of annex 33 on accounting criteria provides core definitions on problem, pass and past-due loans, including loan restructuring and renewal. This Section also puts forward a test of effective payment, precluding indirect refinancing of arrears. It requires full payment of due interest and a 25 percent reduction of principal. Moreover, Section B-6 provides the criteria for transfer among accounting classes and interest



suspension on past-due loans. Restructured loans are deemed in default and kept as past-due if they fail to pass a test of sustained service payment of three consecutive monthly payments, or one for installments longer than 60 days.

For the purpose of loan classification and provisioning, the regulations set by CUB divide the credit portfolio into three relevant asset classes:

consumer, housing, and commercial loans, and differentiate between two sub-classes of revolving and nonrevolving consumer loans (see diagram above).

For each asset class, the regulations offer a choice of methodologies for loan classification and provisioning. The institutions can choose to use a general method based on algorithms estimated by the CNBV. Alternatively, the institutions can choose to use their internal methods for loan classification and provisioning, if approved by the CNBV in compliance with qualifying criteria (Articles 94 and 104 for retail, including annex 15, and Article 124 for corporates, including annexes 25 to 27).

For retail loans (consumer revolving and nonrevolving, and household mortgages), the CUB allows three eligible methodologies: (1) a generalized parametric algorithm

	<p>estimated by the CNBV; (2) CNBV approved internal methods developed by an institution; and (3) risk parameters used as part of a CNBV approved IRB capital model developed by an institution.</p> <p>Loan loss reserves (LLR) are calculated following the traditional formulation (Loss provisions = PD * LGD * EAD). For disclosure purposes, all loan segments are mapped to a loan grade master scale (ABCDE) according to the level of provisioning reserved (Article 97). Required provisions are in all cases expected loss (EL) provisions estimates to a twelve month horizon with point in time (PIT) probabilities of default (PD) and reasonable loss given default (LGD) estimates.</p> <p>These LGD estimates for retail portfolios range from 60 to 75 percent considering the nature of the collateral available. After a number of mandated payments in arrears, consumer loans attract a 100 percent LGD. Household mortgage loans use a well conceived LGD algorithm that includes a loan-to-value factor for mortgages and differentiates among Mexican States considering the overall effectiveness of their judicial process and loan recovery activities.</p> <p>Similarly, for commercial loans, the CUB allows three eligible methodologies: (1) a generalized parametric algorithm; (2) CNBV approved internal methods developed by institutions, or the use of risk parameters used as part of a CNBV approved IRB capital model; and (3) the application of a general methodology for individual corporate borrower analysis (Articles 112.I to 122). In all cases the level of the loan loss reserve is calculated as per the traditional formulation (Loss provisions = PD * LGD * EAD) where the PDs and LGD are estimated following the methodologies indicated, or by mapping the loan classification of an individual corporate borrower to a master scale that dictates the loan provisioning levels (Article 130).</p> <p>For exposures of 4 million of “Unidades de Inversion” (UDIs, index) or higher (about US\$ 0.8 million) institutions are required to undertake an individual classification process based on a dual dimension approach (borrower rating and rating of the transaction), rather than allowing the use of the generalized parametric or the use of internal models. Articles 115 to 123 of the CUB, including associated annexes 18 to 19 of the CUB, provide an exhaustive set of steps to:</p> <ol style="list-style-type: none"> (1) analyze and assign a credit rating to the borrowers (annexes 20.1 to 23) for its country, financial and industry risks, including payment experience; (2) proceed to the rating of the transaction by splitting the loan between its unsecured and secured portions; (3) evaluate personal guarantees and eligible collateral subject to strict eligible conditionality (annex 24); and (4) reach a final split rating classification (Article 112) to assign a level of provisioning for such rating (Article 130) according to the procedures specified in annex 28. <p>Eligible personal guarantees (Article 119) and pre-determined haircuts for eligible collateral (Article 120) indicated in step (3) above are combined to determine one to three upgrades to the borrower rating grade reached in step (1) before mapping to the corporate borrower scale (Article 122).</p> <p>Finally, all loans graded by any of the methods discussed above are mapped to a master scale adopted by the CNBV (Article 131) made up of nine classes A-1 to E.</p>
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	<p>This is done for both retail and corporate segments, whether using a generalized algorithm estimated by the CNBV, an internal model approved by the CNBV, or the general methodology to grade individual corporate loans.</p> <p>The CNBV is now discussing with the industry the introduction of generalized parametric algorithms that it has estimated for sub-segments in the corporate portfolio, including local authorities, small and medium enterprises, large corporates, and financial institutions.</p>
EC2	<p>The supervisor confirms the adequacy of the classification and provisioning policies and processes of a bank and their implementation; the reviews supporting this opinion may be conducted by external experts.</p>
Description and findings re EC2	<p>The CNBV determines the suitability of the policies and procedures used to implement the provisions for classifying loans and estimating appropriate expected loss provisions. It does this through various activities, including:</p> <ol style="list-style-type: none"> 1) offsite monitoring of the periodic reports indicated in EC1 above; 2) evaluation of the reports of the risk management and internal audit units presented to the CNBV; and 3) onsite reviews of the institutions' activities conducted by the supervisors of the three institutional vice-presidencies according to the risk focus of the annual program of inspections approved by the Supervisory Group (see CP19). <p>Onsite reviews and individual loan reviews are carried out as per mandated procedures adopted by the CNBV as part of its Institutional Manual for Supervision, which identifies control points and the expected depth and details of reviews, including individual loan line sheets.</p> <p>Loan sampling does not follow a precise internal policy explicitly related to the assessment and grade granted to the credit risk management process of an institution—the grade being based on the reliability, adequacy, and overall effectiveness of the management systems and controls seen in operation. Sampling per segment tends to focus on the largest risk exposures, at times reaching 46 percent of the total loan portfolio. In other cases, such as for retail products, sampling is only 4 percent.</p> <p>The assessors recommend that:</p> <ul style="list-style-type: none"> • The rating of management systems and controls (their adequacy, effectiveness, and reliability) be explicitly related to the sample size, subject to formal exceptions granted, based on the adequacy of such systems and controls in the individual transactions reviewed and the rating granted to the systems and controls. • The rating of credit risk management systems and controls be based on a dual top-down (qualitative assessment) and bottom-up (transaction review) process. <p>The assessors were allowed to review a number of loan line sheets and gained the impression that the loan reviews conducted by the supervisors of the CNBV were sufficiently deep and well prepared. However, the assessors strongly believe that there is a need to develop and put into operation a good system of electronic documentation for onsite inspection and supervision.</p> <ul style="list-style-type: none"> • As a consequence of its review work, the CNBV initiates formal or informal action, as the case might require. The assessors have been provided with cases

	where the CNBV requires institutions to remedy deficiencies noted, including reclassification of problem loans and additional provisions. Follow-up of progress by the institutions in remedying the deficiencies noted is performed by means of offsite and onsite work.
EC3	The system for classification and provisioning takes into account off-balance sheet exposures
Description and findings re EC3	This is explicitly mandated by Article 76 of the LIC as well as in the CUB Chapters I to V of the Second Title.
EC4	The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations.
Description and findings re EC 4	As described in EC1 and EC2 above (CP9), both the generalist and risk specialist supervisors of the four vice-presidencies follow the procedures and work program established in the Manual of Institutional Supervision.
EC5	The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.
Description and findings re EC5	As described in EC1 and EC2 (CP9) above, both the generalist and risk specialist supervisors of the four vice-presidencies follow the procedures and work program established in the Manual of Institutional Supervision.
EC6	The supervisor is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.
Description and findings re EC6	In EC1 above, the suite of reports on credit risk is summarized, including: <ul style="list-style-type: none"> (1) the 16 prudential reports on credit risk (A-0411 to H-0493) under the credit portfolio R04 Series, as required by Article 207 of the LIC; and (2) the quarterly report on the level of repossessed assets and their specific loss provisions (as required by Series R-06: A-0611).
EC7	The supervisor has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern.
Description and findings re EC7	The CNBV has the general power to increase the capital adequacy of an institution as per Article 2 Bis 117 of the CUB as well as to require additional provisions as per Article 136 of the same CUB. In practice, both powers have not been used on a general basis, since additional provisions are required on a loan by loan exposure basis (see EC8).
EC8	The supervisor assesses whether the classification of the credits and assets and the provisioning is adequate for prudential purposes. If provisions are deemed to be inadequate, the supervisor has the power to require additional provisions or to impose other remedial measures.
Description and findings re EC8	The supervisors of the CNBV perform the above assessment through a combination of offsite and onsite activities discussed in EC2 above. Article 136 of the CUB empowers supervisors to require reclassification to more adverse risk grades and increase provisioning. The assessors have been provided with cases where such powers have been exerted in practice. Current loan loss provisioning regulations approximate a level of expected loss per loan calculated to a 12-month horizon as per PIT estimations of the PD made using the parametric algorithm of the CNBV or the internal models when approved by the CNBV.

	The assessors believe that the algorithm does not include a scaling factor that considers the credit acceleration in the credit cycle per segment. The assessors recommend the inclusion in the algorithm of an automatic breaker that scales up the level of the estimated PD when the speed or growth of credit in a particular segment exceeds adjusted historic patterns.
EC9	The supervisor requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realizable value.
Description and findings re EC9	Articles 116 to 120 of the CUB establish adequate criteria for assessing the credit quality. The specific procedures for the valuation of eligible collateral are established in Article 120, including haircuts on appraised values, and detailed eligibility criteria are set out in annex 24.
EC10	Laws, regulations or the supervisor establish criteria for assets to be identified as impaired, e.g., loans are identified as impaired when there is reason to believe that all amounts due (including principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.
Description and findings re EC10	As discussed in EC1 above, the regulations set out in the CUB to classify impaired loans, including the suite of parametric algorithms in operation, are considered complete and constitute a good example for best international practice that other members of the BCBS should consider adopting as soon as possible. The rules discussed in AC1 below to govern re-aging and restructuring are an essential component and ensure that “curing” practices do not hide problem loans in the portfolios.
EC11	The supervisor determines that the Board receives timely and appropriate information on the condition of the bank’s asset portfolio, including classification of credits, the level of provisioning and major problem assets.
Description and findings re EC11	This determination follows the obligation of the risk management unit to report the outcome of the loan classification and provisioning process at least monthly to the internal credit risk committee and quarterly to the Board as per the detailed provisions of the CUB discussed in EC1 above. Determination of adherence to these provisions is made by the supervisors of the CNBV following the activities indicated in EC2 above.
EC12	The supervisor requires that valuation, classification and provisioning for large exposures are conducted on an individual item basis.
Description and findings re EC12	Such requirement is explicitly noted in Article 111 of the CUB. The mandated individual process follows the procedures established in Articles 115 to 121 borrower by borrower, and transaction by transaction, when any of the exposures are equal to or exceed 4 million of UDIs (about US\$ 0.8 million). Individual specific provisions before mapping to the master scale are calculated by netting the dual borrower and transaction rating as per Article 121. Mapping to the CNBV’s provisioning scale is required by Article 122 to be provisioned as per the tables of expected loss set out in Article 130 and, subsequently, to be finally mapped to the master scale (Article 130) for reporting and disclosure purposes. Using its rich information system of credit risk across the system, the CNBV has developed a number of tools to assist in spotting problem loans, including comparing borrowers with different levels of risk grading and provisioning across different banks in the system.
Additional criteria	

AC1	Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classification for such loans.
Description and findings re AC1	<p>The rules to govern re-aging of loan arrears, renewal of past-due loans, and restructuring of troubled debts as regulated in the CUB are complete and satisfactory, as per the definitions and rules set out in the accounting series B-6, including the accounting rules for repossessed and other real estate assets listed in series B-7.</p> <p>Appropriate terms and conditions to account for arrears are built into these regulations, including to prevent re-aging and restructuring stratagems. In addition, the parametric algorithms estimated by the CNBV for retail segments properly consider the terms for arrears and accumulation of unpaid installments.</p> <p>The assessors would like to praise the CNBV for the completeness of its regulations and only note that, based on their experience, the terms to test sustained payment and reclassify an operation past due as “pass” in the loan classification (i.e.; current), would seem to be in need of further reinforcement.</p> <p>The assessors therefore recommend that the terms for the test of sustained payment (currently three consecutive monthly payments, or one payment for installments with a frequency of 60 days or longer) be reviewed and extended at least to provide a longer observation period covering 20 to 25 percent of the new term approved in a restructuring or refinancing.</p> <p>In addition, since the terms of the original transaction renewed or restructured are to be kept in the records of the institutions, the assessors recommend that a rule be adopted to limit the number of ‘curing’ transactions (re-aging, renewal, re-writing, and restructuring) per period. For example, no more than one curing transaction per borrower would be allowed every five years, and any such transaction that falls into arrears after having been restructured would be automatically classified as ‘D’ or worse.</p>
Assessment of Principle 9	Compliant.
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP has been fully achieved. However, the following minor suggestions are provided to enhance further the current regime:</p> <ul style="list-style-type: none"> • Consider including an automatic breaker to scale up the estimated PIT PD as per the algorithm estimated by the CNBV when the speed of credit growth in a segment exceeds a pre-established norm; • Consider developing or acquiring from vendors a compact electronic data base system to maintain and re-utilize onsite inspections and other supervisory work documentation (EC2); • Extend the test of ‘sustained payment’ from the current period to a longer more prudent period (AC1); • Adopt a more explicit rule to govern the maximum number of re-aging/ re-financing allowed per borrower or per transaction (AC1); and <p>If other consolidating entities follow different loan loss accounting policies, amend the LAF to require consistent loan provisioning at the group level, including by local holding companies and significant nonbanking institutions within a group.</p>

Principle 10	Large exposure limits. Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Summary description and findings re Principle 10	
Essential criteria	
EC1	Laws or regulations explicitly define, or the supervisor has the power to define, a “group of connected counterparties” to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
Description and findings re EC1	<p>Article 1 CXXII of the CUB defines “common risk” for natural and legal persons and identifies other parties connected to them for the purpose of managing intra-credit concentration risk. The CNBV has not yet adopted standards for inter-risk concentration relating credit risk to other risks and vice versa.</p> <p>Article 52 (Second Title, Chapter III) of the CUB conceptualizes the scope of connected parties as “common risk.” It defines three types of relationship for presuming a “common risk” unless proven otherwise.</p> <p>The following parties are deemed to be connected and constitute a common risk: 1) persons acting in concert due to specific family relationships; 2) persons not having control but being able to exert “administrative” power upon a company; and 3) persons exerting control by being able to impose decisions on the general assembly or to nominate the majority of the Board of a company. The criterion of “acting in concert” is restricted to parties connected by family relationships. There is no explicit regulatory guidance or interpretation on how to construe its implementation.</p> <p>The CNBV does not have explicit powers to exert discretion in regard to exposures among parties that are not connected in terms of the links established in Articles 1 and 52 of the CUB, and CNBV’s Board has not yet approved specific internal policies on this issue. The assessors have not been provided with relevant cases demonstrating that in practice the CNBV exerts discretion based on its moral authority and standing.</p> <p>The CUB does not provide an explicit criterion to ‘connect’ as a single ‘common risk’ the exposures of two or more parties when there is mutual ‘economic interdependence’ among them, such as when the problems of one of such parties could significantly affect the capacity of the other parties to serve their debts or to discharge their obligation to the credit institution, whether or not the conditions listed above are present.</p> <p>Article 53 allows certain risks among connected parties to be excluded from the aggregation to determine the lending limits when the repayment sources of a principal party are not dependent on those of a connected party. Conditions for excluding such risks include the absence of cross-obligations among parties in a corporate group, as well as inter-company debts when contracted at market rates.</p> <p>Exclusion is left to the discretion of an institution without further guidance and interpretation from the CNBV. There is neither ex-ante, nor ex-post notification requirements from an institution to the CNBV regarding exclusions, including the</p>

	<p>requirement to keep records and reports which allow the tagging and tracking of such situations to be reported by bank Boards to the CNBV.</p> <p>Article 56 excludes from the lending limits exposures to the Government of Mexico, BoM, and IPAB, as well as loans to sub-national governments in compliance with eligible conditions. The latter has resulted in cases of excessive risk concentration in some banks.</p> <p>Since the last FSAP, the concept of “common risk” has been extended to include trust structures. The assessors were not presented with cases where such provisions have been effectively used to mitigate risks from situations that would have otherwise escaped the regulation.</p> <p>Besides the criteria to presume “connection” as stated in Article 52, the Board of the CNBV would like to issue additional guidance or specific interpretations on observed unsound practices. No cases were presented to the assessors, demonstrating that the CNBV monitors such cases and effectively mitigates unsafe risk concentration among connected parties, as per current definitions.</p> <p>Article 52 requires institutions to adopt procedures for implementing the risk aggregation requirements and these procedures must be approved by the CNBV.</p>												
EC2	<p>Laws, regulations or the supervisor set prudent limits on large exposures to a single counterparty or a group of connected counterparties. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet. The supervisor confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.</p>												
Description and findings re EC2	<p>Article 54 of the CUB establishes a gradient of maximum permissible lending limits that vary with the capital adequacy level of an institution, as follows:</p> <table border="1" data-bbox="509 1094 1393 1518"> <thead> <tr> <th>Capital adequacy level</th> <th>Maximum lending limit on basic capital</th> </tr> </thead> <tbody> <tr> <td>Less than 8 percent to 9 percent</td> <td>12 percent</td> </tr> <tr> <td>More than 9 percent to 10 percent</td> <td>15 percent</td> </tr> <tr> <td>More than 10 percent to 12 percent</td> <td>25 percent</td> </tr> <tr> <td>More than 12 percent to 15 percent</td> <td>30 percent</td> </tr> <tr> <td>More than 15 percent</td> <td>40 percent</td> </tr> </tbody> </table> <p>The maximum lending limit for institutions with a CAR of more than 12 percent exceeds the standard 25 percent international standard. The incremental concentration allowed so as to reach the 40 percent level with a 15 percent CAR appears excessive and will consume about 56 percent of the increase in capital required to operate at such a concentration level.</p> <p>In addition, by CNBV’s rules, the three largest exposures of an institution cannot exceed 100 percent of a credit institution’s basic capital (Tier Capital 1).</p> <p>Current regulations do not provide an explicit definition of large exposures at, say, the generally accepted 10 percent level, and there is no maximum aggregated lending</p>	Capital adequacy level	Maximum lending limit on basic capital	Less than 8 percent to 9 percent	12 percent	More than 9 percent to 10 percent	15 percent	More than 10 percent to 12 percent	25 percent	More than 12 percent to 15 percent	30 percent	More than 15 percent	40 percent
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	<p>limit for all large exposures. However, Article 58 of the CUB requires institutions to track and report to business units, to the Board and committees, and to the general public those exposures that equal or exceed 10 percent of basic capital.</p> <p>There was no analysis available for the assessors to understand whether the above national standard is or is not more beneficial than international practice.</p> <p>The CNBV could compile such information for monitoring purposes and to calculate intra-credit risk concentration metrics at lower levels than those required by regulation. This information could be utilized as an early warning indicator to alert ahead of time if concentration risk is higher than warranted. It could also be used to compute 'entry notes' under the risk rating methodology of the CEFER (see CP19), as well as for the purpose of implementing the internal capital adequacy assessment process (ICAAP) of Pillar 2.</p> <p>Article 57 of the CUB mandates the use of the same credit conversion factors applicable for calculating credit capital charges for off-balance sheet exposures in order to calculate equivalent risks for credit concentration purposes.</p> <p>The above limits are not applicable on a fully consolidated basis up to the highest level of the regulated parent in Mexico (the financial holding company regulated by the SHCP).</p> <p>The applicable rules for nonbank institutions that are part of a regulated group are not fully consistent with those applicable to banking institutions, including requirements to operate compatible standardized client records and management information systems and policies at the group level to facilitate consolidation. These requirements could also be extended through conditions imposed as part of licensing activities to material but unregulated affiliates of mixed-activity groups ("bancos tienda").</p>
EC3	The supervisor determines that a bank's management information systems identify and aggregate on a timely basis exposure to individual counterparties and groups of connected counterparties.
Description and findings re EC3	<p>Article 60 of the CUB requires institutions to operate information systems capable of reporting risk exposures at the level of individual and aggregated exposures, including by geographic location and economic sector of the borrowers, as well as by market segment. Exceptions to the risk aggregation rules to connect borrowers are not required to be reported (see EC1 above).</p> <p>The CNBV determines the effectiveness of these systems during the course of its onsite inspections, as evidenced by some of the inspection reports reviewed by the assessors. The CNBV could supplement its onsite efforts by requiring that annual internal and external audit programs include appropriate review procedures to assess the integrity of associated systems. This requirement could state explicitly that both internal and external auditors must conduct reviews and give opinions of compliance with the requirements of Article 60 of CUB, the reliability of the data, and effectiveness of associated controls, including to the highest point of consolidation.</p>
EC4	The supervisor confirms that a bank's risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.
Description and findings re EC4	Articles 80 of the CUB direct institutions to adopt appropriate risk limits at levels at least as stringent as those established in the CUB, including concentration by type of credit facility, economic sector, geographic location, and single and group exposures of borrowers.

	<p>The systems and risk limits are subject to review and monitoring by the risk management unit (Article 74), the internal audit unit (Article 76), as well as by a bank compliance officer (Article 143).</p> <p>These three control functions report to the audit and risk committees, which inform the bank's Board with different frequencies (monthly to annual basis).</p> <p>In addition, Article 15 III c) of the CUB (Second Title, Chapter I) requires testing of the sensitivity of the projected cash flow of credit exposures grouped as a "common risk" if credits are granted with tenors exceeding 12 months.</p> <p>The CNBV reviews the reports generated by the audit and risk management units, and the relevant committees, and confirms that the Board is well informed so that it can take effective decisions.</p> <p>The assessors have been provided with evidence that the CNBV covers in its onsite reviews the effectiveness of the work program of both the internal audit and risk management units, including the minutes of the relevant committees and the Board.</p>
EC5	<p>The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed. The supervisor has the power to require banks to take remedial actions in cases where concentrations appear to present significant risks.</p>
Description and findings re EC5	<p>The CNBV receives monthly a comprehensive inventory of all banks' exposures in their credit portfolio, thus allowing it to monitor credit risk concentrations. These reports feed the monitoring and data query system (SISECO) of the CNBV. This reporting system allows the CNBV to monitor offsite concentrations for the dimensions indicated in this EC5 consistently with those required by Article 80 (II. a) of (Chapter IV) of the CUB. A monthly uniform report prepared by the Technical vice-presidency provides a set of concentration measures per the dimensions required in this EC.</p> <p>Supervised institutions are required by Article 61 of the CUB to report excesses over exposure limits to the CNBV, including a proposed remediation plan subject to approval by the Commission. The same Article provides the CNBV with the power to require remedial action. In addition, Article 59 of the CUB empowers the CNBV to impose more stringent risk exposure limits than those stipulated in Article 54, based on its assessment of deficiencies in risk management and control systems at supervised institutions.</p> <p>The assessors have been provided with examples showing that the CNBV has used its powers and imposed economic sanctions for breaches of the maximum lending limits. Moreover, in several cases the CNBV has formally required institutions to strengthen their information systems and concentration risk procedures.</p>
Additional criteria	
AC1	<p>Banks are required to adhere to the following definitions:</p> <ul style="list-style-type: none"> - 10 percent or more of a bank's capital is defined as a large exposure; and - 25 percent of a bank's capital is the limit for an individual large exposure to a private sector nonbank counterparty or a group of connected counterparties. <p>Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.</p>

Description and findings re AC1	<p>Whilst the regulatory framework for risk exposure limits set out in the CUB does not specify a minimum threshold above which an exposure is deemed to be a large exposure, its Article 58 requires institutions to identify, measure, monitor, control and report to business units, the institution's Board and committees, all single and connected risk exposures in excess of 10 percent of basic capital (Tier Capital 1), including geographic and sector concentrations.</p> <p>Article 54, which follows a gradient approach to maximum permissible lending limits, prohibits exposures that exceed the corresponding capital adequacy level (see above EC2). The assessors believe this to be less stringent than general international practice, including the lack of a combined risk limit for all large exposures above 10 percent of no more than 800 percent of a bank's capital.</p>
Assessment of Principle 10	Largely Compliant
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP has been largely achieved and can be further strengthened, including in order to mitigate concentration risks, by implementing the following actions:</p> <ul style="list-style-type: none"> • Adopt a broader concept of 'economic interdependence' to relate borrowers, whether or not there is control or a family relationship among them (EC1). • Monitor closely the exclusions allowed by Article 56 of the CUB, including requiring institutions to put in place systems to tag, track, and notify exclusions that should be closely scrutinized and challenged as necessary by the CNBV (EC1). • Amend the LAF to require observance of lending limits on a full consolidated basis at the holding company level and extend the requirements to unregulated mixed-activity holdings (EC2). • Adopt an explicit definition of large exposure, including a maximum aggregated lending limit for those exposures (AC1). • Use the concentration metrics already calculated as 'entry note' to rate the risk profile of an institution explicitly under the current risk rating methodology (see CEFER in CP19). • Once the Basel II Pillar 2 is 'fully' operational, develop a risk charge to price the level of specific and sectoral concentration risks in terms of additional capital, by means of developing relevant indexes (see, CP19).
Principle 11	<p>Exposures to related parties. In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.</p>
Summary description and findings re Principle 11	
Essential criteria	
EC 1	Laws or regulations explicitly provide, or the supervisor has the power to provide, a comprehensive definition of "related parties." This should consider the parties

	<p>identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.</p>
<p>Description and findings re EC1</p>	<p>Article 73 of the LIC provides the applicable standard definition of “related party.” Article 1, CVII, of the CUB adopted in 2010 defines a more delimited concept of “relevant related party.” The scope and conditions of the ‘related party’ definition, including the associated lending limit, cannot be modified by the CNBV as it would require an amendment of the LIC through parliament. The scope and the conditions of the ‘relevant related party’ definition are under the regulatory powers of the CNBV and determine the risk excess to be deducted from capital adequacy.</p> <p>Article 1, CXXII, of the CUB sets forth additional criteria to extend the definition of related parties to any person, whether related or not to the institution. These provisions set out the scope for imposing two types of applicable lending limits (see EC5 below) with related parties as described below, including: (i) a general lending limit; and (ii) a lending limit with relevant related parties. The scope of parties connected to a ‘relevant related party’ (CUB 1 CXXII) is more restrictive than the scope of parties connected to a ‘standard related party’ (LIC 73).</p> <p><u>Standard definition of related parties.</u></p> <p>The scope of the standard definition for related parties set by Article 73 of LIC is in essence consistent with that enunciated by the IAS 24.9. It includes: (1) shareholders controlling 2 percent or more of the capital of an institution, its parent company, or an entity of the financial group where the former is integrated; (2) members of the Board of Directors of the entities referred to in (1); (3) relatives of persons listed in (1) and (2); (4) other persons with the power to sign on behalf of the institution; (5) legal persons, and their directors and officers, in which the institution or a member of its financial group, including its parent company, control 10 percent or more of their capital; (6) legal persons where directors and officers of the institution serve in similar positions; (7) legal persons where any of the above parties control 10 percent or more of their capital; and (8) any operation through an unrelated third party or a trust, where the counterpart funds depend on any of the parties previously listed.</p> <p><u>Relevant related parties</u></p> <p>The scope of relevant related parties as set by Article 1, CVII, of the CUB includes those natural or legal persons who control 20 percent or more of the capital of an institution. For such purposes, the shares of such persons shall be added to the shares owned by their relatives and by trusts whose cash flow for repayment depend on relevant parties and their relatives. In addition, all the legal persons and members of a corporate group under the control of the above natural or legal persons shall be considered as relevant related parties.</p> <p>The assessors note that the applicable definition of control of the CUB Article 52 III requires the power to impose decisions at the general assembly, or to nominate or replace the majority of the Board.</p> <p>Accordingly, companies where a relevant related party controls 50 percent or less of the shares (e.g., associate companies under IAS 38) might be excluded from the scope of aggregation. Individual companies, where a relevant related party has joint control, has an interest that gives it significant influence, or is an associate, will also be excluded from the scope of parties connected to the relevant related party.</p> <p>The scope of operations captured as related party transactions listed in Article 73 of the LIC is not fully consistent with the scope listed in the IAS 24.2. The scope of transactions set by Article 73 does not explicitly include all transfers of resources,</p>

	<p>services and obligations regardless of whether a price is charged and that might be different from a credit.</p> <p>Accordingly, certain transactions might be excluded from the scope of related party transactions, including purchases and sales of property and other assets; rendering and receiving services; leases; transfers of rights under licensing agreements; settlement of liabilities; trading operations; use of common names and operational structures; transfer of risks through insurance, reinsurance of credit derivatives; exposure from placing client assets; provision of management and other service agreements; and any other transaction resulting in shifting risk exposures between an institution and a related party.</p> <p>In practice, the CNBV ensures by means of findings during onsite inspections that transactions different from those related to credit and investment, as listed in the second paragraph of the LIC Art. 73, are subject to similar conditions.</p> <p>The CNBV does not have explicit powers to (i) exert discretion in determining related parties not formally related as per the above conditions, or (ii) expand the scope of related party transactions for computing aggregated risk exposures. CNBV's Board has not approved specific internal policies to such effect.</p> <p>The assessors note that there are no comparable standards for regulated holding companies similar to those required of banks acting as parents in a banking group.</p>
EC2	Laws, regulations or the supervisor require that exposures to related parties may not be granted on more favorable terms (i.e. for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding exposures to nonrelated counterparties.
Description and findings re EC2	Article 73 VII (4 th paragraph) of the LIC requires that all operations with related parties be entered into on terms and conditions no more favorable than similar operations entered into by an institution with the general public.
EC3	The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process.
Description and findings re EC3	<p>Article 73 of the LIC requires that the approval of related party operations be made by at least three-fourths of the directors present at a Board meeting. Article 22 XI of the LIC requires a minimum quorum of half plus one of the members of the Board to be present. Hence, per current regulation, the number of favorable votes will never exceed half of the total Board members.</p> <p>Article 73 VII (third paragraph) requires that directors and officers be absent from meetings and abstain from voting in those cases where they have a direct interest at stake.</p> <p>Article 73 Bis requires all operations with related parties to be submitted to the Board for approval.</p>
EC4	The supervisor requires that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure.
Description and findings re EC4	An explicit regulatory requirement is not available. However, Article 73 VII (3rd. paragraph) requires that directors and officers be absent from meetings and abstain from voting in those cases where they have a direct interest at stake.

EC5	Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits are set on aggregate exposures to related parties, they are at least as strict as those for single counterparties, or groups of connected counterparties.
Description and findings re EC5	<p>Standard related parties, whether integrating or not a “common risk,” are individually subject to the same general lending limits applicable to “connected parties.” This follows a scale going from 12 to 40 percent of the bank’s basic capital (Tier 1) for each standard related party, after aggregation with its connected persons (see CP10 EC2, including exclusions per EC1). In addition, related party lending is subject to the maximum aggregated limits for standard related and relevant related parties described below.</p> <p>Standard related parties are subject per Article 73 Bis of the LIC to an aggregated 50 percent maximum lending limit as a whole set of parties related to an institution. The CNBV believes that this aggregated lending limit should be further reduced to more prudent levels. However, this change would require an amendment of the LIC for which there might not be the necessary political consensus.</p> <p>To constrain and minimize the transfer of resources during the global crisis in 2009 from the local subsidiaries of three international banking groups operating in Mexico to their parent banks abroad, the CNBV introduced in 2010 an additional indirect lending limit which, if exceeded, must be deducted from Tier 1 capital.</p> <p>For this purpose, the CNBV amended Article 2 Bis 6 XIV of the CUB, requiring banks to deduct from their basic capital (Tier 1) the aggregated risk exposures with their relevant related parties which exceed 25 percent of their adjusted basic capital (adjusted for mandated capital deductions).</p> <p>The assessors note that exposures with associated and joint venture companies related to a relevant related party will not be included in the scope of the above deduction. Further, loans granted to entities controlled by a director or senior officer of an institution, or where such parties may exert significant influence, will also be outside the scope of this deduction.</p> <p>Except for the above deduction, any other instance of lending limits with related parties being exceeded is not mandated to be deducted from capital under the LIC.</p> <p>The above limits for related party exposures do not apply on a full consolidated basis up to the highest regulated parent company located in Mexico and are different from the related party exposure limits applicable to other nonbank financial intermediaries.</p>
EC6	The supervisor requires banks to have policies and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. The supervisor confirms that exceptions to policies, processes and limits are reported to the appropriate level of senior management and, if necessary, to the Board, for timely action. The supervisor also confirms that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.

Description and findings re EC6	<p>Article 80 I a) 2 of the CUB requires institutions to operate with policies and procedures with parties who present a “common risk.” There are further explicit provisions requiring specific policies and procedures to govern lending activities with related parties.</p> <p>The CNBV confirms compliance with the above by means of its onsite inspections as well as through offsite procedures that include reviews of the summaries of the minutes of the meetings of the Board of Directors and credit committees, as necessary.</p>
EC7	The supervisor obtains and reviews information on aggregate exposures to related parties.
Description and findings re EC7	The CNBV obtains information on related parties through two regulatory reports, ‘R04C’ and report ‘R24C’. In addition, the CNBV periodically examines the statistics reported to BoM regarding interbank transactions, including those entered into between a Mexican institution and its foreign parent. Monitoring of these transactions is done on an on-going basis through offsite surveillance.
Assessment of Principle 11	Largely compliant
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP has been largely achieved and can be strengthened. In particular, risks to the effectiveness of capital can be mitigated by implementing the following actions:</p> <ul style="list-style-type: none"> • Amend Article 73 of the LIC to reduce the 50 percent of capital aggregated maximum limit with standard ‘related parties’ to a level consistent with international practice (EC1); • Expand the scope of related party transactions to all those transactions considered under IAS 24.2 not captured at present under current CNBV regulations (EC1); • Provide explicit powers to the CNBV to exert discretion in applying relevant definitions on a case-by-case basis (EC1); • Amend the LAF to require observance of lending limits on a full consolidated basis at the holding company level and extend requirements to unregulated mixed-activity holdings (EC5); and • Use the concentration metrics already calculated as an ‘entry note’ to support the rating of the risk profile of institutions under the current risk rating methodology (see the CEFER, EC19).
Principle 12	Country and transfer risks. Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.
Summary description and findings re Principle 12	
Essential criteria	
EC1	The supervisor determines that a bank’s policies and processes give due regard to the identification, measurement, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to

	<p>the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.</p>
<p>Description and findings re EC1</p>	<p>The CNBV believes that country risk and transfer risk are not significant risks to which the local institutions are exposed. Accordingly, these risks have not been explicitly conceptualized yet in the general provisions of the CUB governing risks and risk management (Second Title, Chapter IV) with the same depth as other financial risks.</p> <p>Article 114 of the CUB requires the analysis of country risk as part of credit analysis under the general methodology for single borrowers with exposures above UDI 4 million. [The UDI – Unidades de Inversion -is a reference index (currency) equivalent to about MX\$ 4.6 as of September 14,2011] Annexes 20 and 21 of the CUB mandate the use of the sovereign ratings of three international rating agencies to map the country risk of a borrower to the nine categories contained in the master scale utilized by CNBV for loan classification and provisioning purposes (see CP9). This provides an initial entry grade to consider the underlying country risk to which a client is exposed. Transfer risk is not yet explicitly treated in CNBV's regulations.</p> <p>Through several prudential reports (RC01 and RC02) the CNBV obtains monthly information on country risk exposures when a borrower or counterparty is not a Mexico resident party. Further, the CNBV has developed an ad-hoc procedure to aggregate monthly the credit exposures to Mexican banks of local Mexican entities (both companies and banks) whose controlling parent is located in a European country under stress, including off-balance sheet exposures (e.g., financial derivatives) entered into in the course of trading and capital market activities.</p> <p>Based on its last available data, for the total banking system, the CNBV estimates that about 0.57 percent of the total assets and off-balance sheet activities of the aggregated financial groups and banks might be subject to final (end-borrower/end-counterparty) country risk or involve local companies whose controlling parent is located abroad, whether or not contractually the parent is the final obligor.</p>
<p>EC2</p>	<p>The supervisor confirms that banks have information systems, risk management systems and internal control systems that accurately monitor and report country exposures and ensure adherence to established country exposure limits.</p>
<p>Description and findings re EC2</p>	<p>There are no specific requirements set by CNBV regulation regarding the manner in which information, risk management and control systems are expected to capture and report country risk and transfer risk.</p> <p>However, in practice the CNBV requires institutions to report all credit exposures with nonresidents with a specified code identifying the country of residence of the borrower. This does not mean necessarily, that residents whose final borrower is located abroad are identified using this code, nor that this code tags the fact that the end-borrower/end-counterparty is located abroad. The CNBV has tagged as such only the largest known local corporate entities whose parent is located in Spain. A similar procedure is not followed for other relevant countries, such as those from NAFTA, or elsewhere.</p> <p>In the course of its onsite inspection work, as well as through the routine work of the internal audit function, CNBV confirms periodically the accuracy with which nonresident borrowers are tagged for the purposes of prudential reporting.</p>
<p>EC3</p>	<p>There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices, which are all acceptable as long as they lead to risk-based results. These include:</p>

	<ul style="list-style-type: none"> - The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country. - The supervisor (or some other official authority) sets percentage ranges for each country, and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. - The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor. 																																														
Description and findings re EC3	<p>Article 130 of the CUB sets the range of loan provisioning resulting from the classification of a borrower, after considering all relevant mandatory factors for credit analysis (country, financial, industry, and arrears performance).</p> <p>The classification of a borrower regarding country risk is the first step in the credit analysis process (per Article 114), following the mapping of external rating agencies to the CNBV's master scale of nine grades (see below).</p> <p>The initial classification might be modified in accordance with the other factors that drive the final classification, such as the grading provided based on the financial, industry and payment performance of the borrower. The initial classification for country risk is accepted if it results in a classification that is lower than that given by the other risk factors; hence provisions are not additive.</p> <p>The provisions for country risks are constituted per Article 130 (see table below). If country risk is present in other risk factors, the provisions should be constituted accordingly.</p> <table border="1" data-bbox="532 1060 1370 1799"> <thead> <tr> <th colspan="2">Mapping per annex 20 and 21</th> <th colspan="3">Article 180 of CUB</th> </tr> <tr> <th>External rating</th> <th>Internal</th> <th colspan="3">Provisioning levels</th> </tr> <tr> <th>S&P (as example)</th> <th>Master scale</th> <th>Lower</th> <th>Middle</th> <th>Upper</th> </tr> </thead> <tbody> <tr> <td>AAA</td> <td rowspan="3">A-1</td> <td colspan="3" rowspan="3">0.5 percent</td> </tr> <tr> <td>AA+</td> </tr> <tr> <td>AA</td> </tr> <tr> <td>AA-</td> <td rowspan="2">A-2</td> <td colspan="3" rowspan="2">0.99 percent</td> </tr> <tr> <td>A+</td> </tr> <tr> <td>A</td> <td rowspan="2">B-1</td> <td>1.0 percent</td> <td>3.0 percent</td> <td>4.99 percent</td> </tr> <tr> <td>A-</td> </tr> <tr> <td>BBB+</td> <td rowspan="2">B-2</td> <td>5.0 percent</td> <td>7.0 percent</td> <td>9.99 percent</td> </tr> <tr> <td>BBB</td> </tr> <tr> <td>BBB-</td> <td rowspan="2">B-3</td> <td>10.0 percent</td> <td>15.0 percent</td> <td>19.99 percent</td> </tr> <tr> <td>BB+</td> </tr> </tbody> </table>	Mapping per annex 20 and 21		Article 180 of CUB			External rating	Internal	Provisioning levels			S&P (as example)	Master scale	Lower	Middle	Upper	AAA	A-1	0.5 percent			AA+	AA	AA-	A-2	0.99 percent			A+	A	B-1	1.0 percent	3.0 percent	4.99 percent	A-	BBB+	B-2	5.0 percent	7.0 percent	9.99 percent	BBB	BBB-	B-3	10.0 percent	15.0 percent	19.99 percent	BB+
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EC4	The supervisor obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of individual banks.																								
Description and findings re EC4	<p>There is no dedicated prudential report to obtain information on country and transfer risks.</p> <p>However, in practice the CNBV requires institutions to report all credit exposures with nonresidents with a specified code identifying the country of residence of the borrower. This does not mean necessarily, that residents whose final borrower is located abroad is identified using this code, nor that this code tags the fact that the end-borrower/end-counterparty is located abroad. The CNBV has tagged as such only the largest known local corporate entities whose parent is located in Spain. A similar procedure is not followed for other relevant countries, such as those where the parents and actual end-borrower/end-counterparty are residents of NAFTA countries, or elsewhere.</p> <p>In the course of its onsite inspection work, as well as through the routine work of the internal audit function, CNBV confirms periodically the accuracy with which nonresident borrowers are tagged for the purposes of prudential reporting, as described above for the other ECs.</p>																								
Assessment of Principle 12	Largely compliant																								
Comment	<p>The opinion of the assessors is that compliance with the conditions of this CP has been largely achieved in practice and can be further strengthened by adopting a more proactive approach to the supervision of this risk, including implementing the following actions:</p> <ul style="list-style-type: none"> • Require that institutions, whose parents are located in the EU and NAFTA countries, undertake ad-hoc periodic reporting of both country and transfer risks, based on the management information system that is utilized to report to their parent institutions; • Require that all other institutions review the codification of the prudential reports RC01 and RC-02 to ensure that appropriate tagging of the end-borrower/end-counterparty, rather than only of nonresident borrowers, takes place for the reporting of both types of exposure by country; and 																								

	<ul style="list-style-type: none"> Consider the publication of further guidance on the risk management practices expected from institutions, after compilation of the practices observed in leading local institutions.
Principle 13	Market risk. Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
Summary description and findings re Principle 13	
Essential criteria	
EC1	The supervisor determines that a bank has suitable policies and processes that clearly articulate roles and responsibilities related to the identification, measuring, monitoring and control of market risk. The supervisor is satisfied that policies and processes are adhered to in practice and are subject to appropriate Board and senior management oversight.
Description and findings re EC1	<p>The CNBV determines periodically the suitability of market risk management processes and applicable policies by means of: 1) the evaluation of the annual reports of the risk management and internal audit units; 2) risk focused and annual onsite reviews of institutions' activities.</p> <p>The annual reports from internal auditors are reviewed offsite and changes to the focus or extension of their audit program requested as necessary. This includes in certain cases a request for ad-hoc internal audit work to provide specific opinions ('certifications') to the CNBV on non-essential issues.</p> <p>Following the level of risk assessed as per the risk matrix of each institution (see risk rating CEFER, CP19) regarding its trading and capital market activities, the Supervisory Group of the CNBV decides each year whether to inspect these activities and the scope of the inspection. The CNBV's normal practice is to conduct an onsite inspection that covers market risk every two years.</p> <p>The precise frequency and intensity of the review cannot be identified given that the internal costing system does not differentiate among individual activities. For large institutions, nearly every year there is a target review in the area of market risk.</p> <p>Transaction testing onsite is performed to (i) verify positions and transactions in financial instruments, with a focus on valuation, data entry and the calculation of and compliance with trading and market risk limits; and (ii) assess the effectiveness and reliability of management and control systems.</p> <p>Onsite reviews are performed both by inspectors allocated to the Institutional vice-presidencies and, if requested by them, by the risk specialists assigned to the technical vice-presidency. Market risk models and risk measurement techniques are normally reviewed by the latter. Both groups of inspectors utilize specific procedures, which focus respectively on: (a) establishing compliance with policies and procedures ('bitacora de cumplimiento') as required by the CUB; and (b) evaluating the effective implementation and reliability of management and control systems. Both sets of procedures can be made more consistent in practice, including by integrating them more effectively for the purposes of rating the risk profile of trading and capital market activities.</p>

	<p>Consequent upon the review work performed, the CNBV initiates formal or informal actions, as the case might require. The assessors have been provided with evidence where the CNBV requires institutions to remedy the deficiencies noted. Follow-up on the progress made by the institutions in remedying these deficiencies is performed by means of both offsite and onsite work.</p> <p>The assessors note that there are no standards for market risk management for regulated holding companies similar to those required of banks acting as parents in a banking group.</p>
EC2	<p>The supervisor determines that the bank has set market risk limits that are commensurate with the institution's size and complexity and that reflect all material market risks. Limits should be approved by the Board or senior management. The supervisor confirms that any limits (either internal or imposed by the supervisor) are adhered to.</p>
Description and findings re EC2	<p>Article 78 of the CUB sets the general requirements for all risk management activities, including the organization, roles and responsibilities of Board and management, as well as those of the risk committee and the risk management unit. The requirements extend to the determination, control and reporting of limits and to when these limits are exceeded. Further guidance on actual practices in trading and capital market activities could be made public.</p> <p>In addition, Article 82 of the CUB sets specific de-minimis requirements for capital market and trading activities that give rise to market risk, including use of models, valuation of positions and instruments, model validation, and market risk concentration. The requirements extend also to data gathering, back-testing, stress testing, as well as comparing actual versus projected results and risk measures.</p> <p>Institutions inform the CNBV of their market risk and capital market activities by means of a suite of prudential reports. The CNBV has access to the information system warehoused by the BoM. This allows the CNBV to have a full inventory of all the financial instruments, including off-balance sheet contracts and OTC derivatives, which integrate the portfolios (trading, AFS and held-to-maturity).</p> <p>For large institutions and for institutions that present a higher risk contribution from trading and capital market activities, the units in charge of their supervision require in excel format more frequent (weekly) reports and granular analysis.</p> <p>The information warehoused is utilized to elaborate a series of analytical reports and indicators which allow weekly and monthly analysis. The standardized monthly report on market risk for each institution, prepared by the technical risk vice-presidency, is well structured and comprehensive, and it provides a suite of indicators on market risk, both at notional and marked-to-market values, including</p> <ul style="list-style-type: none"> • A summary reconciliation of portfolios-at-risk to balance sheet and marked-to-market values; • Relative positions in fixed income, derivatives, equity, and foreign exchange sub-portfolios; • Long, short and net positions by risk factor (interest rate by currency, equity, and FX rate); • VaR by the same risk factors at the 99 percent level (1 and 10 days), and expected shortfall;

	<ul style="list-style-type: none"> • Potential loss under stress: (a) 99 percent, 1 day VaR and split VaR; and (b) VaR per market (99 percent, 1 day and 10 day) • Composition of the trading portfolio (gross and net) by market (cash, derivatives, currency and equity) and major instrument type; and • Capital adequacy ratio estimated under stressed VaR (above) and past scenarios. <p>These standardized market risk metrics extracted from the system should as soon as possible be used for rating the risk profile of the institutions, as proxy 'entry note' for the market risk quantity.</p> <p>The CNBV determines adherence by the institutions to their internal market risk limits, and the performance by the Board and senior management on their respective roles and responsibilities by means of the supervisory activities discussed in EC1. Moreover, offsite supervisors follow up on the risk limits communicated to the Commission against the above set of metrics.</p> <p>The CNB has powers to request modification of the market risk limits adopted by the institutions, as well as to require specific capital charges and limits on exposures to those institutions that present deficiencies in their risk management or control processes.</p> <p>The assessors have been presented with examples of actions and interactions where such powers have been used to reduce the risk profile identified in institutions.</p>
EC3	<p>The supervisor is satisfied that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' marked to market positions are revalued frequently, using reliable and prudent market data (or, in the absence of market prices, internal or industry-accepted models). The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.</p>
Description and findings re EC3	<p>The requirements for the valuation of financial instruments are set out according to accounting criteria in Article 174 of CUB and compiled in Annex 33, including Series: B-2 on financial instruments; B-3 on repo operations; B-4 for securities lending; and B-5 for financial derivatives and hedging transactions.</p> <p>The accounting criteria include rules to adjust values, make provisions, and establish investment loss reserves, as well as to value less liquid securities including provisions for marking-to-model.</p> <p>The CNBV evaluates the adequacy and reliability of the systems and controls in place by monitoring the annual work programs and reports of the risk management and internal audit units discussed above in EC1, including target reviews following the procedures established in the Manual of Institutional Supervision.</p> <p>The assessors have been provided with examples where the CNBV requires institutions to remedy deficiencies noted. Follow-up on progress in resolving deficiencies is performed by means of both onsite target visits and offsite work. The latter involves ad-hoc reports from the internal audit or risk management unit.</p>
EC4	<p>The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate and periodic validation or testing of the systems used to measure market risk. The supervisor confirms that the approaches are integrated into risk management policies and processes, and results are taken into account in the bank's risk-taking strategy.</p>

Description and findings re EC4	<p>Stress testing for positions in financial and derivative instruments is required as per Articles 82 VI for trading and available for sale portfolios, including associated hedges, and by Article 83 VI for other financial instruments classified as held to maturity.</p> <p>The CNBV evaluates the adequacy and reliability of the systems and controls in place by monitoring the annual work programs and reports of the risk management and internal audit units discussed above in EC1, including target reviews following the procedures established in the supervisory manual of procedures.</p>
Additional criteria	
AC1	The supervisor requires that market data used to value trading book positions are verified by a function independent of the lines of business. To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is independently tested.
Description and findings re AC1	Institutions are mandated to value their trading portfolios using indicated price vendors (CUB 172 Bis 2). The CNBV has authorized two vendors as providers of official prices for the valuation of financial instruments. Both vendors are supervised by the CNBV by means of ad-hoc visits.
Assessment of Principle 13	Compliant
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP has been fully achieved and can be further enhanced by implementing the following actions:</p> <ul style="list-style-type: none"> • Achieve further consistency between the inspection procedures used to verify compliance and the procedures performed to assess substantive implementation of market risk management practices, including the criteria for rating the risk profile of institutions (EC1); • Use the concentration metrics already calculated as 'entry note' to rate the risk profile of institutions explicitly under the current risk rating methodology (EC2), also see CEFER in CP19; • Compile and publish observed risk practices among different types of institutions in managing market risk inherent in their trading and capital market activities (EC1); • Alternatively, endorse the BCBS as the appropriate reference for guidance. • Amend the LAF to require consistent market risk management standards at the group level, including local holding companies and significant nonbanking institutions within a group.
Principle 14	Liquidity risk. Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.
Summary description and findings re Principle 14	
Essential criteria	

EC1	The supervisor sets liquidity guidelines for banks. These guidelines take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.
Description and findings re EC1	<p>Article 78 of the CUB sets general objectives for risk management and the requirement that institutions operate within their internal limits and policies. Article 81 sets seven general principles that the institutions must observe as part of their liquidity risk management programs. It requires institutions to forecast cash flows, diversify funding sources, and quantify potential losses of liquid assets in case of a forced sale. The institutions are also mandated to have a contingency liquidity plan and to estimate the impact of alternative scenarios by means of liquidity stress testing and modeling.</p> <p>Besides these general principles, it is needed to provide further detailed guidance on funding liquidity risk management regarding the scope of policies and limits, and the alternative risk measurement techniques and information systems expected to be in operation to implement the above principles and to control liquidity funding limits.</p> <p>Prudential regulation of liquidity risks is a shared responsibility between the BoM and the CNBV, within the domain of their respective authority.</p> <p>BoM requires institutions to comply with two sets of liquidity measures for local and foreign currency liabilities, respectively, which fulfill a dual monetary and prudential policy objective.</p> <p>Circular 30/2008 of the BoM requires institutions to maintain in the central bank remunerated deposits for the purposes of monetary policy regulation in an amount equivalent to about 11 percent of the banks' deposits as of the end of July 2011.</p> <p>In addition, Circular 2,019 M13.3 of the BoM requires institutions to comply daily with two measures relating to foreign currency assets and liabilities, considering their contractual maturities.</p> <p>The first measure limits the daily 'net gap of permissible liabilities' to 1.83 times the basic capital of an institution. The 'net gap of permissible liabilities' equates to the sum of designated liabilities less the sum of designated assets. For such purposes, designated liabilities are slotted into four groups with maturities of one to more than three years and weighted by a decreasing factor approximating their demand ability. Designated assets are slotted into two groups (liquid assets and loans) and weighted by a factor that approximates their haircut for prompt liquidation value.</p> <p>The second measure imposes a minimum level of eligible liquid assets in foreign currency, taking into account the original maturity and designated liabilities. The latter is made of the sum of two amounts: 1) the sum of net short-term liquidity gaps (required liquid assets to compensate for accumulated liabilities for four time bands going from 1 to 60 days); and 2) the sum of net daily liquidity gaps (required liquid assets needed to compensate for liabilities for 1 to 60-day time bands).</p> <p>The assessors note that original maturities rather than residual maturities are used for the above purposes, which makes it difficult to monitor liquidity gaps through these metrics.</p> <p>At the time of the assessment, the CNBV and the BoM are preparing a major overhaul of the liquidity standards in Mexico, in order to implement the proposals of the BCBS under the Basel III regime. The reform includes a revision of applicable risk management standards for this and other risks (see CP7).</p>

	<p>The BoM and the CNBV have already communicated to the industry the proposed amendments in draft form. Discussions are underway to refine the elements that will integrate the two liquidity ratios being considered, which are similar to the Basel III liquidity standards. The CNBV has organized a quantitative impact study (QIS) to evaluate the implications and details of the new liquidity regulations. Subject to the final phase-in period granted for implementation, the new liquidity regulations are expected to be adopted during the last quarter of 2011.</p> <p>The results of the QIS are still not available. In conversations with the industry, the assessors noted that the larger banks, including the subsidiaries of foreign international banks, seemed to have no major issues in complying with the proposed new regulations. However, smaller local banks will be challenged to implement them, since some of them might run more significant structural imbalances. These banks' business models could be affected and they might require more time for adaptation and implementation.</p> <p>Whilst there have no recent cases of liquidity stress in the banking sector, the assessors support prompt adoption of the draft regulation that will appropriately consider residual rather than contractual maturities for assets, liabilities and off-balance sheet positions.</p> <p>The assessors praise highly the wording of the draft amendments, whose effective implementation will allow regulation and supervision to comply in substance with the conditions of this principle. The assessors recommend using the opportunity of this amendment to introduce in full the principles associated with the Pillar 2 of the Basel II regime (see CP 19).</p>
EC2	<p>The supervisor confirms that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. The supervisor also confirms that the Board has an oversight role in ensuring that policies and processes for risk-taking are developed to monitor, control and limit liquidity risk, and that management effectively implements such policies and processes.</p>
Description and findings re EC2	<p>The CNBV determines the suitability of the liquidity risk management strategy and processes, including the oversight role exercised by the banks' Boards, through a number of activities, including: 1) offsite monitoring of the proxy liquidity indicators calculated on a daily and monthly basis; 2) the evaluation of the reports of the risk management unit, which are requested on a weekly or more frequent basis, if needed, for the most relevant institutions (see EC3 below); and 3) the onsite reviews of the institutions' activities conducted by the supervisors of the institutional and risk management vice-presidencies.</p> <p>Onsite reviews are carried out as per mandated procedures adopted by the CNBV as part of its Institutional Manual for Supervision, which identifies control points and the expected depth and detail of systems and controls to be reviewed.</p> <p>Following the review work performed, the CNBV initiates formal or informal actions, as the case might require. The assessors have been provided with cases where the CNBV requires institutions to remedy deficiencies noted during CNBV inspections. Follow-up of progress by the institutions in remedying the deficiencies noted is performed by both offsite and onsite work.</p>
EC3	<p>The supervisor determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank.</p>

Description and findings re EC3	<p>(i) <i>A monthly liquidity coverage ratio (LCR)</i> that measures available liquid assets against total short-term liabilities up to one month (which does not include a proxy haircut to simulate potential market discounts on securities);</p> <p>(ii) <i>A concentration ratio</i> that measures the 50 larger clients whose deposits mature one month ahead against total maturing deposits with the same time horizon; and</p> <p>(iii) <i>The liquidity ratio in foreign currency</i>, which is reported to the BoM.</p> <p>As an ad-hoc practice performed by CNBV's institutional vice-presidencies, institutions are requested to forward their internal liquidity management reports used to establish funding limits. This is a good supervisory practice done on a daily, weekly and monthly basis, as needed. The assessors were presented with samples from larger and smaller institutions, including flexible interaction by means of an exchange of e-mails with the supervised institutions.</p> <p>On a monthly and quarterly basis, the institutional vice-presidencies produce financial performance reports which include: (1) a review of liquidity risk with three additional balance sheet liquidity stock ratios; (2) a funding-mix analysis; and (3) the effects on liquidity from trading and capital market activities, including activities in derivative instruments.</p> <p>Moreover, by means of a financial simulation model recently developed by the technical vice-presidency in charge of supervising risk, the CNBV performs a stress test analysis of liquidity risk by simulating, on a monthly basis, a selected scenario of deposit run-off.</p>
EC4	<p>The supervisor requires banks to establish policies and processes for the ongoing measurement and monitoring of net funding requirements. The policies and processes include considering how other risks (e.g.; credit, market and operational risk) may impact the bank's overall liquidity strategy, and require an analysis of funding requirements under alternative scenarios, diversification of funding sources, a review of concentration limits, stress testing, and a frequent review of underlying assumptions to determine that they continue to be valid.</p>
Description and findings re EC4	<p>Such policies and processes are required according to the provisions of Article 81 of the CUB.</p> <p>The draft regulation being discussed with the industry on liquidity risk management and prudential ratios include additional provisions on the subject. These provisions include, for the first time, the obligation to monitor inter-risk concentration, an expression of risk appetite by the banks' Boards regarding liquidity risk, as well as more explicit standards for diversification and evaluation of funding liquidity under alternative scenarios, which today are not still explicitly mandated.</p>
EC5	<p>The supervisor obtains sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. Where a bank or banking group's foreign currency business, either directly, or indirectly through lending in foreign exchange to domestic borrowers, is significant, or where a particular currency in which the bank has material exposure is experiencing problems, the supervisor requires the bank to undertake separate analysis of its strategy for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant individual currency.</p>
Description and findings re EC5	<p>As indicated in EC1 and EC3, the BoM receives daily information from the institutions regarding the structural gaps in foreign currency. This includes all forms of derivative transactions, including over-the-counter instruments.</p>

	This regime is being overhauled with the new liquidity regulation under discussion and will result in fundamental changes to align the current regulatory regime and practices to the international standards proposed by the BCBS.
EC6	The supervisor determines that banks have contingency plans in place for handling liquidity problems, including informing the supervisor.
Description and findings re EC6	Supervisors perform this determination as part of the activities discussed in EC2 above. The assessors have been provided with evidence that such plans are evaluated on an ad-hoc basis as part of the banks' annual inspections. In addition to the more explicit requirements in the new regulations referred to above, the CNBV has started to assess onsite the effectiveness and actual level of implementation (not only its existence) of liquidity contingency planning. According to the work already undertaken, the largest banks already have in place complex arrangements that relate contingency liquidity planning to actual management. However, the practice is less developed in smaller banking institutions, which will be challenged by the demands under the new regulation under discussion.
Additional criteria	
AC1	The supervisor determines that, where a bank conducts its business in multiple currencies, foreign currency liquidity strategy is separately stress-tested, and the results of such tests are a factor in determining the appropriateness of mismatches.
Description and findings re AC1	Supervisors perform this determination as part of the activities discussed in EC2 above. The assessors have been provided with evidence that such plans are periodically evaluated, focusing mainly on the larger and more complex banks, including a bank where the CNBV has requested that the existing plans be amended and strengthened.
AC2	The supervisor confirms that banks periodically review their efforts to establish and maintain relationships with liability holders, maintain the diversification of liabilities, and aim to ensure their capacity to sell assets.
Description and findings re AC2	Supervisors perform this determination as part of the activities discussed in EC2 above. The new draft regulation, which deals explicitly with this practice, will result in more visibility and attention being placed on this practice by both banks and bank supervisors.
Assessment of Principle 14	Largely Compliant
Comments	<p>The opinion of the assessors is that compliance with the conditions of this CP is not being achieved today in full, in terms of form and substance. However, in consideration of the efforts underway to revamp the liquidity regulations, which will be adopted during the last quarter of 2011, including the efforts to monitor liquidity in practice, the assessors are granting a largely compliant rating, and suggest the following recommendations to enhance the effectiveness of implementation:</p> <ul style="list-style-type: none"> • Emphasize in the new regulation the need for directors and senior managers of supervised institutions (in particular, consumer banks) to (i) relate explicitly the business model of their activities to their statement of risk appetite; (ii) relate credit risk to liquidity risk; and (iii) operate versatile information systems to monitor and report a diversity of core liquidity risk limits that encapsulate the stated risk appetite. • Ensure that information systems enable the reporting and monitoring of residual maturities;

	<ul style="list-style-type: none"> • Ensure that banks are clearly mandated to estimate and report to their Boards and the CNBV their liquidity positions using expected behavioral roll-off patterns for assets and liability holders, with and without explicit contractual maturities, including any embedded contractual optionality; • Emphasize the use of forward-looking liquidity risk metrics, both future static gaps, threats to changing expected maturities, and estimated flows under alternative scenarios.
Principle 15	<p>Operational risk. Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.</p>
<p>Summary description and findings re Principle 15</p>	<p>In its Title II, chapter IV, the Circular Unico de Bancos (CUB) establishes the principles and requirements for risk management policies and processes. According to this circular, risks are classified into two main categories: (i) the discretionary risks—riesgos discrecionales—that result from a risk-taking decision (e.g., credit, liquidity and market risks); and (ii) the nondiscretionary risks—riesgos no discrecionales—including, but not limited to, operational risks resulting from breakdowns in internal procedures, people, and systems.</p> <p>The Circular requires banks to have in place comprehensive risk management processes, including appropriate oversight by the Board of Directors and senior management. It states that risk management processes should address, among others, operational, technological and legal risks. According to this circular, a bank's Board of Directors must approve risk exposure limits submitted by the bank's Risk Committee.</p> <p>Art. 86 of the CUB specifically addresses operational risk (OR) areas and requires banks to identify operational risks, and establish measurement and monitoring practices. Banks are required to have a risk management unit (Unidad para la Administración Integral de Riesgos) that is independent of the Board and responsible for ensuring that the bank has internal controls and controls over such areas as information technology and legal risk.</p> <p>In terms of supervisory arrangements, OR is within the perimeter of the two prudential VPs. In addition, two departments are more particularly in charge of operational risks: the Department for Technical and Operational Risks (Dirección General de Supervisión de Riesgo Operacional y Tecnológico- DGSROT) and the Department for Discretionary Risks (Dirección General de Supervisión de Riesgos Discrecionales- DGSRD). DGSROT is composed of 30 examiners who are responsible for measuring OR on an individual and macro basis. It also deals with IT security and contingency planning (according to CNBV, all banks have been inspected on this particular issue, after approximately 60 to 80 on-site visits). DGSRD is more focused on the implementation of the methodology for OR management (detection of systemic issues).</p> <p>Despite a clear regulatory regime and progress made in terms of methodologies, supervision of OR is still in a transitional phase. As of today, OR is approached indirectly through the supervision of internal controls and risk management. CNBV's objective is to have OR fully integrated into its supervisory process by 2012. It is expected that in the months to come, CNBV will create a database to measure OR by banks and at the industry level, and determine capital charges more accurately. To this end, CNBV has launched a few on-site visits (only 5) to assess banks' readiness</p>

	for data reporting. Banks are making progress in this area, but there is still a way to go. CNBV reports that banks are moving slowly, including the group of seven large banks (G7), toward a more comprehensive operational risk framework. Reluctance to invest in systems seems to be the main reason for the slow progress.
Essential criteria	
EC1	The supervisor requires individual banks to have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk. These policies and processes are adequate for the size and complexity of the bank's operations, and the supervisor confirms that they are periodically adjusted in light of the bank's changing risk profile and external market developments.
Description and findings re EC1	<p>According to the CUB, banks must have comprehensive risk control processes in place that include the management of the various risks to which they may be exposed, in addition to adequate information systems and committees (e.g., Comité de Riesgos) needed to manage those risks. They must also have suitable systems of risk identification, measurement, and monitoring as determined by regulation. Even though these processes apply to all types of risks, including operational risk, the CUB also contains a specific set of requirements that addresses operational risks as stipulated in its Art. 86. According to this Article, banks must comply with all internal control obligations (as prescribed in the CUB, Chapter VI) and implement a series of policies and processes to manage operational risks.</p> <p>All banks are required to establish an internal database of loss events and to classify them according to seven loss-types. Identified losses must be grouped under each of the bank's business lines and must match its accounting records. These internal databases, however, have not been established evenly across the industry.</p> <p>Further, Art. 88 requires banks to publicly disclose information on their policies, methodologies, level of risk, and risk management practices for each type of risk. This disclosure has to be made on a quarterly basis through the banks' respective websites, and annually through notes to their financial statements. According to the same Art. 88, banks are required to communicate quantitative information on their operational risks, including technological and legal.</p> <p>Regarding capitalization rules, CNBV requires banks to maintain capital for operational risk using the Basic Indicator Approach. This approach complies with the requirements of Basel II (15 percent of the net average annual income of the last 3 years), but it is limited to 5 percent - 15 percent of the capital requirements for credit and market risks. These limits were established because the financial authorities were expecting a major impact on banks' capitalization ratios with the inclusion of the capital requirement for operational risk, due to Mexican banks' income levels. CNBV is planning to incorporate the other approaches set in Basel II in the near future.</p> <p>Assessors were told that only a few banks are using different types of qualitative tools to assess their operational risk, including the risk control self assessment (RCSA), key risk indicators (KRI), scorecards and risk maps. Currently the CNBV is reviewing their use in banks in order to determine if institutions have an operational risk management system that is conceptually sound. For the CNBV, this work is a pre-requisite to ensure that banks are ready to report quantitative data to the CNBV.</p>
EC2	The supervisor requires that banks' strategies, policies and processes for the management of operational risk have been approved and are periodically reviewed by the Board. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.

Description and findings re EC2	Pursuant to the CUB, the Board oversees management and ensures that banks' strategies, policies and processes for the management of operational risk are implemented effectively through the Audit Committee which follows the activities of Internal Audit Unit.
EC3	The supervisor is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management.
Description and findings re EC3	<p>CNBV has conducted very few onsite reviews of operational risk management in banks. The only targeted on-site visits on OR were done in 2009 and were limited to a few G7 banks. The other sectors (commercial, investment) have not been inspected on this particular topic.</p> <p>Several inspections, however, were carried out in 2008, 2009 and 2010 to specifically monitor internal controls, the internal audit function, corporate governance and risk management. Even though these visits did not cover explicitly OR, outcomes were used to understand aspects that are relevant for OR oversight.</p> <p>In particular, reviews focused mainly on verifying that (i) the responsibility for managing this risk has been assigned at the proper level and with adequate segregation of functions and independence; (ii) bank Boards have approved policies to identify and manage the various operational risks; and (iii) these policies are adhered to by management. In practice, banks have generally not completely conceptualized this risk and do not have a proper framework to control it.</p>
EC4	The supervisor reviews the quality and comprehensiveness of the bank's business resumption and contingency plans to satisfy itself that the bank is able to operate as a going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.
Description and findings re EC4	The CNBV verifies that banks have business continuity and contingency plans to satisfy itself that the bank is able to operate as a going concern and minimize losses. CNBV has given greater attention to these issues over the last few years. Around 80 on-site visits have been carried out, including overseas.
EC5	The supervisor determines that banks have established appropriate information technology policies and processes that address areas such as information security and system development, and have made investments in information technology commensurate with the size and complexity of operations.
Description and findings re EC5	For IT risk management, banks are obliged to assess vulnerability in hardware, software, systems, applications, security, information retrieval systems and networks. The regulation requires banks to submit regular reports on their IT system and any significant modifications that might impact the operational risk profile. CNBV has a dedicated team of experts who conduct IT reviews.
EC6	The supervisor requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
Description and findings re EC6	Regulations do not explicitly mandate a reporting system or a requirement that banks apprise the CNBV of developments affecting their operational risk, except on IT.
EC7	The supervisor confirms that legal risk is incorporated into the operational risk management processes of the bank.
Description and findings re EC7	According to the CUB, Art. 86, banks are required to create an historical database of internal risk events by business line. The legal risk should be covered (Art. 86, section III).

	<p>At a minimum, banks are expected to:</p> <ol style="list-style-type: none"> 1. Identify and document processes that describe the activities of each business unit of the bank, and also identify the implicit operational risks, 2. Evaluate and report at least quarterly the consequences of any materialization of identified risks and report results to the person in charge of the business units, 3. Establish risk tolerance levels for each identified risk (including legal), defining its causes, origins and risk factors, 4. Register loss events, and 5. Establish mechanisms to ensure an adequate flow, quality and timeliness of information between the Integral Risk Management Unit and other units within the entity.
EC8	<p>The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management program should cover:</p> <ul style="list-style-type: none"> • conducting appropriate due diligence for selecting potential service providers; • structuring the outsourcing arrangement; • managing and monitoring the risks associated with the outsourcing arrangement; • ensuring an effective control environment; and • establishing viable contingency planning. <p>Outsourcing policies and processes should require the institution to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.</p>
Description and findings re EC8	<p>Regulations also oblige banks to obtain CNBV approval for outsourcing activities. CNBV performs on-site visits, including overseas, to monitor IT-based transaction processing and the integrity of information more generally. Also, examiners check that banks have policies to assess, manage, and monitor outsourced activities.</p>
Additional criteria	
AC1	<p>The supervisor determines that the risk management policies and processes address the major aspects of operational risk, including an appropriate operational risk framework that is applied on a group-wide basis. The policies and processes should include additional risks prevalent in certain operationally intensive businesses, such as custody and correspondent banking, and should cover periods when operational risk could increase.</p>
Description and findings re AC1	<p>Under the current regime for operational risk, banks are required to identify and document all processes and operational risk involved in the daily operations and activities of each business unit. In addition, at least quarterly, banks must assess the impact of the identified operational risks. The assessors could not find that this requirement also applies on a consolidated basis. There is no obligation requiring banking groups to conduct operational risk management on a consolidated basis and implement operational risk management policies and processes on a group-wide basis.</p>
Assessment of Principle 15	<p>Materially noncompliant</p>
Comments	<ul style="list-style-type: none"> • Strengthen supervision of operational risk and make it operational. <p>Until now, CNBV has overseen OR indirectly, through the examination of</p>

	<p>compliance in the areas of internal controls, corporate governance, and risk management more broadly. In the risk Matrix CEFER, there is a component that is supposed to capture OR but, in practice, this component is related to internal controls and not to the other underlying components of OR (e.g.; legal). It is expected that a specific risk matrix for OR will be in place sometime soon.</p> <ul style="list-style-type: none"> • Increase the number of targeted on-site visits on OR, including in non G7 banks. <p>Very few inspections targeting OR have been carried out and most of them focused on G7 banks. The assessors urge the CNBV to increase its focus on this area in the next inspection planning.</p> <ul style="list-style-type: none"> • Incorporate operational risk within the CNBV's methodology and processes. <p>The framework is in place, tools for capturing data have been designed, and the methodology for measuring risk exposure is ready. However, the system is not yet operational. Even though banks are required by law to have in place processes and systems to measure and mitigate exposure to operational risks, they are not yet required to report data to the CNBV. In this regard, the CNBV is working on an infrastructure that will permit (i) tracking of the main products and processes that concentrate the biggest loss events; (ii) identification of banks with major problems in managing operational risk; and (iii) assessment of banks' tolerance to OR. Once this system is operational, CNBV will be able to better monitor OR by bank and on a macro level.</p>
Principle 16	Interest rate risk in the banking book. Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.
Summary description and findings re Principle 16	
Essential criteria	
EC1	The supervisor determines that a bank's Board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measuring, monitoring and control of interest rate risk. The supervisor also determines that management ensures that the interest rate risk strategy, policies and processes are developed and implemented.
Description and findings re EC1	<p>Assessment of the adequacy of interest rate risk management practices started in 2009 with the creation of two dedicated units under CNBV's technical vice-presidency that supervises according to risk (see EC2 in CP7). The first unit (Models and Methodology) is staffed with 35 specialists in modeling and quantitative risk measurement. The second unit (Risk Management Practices) is staffed with 23 specialists in evaluating the degree of implementation, in practice, of risk management systems at supervised institutions. Both units assist the work of the three vice-presidencies in charge of institutional supervision, which also perform work in this area.</p> <p>The activities to determine the suitability of interest rate risk management processes and applicable policies focus on the systems in operation to manage the market risk inherent in both the trading and banking book activities (see CP13). Both books attract</p>

	<p>a capital charge following a standardized VaR approach for interest and exchange rate risks, among other market risk factors (see CP13). This peculiarity of the Mexican regulatory system might have inhibited greater specificity in singling out interest rate risk from the monitoring and supervision of market risk as a whole.</p> <p>Supervisory work takes place through a mixture of activities, including: (1) the evaluation of the annual reports of the risk management and internal audit units; (2) the offsite evaluation of the sensitivity of the institutions to changes in interest rates to identify those institutions that present a more adverse/riskier profile; and (3) targeted onsite reviews of the institutions' activities.</p> <p>Institutions report to the CNBV their exposures by means of a suite of reports; in addition, the CNBV accesses daily the CIF (Central de Informacion Financiera), which is the financial database of the BoM (see CP13 and CP14). These reports are warehoused in the institutional databases of the CNBV and are used to elaborate a series of analytical reports and calculate indicators for monitoring and analysis.</p> <p>In practice, the focus of supervisors is placed on the largest banks operating in the system (G-7), which have more elaborate information systems that already visualize interest rate as a significant inherent risk within their risk management activities. Smaller banks are required to conduct standard market risk stress scenarios periodically; this is being extended to their banking books and captures all interest earning assets and interest bearing liabilities, including loans and deposits.</p>
EC2	<p>The supervisor determines that banks have in place comprehensive and appropriate interest rate risk measurement systems and that any models and assumptions are validated on a regular basis. It confirms that banks' limits reflect the risk strategy of the institution and are understood by and regularly communicated to relevant staff. The supervisor also confirms that exceptions to established policies, processes and limits should receive the prompt attention of senior management, and the Board where necessary.</p>
Description and findings re EC2	<p>The CNBV performs this determination as indicated in EC1 above.</p> <p>Beyond the positions in designated financial instruments (both in the trading and banking books), the CNBV looks at other possible structural re-pricing mismatches among interest-earning assets and interest-bearing liabilities that would give rise to material interest rate risk exposures. The CNBV believes that such risk is adequately covered by the extension of the market risk capital charge to the full banking book of activities. Of the total market risk charge for both books, which as of May 2011 represented 22 percent of the total capital needs for the full banking system, the CNBV estimates that about 40 percent belongs to the banking book and the rest to the trading book.</p> <p>As part of the onsite reviews conducted, the CNBV has established that most sources of interest rate risk in the banking industry are located in the "held to maturity" portfolio of securities, since most loan portfolios are short or medium term, with long-term portfolios largely being contracted at variable interest rates. Nonetheless, the assessors suggest that further attention be given to compiling risk management practices and risk measures of this risk at large banks in order to properly identify the scope of roll-over maturity mismatches, basis risk, and yield curve and optionality risks in the banks.</p> <p>Using a recently developed financial simulation model by the technical vice-presidency that supervises by risk, the CNBV evaluates periodically interest rate sensitivity by performing simulations under different scenarios on a case-by-case basis.</p>

	<p>This model projects cash flows and financial statements on a monthly basis for a two year horizon to mimic the U.S. SCAP (Supervisory Capital Assessment Program) and EU stress test exercises. The CNBV simulates different scenarios to that horizon with changes in the peso exchange rate, inflation, GDP growth, and interest rate changes, including estimated changes in the deposit base of the institutions, as well as the impact on the net interest margin and capital adequacy ratio, both resulting from changes in spreads and the base rate.</p> <p>In addition, the financial simulation model allows simulation of the impact on financial performance of changes and shifts in the banks' funding mix toward more expensive sources, as well as the buffer to break even in terms of coverage of non-interest expenses and pre-provision profits. The sensitivity of the net interest income and capital ratio to interest rates can be combined with other factors affecting the market value of the different portfolios of securities by means of term adjusted VaR measures from the trading measures.</p> <p>The assessors reviewed briefly the specifications of the financial simulation model and provided suggestions to complete the model and data entry in order to allow for standardized exercises of interest rate risk, including: (1) the sensitivity of net interest income and economic value to parallel shifts in the yield curve for selected basis points, including as a percentage of capital; (2) the sensitivity of net interest income and economic value to nonparallel shifts in the yield curve to which institutions might be vulnerable; (3) the sensitivity of net interest income and economic value to key rates to which the institution is vulnerable; (4) the monthly sensitivity and stress testing of the above measures.</p>
EC3	The supervisor requires that banks periodically perform appropriate stress tests to measure their vulnerability to loss under adverse interest rate movements.
Description and findings re EC3	<p>Stress testing for both the trading and banking book exposures to changes in market prices is required under Article 82 VI of the CUB and it is reviewed periodically by CNBV through offsite work for the selected banks, including onsite review during the annual risk focus inspections.</p> <p>There is the opportunity to require formal stress tests for interest rate risk based on standard scenarios prescribed for other interest earning assets and interest bearing liabilities that are different from the positions in designated financial instruments.</p>
Additional criteria	
AC1	The supervisor has the power to obtain from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book.
Description and findings re AC1	<p>Article 89 of the CUB provides general powers to the CNBV to require from the institutions information on their risk management activities.</p> <p>Currently, based on the capital adequacy regulations in place, the CNBV focuses more on monitoring the overall effect of interest and other market rates on the banks' capital charge required for both the trading and banking books, including the sensitivity of this charge to changes in the volatility of these rates. The latter is done by means of the overall stress test performed for both books.</p> <p>These powers are exerted on an ad-hoc basis when deemed necessary considering the scope of and complexity of the activities of the institutions, including their financial derivative activities in OTC and other exchange/trading products.</p>

	<p>At their request, the assessors have been presented with a recent sample internal report for interest rate risk management. This report, which was forwarded by an institution, is currently used for monitoring purposes.</p> <p>The CNBV receives from the institutions under its prudential reporting system information at the instrument level for all financial instruments that are sensitive to interest rate risk. In practice, this information allows the CNBV to estimate the valuation impact for the most interest rate sensitive assets held to maturity.</p> <p>However, the CNBV can request information on all bank assets, liabilities, and off-balance sheet transactions that might be sensitive to interest rate changes. The CNBV uses this information to refine its estimations of the impact of changes in interest rate risk on an institution's net interest income and economic value under a set of pre-established interest rate scenarios.</p>
AC2	The supervisor assesses whether the internal capital measurement systems of banks adequately capture the interest rate risk in the banking book.
Description and findings re AC2	<p>See comments for CP 13. Institutions are mandated to calculate and cover capital charges following the standard approach for market risk for all designated interest earning assets and interest bearing liabilities, including relevant off-balance sheet positions subject to market and interest rate risks in the trading and banking books.</p> <p>However, the CNBV does not yet require all the institutions to measure and quantify their overall exposure and sensitivity to interest rate risk.</p>
AC3	The supervisor requires stress tests to be based on reasonable worst case scenarios and to capture all material sources of risk, including a breakdown of critical assumptions. Senior management is required to consider these results when establishing and reviewing a bank's policies, processes and limits for interest rate risk.
Description and findings re AC3	Articles 71 II c), 74 III), and 82 VI of the CUB require institutions to evaluate potential losses under scenarios of stress for interest and foreign exchange risks assumed both in their trading and banking books. There is no explicit provision in the CUB that requires senior management either to consider the results of stress test exercises in order to establish policies and procedures and set risk limits, or to plan their capital needs accordingly.
AC4	The supervisor requires banks to assign responsibility for interest rate risk management to individuals, independent of and with reporting lines separate from those responsible for trading and/or other risk-taking activities. In the absence of an independent risk management function that covers interest rate risk, the supervisor requires the bank to ensure that there is a mechanism in place to mitigate a possible conflict of interest for managers with both risk management and risk-taking responsibilities.
Description	<p>Oversight of interest rate risk for positions in designated financial instruments is assigned to the risk committee under the governance of the Board of Directors of supervised institutions per Article 70 of CUB. In addition, Article 73 requires institutions to operate a risk management unit to support the risk committee in discharging its functions. This risk management unit is explicitly required to be independent from banks' business units.</p> <p>Besides the regulatory requirement, the CNBV ascertains that these standards are effectively respected by means of its onsite inspections focused on the implementation of risk management.</p>

Assessment of Principle 16	Largely Compliant
Comments	<p>The opinion of the assessors is that compliance with the essential and additional conditions of this CP is not being achieved today in full form and substance. However, in consideration of the efforts underway to monitor interest rate risk management in selected large banking groups, including to assess the impact of alternative market scenarios through financial simulation, the assessors are granting a largely compliant rating and recommend the following recommendations to enhance the effectiveness of implementation:</p> <ul style="list-style-type: none"> • Compile, by means of target inspections, the current status across-the-system of interest rate risk management practices in banks, including information systems in place. • Adopt a plan to single out interest rate risk from current market risk practice as part of the introduction of a formal Pillar 2. • Bifurcate reforms of the CUB for large complex and less complex business models to formally require implementation of interest rate risk management practices. • Extend the current practice of monitoring interest rate risk for larger banking groups using their internal risk management information reports to all relevant banks, including banks seen as running larger structural balance sheet positions. <p>Adjust the specifications of the financial simulation model to approximate better the effect of interest rate changes on both net interest margin and economic value.</p>
Principle 17	<p>Internal control and audit. Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.</p>
Summary description and findings re Principle 17	<p>The Circular Unica de Bancos under its Title II, Chapter VI, provides a comprehensive regulatory framework for internal controls as well as for internal auditing. It aims at adequately controlling operational risk, reinforcing internal audit functions, developing and updating information systems, minimizing conflicts of interest, and clearly defining the responsibilities for all participants.</p> <p>Examiners analyze during on-site examination the corporate governance function and the independence and adequacy of the audit function. The external auditor must report to both the Board and the audit committee in accordance with the CUB.</p> <p>Mexican regulation also requires the establishment of corporate governance principles and a code of ethics (<i>codigo de conducta</i>) for all personnel, as well as an appropriate number (at least 25 percent) of independent directors on the Board of Directors, which includes an audit committee headed by an independent director.</p>
Essential criteria	

EC1	Laws, regulations or the supervisor establish the responsibilities of the Board and senior management with respect to corporate governance to ensure that there is effective control over a bank's entire business.
Description and findings re EC1	<p>The CUB (Art. 141 and 146) requires the Boards to ensure implementation of good corporate governance principles in each of their business activities. The regulation delineates the duties and responsibilities of the Board. The Board approves the objectives of the internal control system and the guidelines for their implementation. In addition, the CUB requires banks to establish several committees, namely the audit committee (Comite de Auditoria) and the risk committee (Comite de Riesgo). There are other functions that banks should have in place, i.e., internal audit, risk management, and compliance functions. The regulations define clearly the respective roles and responsibilities of the Committees involved and senior management's obligations in this regard. The regulations require the Board to take follow-up action on audit findings and recommendations from the bank's internal audit function, the external auditor, CNBV, and/or other oversight authorities.</p> <p>As part of its supervisory work, the CNBV examines banks' compliance with these principles. Over the last 3 years, targeted inspections have been carried out in banks, not only in G7 banks but also in small and medium size entities. Examiners use a detailed questionnaire (bitacora) that contains all points of control to be reviewed during on-site visits. In addition to verifying compliance with the regulations, CNBV examiners also analyze a sample of documents to verify that there is effective control over a bank's entire business (e.g., minutes of Board meetings and other Committee meetings). In this respect, it is a common practice for inspectors to attend meetings of the Audit Committee while on site.</p>
EC2	<p>The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments. More specifically, these controls address:</p> <ul style="list-style-type: none"> - Organizational structure: definitions of duties and responsibilities, including clear delegation of authority (for example, clear loan approval limits), decision-making policies and processes, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance). - Accounting policies and processes: reconciliation of accounts, control lists, information for management. - Checks and balances (or "four eyes principle"): segregation of duties, cross-checking, dual control of assets, double signatures. - Safeguarding assets and investments: including physical control.
Description and findings re EC2	<p>The CUB provides a comprehensive regulatory framework for internal controls as well as for internal auditing, with a system of checks and balances and segregation of duties among the Board of Directors, senior management, audit committee and internal and external auditors (Title II, Chapter VI).</p> <p>It is the responsibility of the Board to ensure the creation, maintenance, and oversight of an effective internal control mechanism aimed at safeguarding and securing the property and assets of the bank; ensuring greater accuracy in reporting; strengthening legal and regulatory compliance; minimizing financial irregularities; and improving efficiency. To achieve this, banks are required to develop internal control systems that</p>

	<p>should at least cover: (i) management oversight and a risk control culture; (ii) risk identification and measurement; (iii) control activities and segregation of duties; (iv) accounting, information, and communication systems; and (v) monitoring activities.</p> <p>Banks are also required to establish an independent internal audit unit. In the same vein, they should appoint an Audit Committee responsible for proposing for the Board's approval, the objectives of the internal control system and the guidelines for their implementation considering the following aspects: organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments.</p> <p>During on-site visits, CNBV's inspectors review compliance with these principles. CNBV expressed concern regarding internal control practices, not only in small and medium banks, but also in a few G7 banks. One of these banks has only four internal auditors, which is not commensurate with the size and organization of the entity. Another matter of concern is the independence of the internal audit function. On several occasions, the CNBV instructed banks' Boards to pay further attention to this issue and ensure clear segregation of functions and the full independence of the internal auditors.</p>
EC3	Laws, regulations or the supervisor place the responsibility for the control environment on the Board and senior management of the bank. The supervisor requires that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment.
Description and findings re EC3	<p>Art. 141 of the CU (chapter VI) spells out the objectives of internal controls that banks should have in place as well as the respective roles assigned to different bodies, which include the Board and senior management, the Risk Committee, the Audit Committee, and the external and internal auditors.</p> <p>Art. 164 places the responsibility for the design and implementation of internal controls with senior management (<i>Dirección General</i>), while Art. 141 gives to the Board the responsibility to approve (i) the objectives of the internal controls and all guidelines for their implementation; (ii) the risk exposure limits; and (iii) the corrective measures.</p> <p>Pursuant to Art. 70, the Board is in charge of establishing a Risk Committee (Comite de Riesgos) that will submit to the Board's clearance the policies for managing risks, the global and specific risk exposure limits, and the mechanisms for implementing corrective actions. On the other hand, senior management (Director General) is also entrusted with the power to define, amend, and update internal control policies and manuals.</p>
EC4	The supervisor has the power to require changes in the composition of the Board and senior management to address any prudential concerns related to the satisfaction of these criteria.
Description and findings re EC4	CNBV can remove or suspend, from three months to five years, any member of the Board, or senior management, when any of these persons does not have sufficient technical skills, reputation, good credit history, or has committed serious or repeated violations of the LIC or the rules established in the CUB. Moreover, Art. 25 of the LIC grants the CNBV, with the approval of its Board, the power to require changes in the composition of the Board and senior management of supervised institutions.
EC5	The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.
Description and	CNBV ensures that there is an appropriate balance of skills between the front office and the supporting functions. The assessors were told that during on-site visits, CNBV

findings re EC5	inspectors also assess the adequacy and appropriate distribution of resources between the back and front offices. Particular attention is paid to the communication between the two units (e.g., daily reconciliation of positions) and to the appropriate segregation of duties between the back office and control functions relative to the front office/business origination.
EC6	The supervisor determines that banks have a permanent compliance function that assists senior management in managing effectively the compliance risks faced by the bank. The compliance function must be independent of the business activities of the bank. The supervisor determines that the Board exercises oversight of the management of the compliance function.
Description and findings re EC6	<p>Neither the LIC nor the CUB requires banks to have a Compliance Officer. Nevertheless, the Board of Directors should establish a committee (Comite de Riesgo) whose role is to assist senior management in managing the compliance risks faced by the institution (Art. 166 and 167). The risk committee should have at least two members of the Board, senior management, the head of the risk management unit and the internal auditor of the institution. This committee shall meet at least once a month and all meetings and agreements shall be recorded in the minutes.</p> <p>CNBV performs an evaluation of the effectiveness of the compliance function mainly during on-site examinations, based on banks' compliance with prudential regulation. CNBV pays particular attention to the following: (i) the audit annual working plan, when applicable, and how it is being accomplished; (ii) the number and importance of the findings during previous CNBV examinations and internal audit reviews; (iii) the suitability of manuals and controls; and (iv) the content, quality and scope of reports issued by the person in charge of the compliance function to senior management and the Audit Committee.</p>
EC7	The supervisor determines that banks have an independent, permanent and effective internal audit function charged with (i) ensuring that policies and processes are complied with; and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the bank's business.
Description and findings re EC7	As observed above, the CUB requires banks to establish an internal audit function that is independent of the other operational units. The internal audit function is assigned responsibility for conducting the internal audit as well as preparing and updating the internal guidelines on the various aspects covered by Mexican regulations. The internal audit responsibilities include analysis and evaluation of financial, accounting, operational, and other activities through both on-site and off-site reporting. In practice, the CNBV conducts examinations to verify whether the bank has an independent, permanent and effective audit function. For this purpose, the CNBV has developed a detailed methodology (MIS and Bitacora) spelling out all the controls to be reviewed. The findings are used to update the risk Matrix CEFER.
EC8	<p>The supervisor determines that the internal audit function:</p> <ul style="list-style-type: none"> - has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; - has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations; - has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;

	<ul style="list-style-type: none"> - employs a methodology that identifies the material risks run by the bank; - prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and - has the authority to assess any outsourced functions. 																																																																																														
Description and findings re EC8	<p>To assess the adequacy, effectiveness and integrity of internal controls and audit, the CNBV has different means: on-site and off-site supervision, review of audit reports, manuals and procedures, examination of external audit's reports, working papers, interviews, etc. This work allows CNBV staff to rate the quality of internal controls and internal audit in the Risk Matrix CEFER as shown below.</p> <p style="text-align: center;">BANK Risk Matrix</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th rowspan="2">Activities</th> <th rowspan="2">Weight</th> <th colspan="5">Inherent risk</th> <th rowspan="2">Total Risk</th> <th colspan="4">Risk Mitigating</th> <th rowspan="2">Net Risk</th> <th rowspan="2">Risk trend</th> </tr> <tr> <th>Market</th> <th>Liquidity</th> <th>Credit</th> <th>Legal</th> <th>Operational</th> <th>Management and Corporate Governance</th> <th>Internal Controls</th> <th>Risk Management</th> <th>Internal Audit</th> <th>Total Risk Mitigating</th> </tr> </thead> <tbody> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> <tr><td> </td><td> </td></tr> </tbody> </table>	Activities	Weight	Inherent risk					Total Risk	Risk Mitigating				Net Risk	Risk trend	Market	Liquidity	Credit	Legal	Operational	Management and Corporate Governance	Internal Controls	Risk Management	Internal Audit	Total Risk Mitigating																																																																						
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AC1	In those countries with a unicameral Board structure (as opposed to a bicameral structure with a Supervisory Board and a Management Board), the supervisor requires the Board to include a number of experienced non-executive directors.																																																																																														
Description and findings re AC1	As set forth in the LIC, Art. 22, the Board will consist of a minimum of 5 and a maximum of 15 members, at least 25 percent of whom must be experienced non-executive directors.																																																																																														
AC2	The supervisor requires the internal audit function to report to an audit committee, or an equivalent structure.																																																																																														
Description and findings re AC2	Pursuant to the CUB, Art. 144, the Internal audit department reports to the Audit Committee.																																																																																														
AC3	In those countries with a unicameral Board structure, the supervisor requires the audit committee to include experienced non-executive directors.																																																																																														
Description and findings re AC3	Audit Committee members will be selected based on their ability and professional expertise. At least one of its members must be a person with extensive experience in finance and/or audit and control. In no case shall officers and employees of the bank be designated as members of the Audit Committee (CUB, Articles 145 and 146).																																																																																														
AC4	Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management.																																																																																														
Description and findings re AC4	The institutions must be sure that persons who are designated as Board members or part of senior management comply with all requirements, and as soon as they become aware of any material information that may negatively affect the fitness and propriety of any of the mentioned persons, they are required to inform the CNBV (LIC, Article 24 Bis).																																																																																														
Assessment of Principle 17	Compliant																																																																																														
Comments	The CUB compiles in one provision all banking regulations issued by the CNBV. This Circular under its Title II, Chapter VI, provides a comprehensive regulatory framework																																																																																														

	<p>for internal controls as well as for internal auditing. The CNBV has also spent a lot of energy and resources on formalizing processes and methodologies to better oversee internal control functions in banks.</p> <p>Some improvements could be considered in the following areas:</p> <ul style="list-style-type: none"> • Consider performing a full cycle of inspections across the industry on internal controls: As observed above and in other principles (see BCP 19 and 20), the CNBV does not follow a full cycle of inspections consisting in reviewing, at least in the systemic banks, the core functions at the end of a given cycle. As a result, there is no structured and comprehensive assessment of the entire internal control function in banks. • Reconsider the five levels of risk in the risk matrix or provide more guidance to improve risk classification: The risk matrix CEFER uses five levels of risk, which seems too high. There is very little difference between the underlying factors that are being used to score the audit function “very good,” “good” or “acceptable.” In the absence of further guidance, the classification of banks between these categories might not be completely accurate. • Develop some metrics to better evaluate and monitor the intensity of banks’ audit efforts: In practice, the CNBV receives and examines the annual work plan sent by banks. This plan should include the audit work program and resources dedicated to it. To better judge the adequacy of resources and the intensity of the bank’s efforts, CNBV may wish to use the following indicators: (i) cost of the annual internal audit; (ii) days per unit of assets; (iii) number of internal auditors to total employees; and (iv) number of senior to total auditors.
Principle 18	Abuse of financial services. Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.
Summary description and findings re Principle 18	<p>(i) Background</p> <p>Drug and human trafficking as well as weapons smuggling are serious concerns in Mexico. CNBV itself also expresses concern about the fast growing operations conducted by criminal organizations. Although Mexican authorities have made some progress in fighting these crimes, the U.S. Department of State still considers Mexico a jurisdiction of primary concern regarding money laundering (see for example the 2010 U.S. State Department of State report on Money Laundering and Financial Crimes, http://www.state.gov/documents/organization/137429.pdf).</p> <p>For Mexico, the fact that a significant portion of the economy is cash-based also presents some serious problems in AML compliance. It is believed that efforts such as the payroll card and the increasing use of debit and credit cards will help the banks and authorities to gain more control of money laundering going forward.</p> <p>Mexico has a dual full membership in the Financial Action Task Force on Money Laundering (FATF) as well as in the FATF style regional body for South America (GAFISUD). In January 2008, Mexico was assessed by the IMF and the detailed evaluation report was endorsed by the GAFISUD Plenary as a mutual assessment in</p>

October 2008. Due to the fact that Mexico did not comply with several key FATF recommendations as observed by the assessors (e.g., on Rec. 1, 5, and 13 and Special Rec. II and IV), it was decided in 2009 to subject Mexico to a follow-up mechanism consisting in reporting to GAFISUD's members on progress made in addressing key shortcomings. To date, Mexico has submitted two follow-up reports.

(i) Current legal and supervisory regime for AML/CFT

Legal. The AML/CFT regulatory regime in Mexico is built around these following pillars: The Federal Criminal Code that contains the principal ML provisions (Art. 400 Bis), and the Penal Procedures Code that criminalizes terrorist financing. In addition, the SHCP issued in 2004 AML/CFT regulations (*Disposiciones de Caracter General*) under the applicable financial laws for all financial sectors subject to the AML/CFT regime at that time. Then, in 2006, the SHCP issued two revised AML/CFT regulations, one for FIs covered under Article 115 of the LIC and one for FIs covered under Article 124 of the Popular Savings and Loan Law (*Ley de Ahorro y Credito Popular*). These revised regulations enhanced the regulatory requirements and introduced more extensive risk-based elements for CDD. Both laws and the subsequent regulations are enforceable. In the wake of the 2008 assessment, new regulations were issued by the SHCP in relation to cash transactions in U.S. dollar and prepaid cards.

The FIU, CNBV, and financial sector representatives jointly issued a set of best practice guidelines to help improve the quality of STRs submitted to the FIU by financial institutions subject to CNBV's supervision.

Supervisory arrangements. CNBV is vested with the power to supervise AML/CFT compliance in banks, *casas de cambios*, regulated *Sofomes*, and a myriad of other entities such as Credit Unions, leasing companies, securities brokers, and Savings & Loan associations. In this regard, a major change has recently been initiated. A 2011 reform has expanded significantly the scope of CNBV's supervision by putting under its umbrella hundreds of new entities (remittances, exchange centers, and unregulated *Sofomes*) previously supervised by the internal revenue service (SAT) (see below).

Before 2007, AML functions were delegated to the CNBV's Legal department, which did not have a supervisory role; in fact, the people in charge of prudential supervision were also overseeing AML. In 2007, as part of a new strategy approach for supervision, a special AML unit was established comprising (i) the *Direccion General de Prevencion de Operaciones con Recursos de Provedencia Illicita* (DGPORPI), in charge of day-to-day oversight; and (ii) the *Direccion General de Atencion a las Autoridades* (DGAAA) responsible for dealing with special requests received from the FIU or the Prosecutor (*Procuraduria de la Republica*). The other supervisory departments of CNBV (*Direcciones Generales de Supervision*) also carry out AML/CFT work for the purpose of their prudential surveillance.

(ii) Main findings since the last 2006 BCP assessment

Improvements have been made in several areas as reported by the country to GAFISUD. New secondary instructions have been issued in 2011 for exchange centers (*centros cambiarios*), remittances and unregulated *Sofomes* (*Sociedades Financieras de Objeto Multiple*). There are, however, significant challenges ahead for AML efforts in Mexico. Banks' internal AML/CFT systems require further improvement, particularly in relation to the detection and reporting of suspicious transactions, particularly for small banks. Casas de cambios and many of Mexico's "nonbank banks"

known as Sofomes and Sofoles (*Sociedades Financieras de Objeto Limitado*) are a matter of concern. Unregulated Sofomes, which can launch operations without the authorization and supervision of Mexican authorities, have faced increasing criticism and accusations of questionable practices, including money laundering.

The applicable financial regulatory laws provide the CNBV with comprehensive powers of supervision, including enforcement powers for noncompliance with AML obligations. In 2007, CNBV developed a new organization to increase the effectiveness of its supervisory activities, by creating a dedicated department (*Dirección General de Prevención de Operaciones Ilícitas-DGPOI*) responsible for AML/CFT oversight, in addition to the existing on-site and off-site capacity of the other prudential units. Integration of DGPOI within the overall architecture of the CNBV was reinforced in 2009 by the upgrading of the department into a Vice Presidency (*Vice Presidencia de Supervisión de Procesos Preventivos-VSPP*) comprising DGPOI and DGAAA.

As a result, AML/CFT has been given the same prominence as the other VPs, but with limited resources. With only 13 dedicated on-site inspectors, the assessors expressed serious concern about the capacity of the VPSPP to properly oversee more than 430 entities, including 41 banks. Most importantly, the upcoming transfer of hundreds of new entities under VPSPP surveillance without any concomitant transfer of resources may jeopardize CNBV capacity and create a reputational risk.

In terms of processes, the supervision of banks is organized along functional lines under various Vice Presidencies. To avoid duplication of effort or gaps in surveillance, mechanisms of cooperation and exchange of information have been established. VPSPP staff participate in general integrated inspections but also they conduct separate on-site visits, independently of the prudential areas. This arrangement helps to increase expertise and cross-fertilization between units.

With the technical assistance of the IMF, significant efforts have been made to harmonize on-site work (through the creation of new manuals and tools- *bitacora*-) and promote a more risk based approach. A Risk Matrix for AML/CFT has also been conceived but is not yet fully implemented. Only 15 banks out of 41 have been rated so far and the risk mapping for the entire banking sector will not be completed before March 2012. Off-site surveillance has also been strengthened, but reporting mechanisms have not been completed yet.

The assessors reviewed several on-site examination reports, including for international active banks in Mexico. The content appeared very detailed and thorough. In addition, the assessors found evidence that CNBV inspectors usually follow up on corrective measures undertaken by the bank since the last visit. Also, on-site work is based on the analysis of a sample of transactions. Furthermore, CNBV inspectors verify the overall quality of STRs sent to the FIU. However, improvements are needed to better align on-site work with off-site surveillance and promote a consolidated supervision for AML/CFT.

On the enforcement front, the credibility of AML policies and procedures is generally measured by the number of convictions and the amount of frozen or seized crime-related assets. In the 2009 assessment report, GAFISUD judged Mexican AML efforts as low relative to sanctions, convictions, and seizures. In 2011, BCP assessors have not seen any notable improvement in this regard. Sanctions from the CNBV have been used on a small scale and appear neither proportionate nor dissuasive. Only fines

	<p>have been applied to banks and these have been relatively small, particularly for the larger institutions. The assessors were told that CNBV is about to hand over “exemplary” sanctions against one bank and a securities firm.</p> <p>Due to the relative importance of ML risks in the Mexican system, especially from drug trafficking and organized crime related offenses, little attention has been given to terrorist financing. Prudential surveillance in banks has mainly focused on compliance with AML obligations. More attention to the surveillance of TF activities through horizontal and thematic inspections would be desirable, although TF has not been identified as posing a particular threat.</p>
Essential criteria	
EC1	Laws or regulations clarify the duties, responsibilities and powers of the banking supervisor and other competent authorities, if any, related to the supervision of banks’ internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
Description and findings re EC1	<p>The responsibilities, duties and powers of the CNBV are clearly established. Under the Mexican system, the Ministry of Finance and Public Credit (SHCP–<i>Secretaría de Hacienda y Crédito Público</i>) is responsible for the implementation of the AML/CFT regime in the financial sector, with overall responsibility for the regulation and supervision of compliance with AML/CFT requirements. Its functions are performed through five administrative bodies and agencies (<i>órganos desconcentrados</i>). As far as banks are concerned, the competent agency is the CNBV.</p> <p>On the other hand, the functions, powers and obligations of the CNBV as the supervisory authority of the financial system, are established in several laws, in particular (i) the National Banking and Securities Commission Law; and (ii) the Credit Institutions Law (LIC). The LIC entitles the CNBV to carry out supervision of the credit institutions through on-site visits while the CNBV Law defines the supervisory and regulatory mandate of the CNBV. It is therefore clearly established that the CNBV is responsible for overseeing the transactions, organization, operations, processes, internal control systems, risk management and information systems of banks. Moreover, CNBV has broad powers to obtain access to and inspect banks’ operations and processes. It is also vested with enforcement powers to sanction any deviation from AML/CFT laws and regulations.</p> <p>The DCG (Art. 115, Regulation 55) further states that the CNBV, in the exercise of its supervisory powers, is mandated to ensure that FIs, including, as the case may be, their offices, branches, agencies and affiliates, both in Mexico and abroad, comply with their AML/CFT obligations. In addition, the CNBV may request, at any time, information or documentation necessary to exercise its powers as contemplated in Art. 115 of the LIC.</p>
EC2	The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.
Description and findings re EC2	Supervisory expectations with regard to the existence of policies and processes to guard against financial abuse are contained in the AML law, and subsequent regulations and guidelines. The AML law requires that banks adopt, develop and implement programs, procedures and internal controls to prevent and detect activities

	<p>related to ML/TF. More precisely, FIs are required to (i) adopt an adequate KYC system; (ii) have procedures to ensure that their staff has a high level of integrity and adequate training; (iii) set up mechanisms to detect suspicious activities; (iv) establish procedures to report suspicions to the FIU in a timely fashion; (v) appoint an officer in charge of communicating these transactions to the FIU; and (vi) have an internal audit system capable of verifying compliance with AML/CFT obligations. In addition, the units in charge of implementing and monitoring this framework are required to have sufficient human and material resources and authority to enable them carry out their functions.</p> <p>At the CNBV level, there is an extensive supervisory program related to verification of internal controls at banks, and the CNBV verifies compliance with reporting obligations during its on-site visits. BCP assessors reviewed several on-site examination reports and observed that CNBV pays special attention to the quality of the reporting system to the FIU. A sampling of significant operations is also conducted during on-site visits to test the effectiveness of banks' detection mechanisms. On several occasions, including for international active banks, measures have been requested to correct deficiencies in their reporting practices. Follow-up mechanisms for these corrective actions are also part of the off-site process.</p> <p>In discussions, CNBV staff mentioned that they were not completely satisfied with the quality of banks' STR processes. This has been confirmed by the FIU in separate interviews. There is still an issue with defensive reporting. In its 2008 assessment, the IMF observed that there had been an overwhelming number of STRs, many of which were irrelevant and of low quality. The situation has not changed in 2011 and the authorities are taking steps to reduce the number and improve the quality of reports. In particular, a new framework for reporting suspicious activities is about to be released.</p>
EC3	<p>In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when they are material to the safety, soundness or reputation of the bank.</p>
Description and findings re EC3	<p>There is no such obligation in the Mexican regime. According to the CNBV legal department, banks have to report suspicious activities in relation to the offenses to which the LIC refers. Under the penal code, fraud is not an offense.</p>
EC4	<p>The supervisor is satisfied that banks establish "know-your-customer" (KYC) policies and processes which are well documented and communicated to all relevant staff. Such policies and processes must also be integrated into the bank's overall risk management. The KYC management program, on a group-wide basis, has as its essential elements:</p> <ul style="list-style-type: none"> - a customer acceptance policy that identifies business relationships that the bank will not accept; - a customer identification, verification and due diligence program; this encompasses verification of beneficial ownership and includes risk-based reviews to ensure that records are updated and relevant; - policies and processes to monitor and recognize unusual or potentially suspicious transactions, particularly of high-risk accounts; - escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; and

	<ul style="list-style-type: none"> - clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Such records should have at least a five year retention period.
Description and findings re EC4	<p>The requirements for customer identification are laid out in the LIC and in Art. 115 of the DCG. Customer Due Diligence and KYC requirements are generally comprehensive. There is, however, no explicit obligation to obtain information on the purpose and intended nature of business relationships. The LIC also contains risk-sensitive approaches that permit enhanced and simplified CDD. Under certain regulations (Regulations 25 and 26 of DCG 115 and DCG 124), banks are required to classify customers and transactions in accordance with the degree of ML and TF risks. It is also suggested that banks understand the person who controls the customer and the actual beneficiary of the transaction.</p> <p>Banks are also required to have internal control mechanisms to monitor and identify unusual transactions. As observed by the IMF in 2008, Mexico has a comprehensive legal and regulatory framework for the reporting of transactions to the FIU, which includes the filing of reports for any suspicion of ML and, more generally, for any unusual transaction that is not justified. Both actual and attempted transactions must be reported, and there are other types of reports based on objective monetary thresholds. There is also a clear obligation to report transactions suspected of being related to domestic terrorism or its financing (the obligation, however, does not extend to suspected financing of international acts of terrorism). The LIC and sectoral regulations also oblige banks and other FIs to have in place mechanisms to keep records for at least 10 years. Compliance management arrangements and adequate training for staff are also mandatory.</p> <p>As part of its on-site work, CNBV verifies compliance with CDD/KYC stipulations and other requirements as mentioned above. BCP assessors read a sample of on-site examination reports and noted that inspectors are giving attention to these topics. In all cases reviewed, there were observations or comments in relation to KYC/CDD (<i>oficio de observaciones</i>). The mechanisms for reporting suspicious activities to the UIF are also closely examined during on-site visits. In several instances, corrective measures were required at the end of the inspection (<i>oficio de medidas correctivas</i>). The AML Unit has also submitted several requests to the Legal department in order to process sanctions against banks that failed to comply with their reporting obligations.</p>
EC5	<p>The supervisor is satisfied that banks have enhanced due diligence policies and processes regarding correspondent banking. Such policies and processes encompass:</p> <ul style="list-style-type: none"> - gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and - not establishing or continuing correspondent relationships with foreign banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.
Description and findings re EC5	<p>The DCGs establish that for the provision of correspondent banking to foreign counterparts, such activity has to be approved by management. In addition, procedures and measures that their counterparts carry out on AML/CFT must be documented. In this regard, banks and other FIs must obtain from their foreign counterparts the following:</p>

	<p>(i) A certification by an independent auditor or, in its absence, a certification by its counterpart, where it should be stated that the said counterpart complies with similar obligations to the ones established for banks in the DCGs, with regard to customer identification and KYC; and</p> <p>(ii) Information that will enable the bank to:</p> <ol style="list-style-type: none"> a. Know the business that is carried out by the said counterpart; b. Assess control mechanisms with the purpose of determining that they comply with international standards on AML/CFT; c. Know if the said counterpart is supervised by any competent authority on AML/CFT issues; and d. Determine if the counterpart has a good reputation. <p>Additionally, the DCGs establish enhanced scrutiny for correspondent banks incorporated in countries or territories where, according to the SHCP, AML/CFT policies are deficient or insufficiently applied.</p> <p>Engaging in a correspondent banking relationship with shell banks is also prohibited.</p> <p>In practice, the CNBV has given particular attention to the issue of correspondent banking and considers this business to be particularly exposed to high ML risks, given the local context.</p>
EC6	<p>The supervisor periodically confirms that banks have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.</p>
Description and findings re EC6	<p>In order to confirm that banks have sufficient controls and systems in place for AML purposes, CNBV has built its supervisory arrangement as follows. As for any other type of risk, there is a mix of on-site and off-site activities for ML. However, unlike the other risks (e.g., market, credit, liquidity), AML is monitored through a dual system. There is a dedicated VP for AML (<i>VPSPP</i>) that can perform both on-site visits and on-going surveillance. In addition, the other VPs in charge of prudential surveillance also carry out AML duties. In theory, VPSPP has the leadership on AML surveillance but, in practice, due to scarce resources, it relies on the other VPs. The DGPOI participates in general integrated inspections, but has also conducted separate focused inspections, independent of the prudential areas. It has also been engaged in special examinations for AML cases.</p> <p>On-site work. Regardless of which VP is involved, CNBV conducts three types of on-site visits: (i) ordinary (<i>visitas ordinarias</i>); (ii) special (<i>visitas especiales</i>); and (iii) targeted (<i>visitas de investigation</i>). They are carried out with the purpose of verifying and evaluating banks' adherence to AML requirements. Internal policies, procedures, and internal controls are examined, and the effectiveness of the reporting system is also tested. On-site visits include verifying that banks have adopted selection processes in order to ensure that their personnel has adequate technical quality and experience, as well as high ethical standards, to carry out their duties.</p> <p>For on-site purposes, a new methodology is being developed. This consists of several inspection processes that form part of the so-called Integral Manual of Supervision (<i>Manual Integral de Supervision</i>). They are built around two key components (i) a worksheet (<i>Bitacora de cumplimiento</i>); and (ii) modules for revising files (<i>Cedulas de revision de expedientes</i>). The "bitacora" is a working document that contains the outcome of the on-site visit; for each component to be analyzed, inspectors assign a</p>

	<p>grade (very good, good, medium, deficient or very deficient) along with comments supporting the grade. In addition, the bitacora contains inspectors' observations and recommendations.</p> <p>The modules for revising files aim to guide the inspectors' work for every single activity to be reviewed. The BCP assessors examined in detail the CNBV methodology and commend CNBV for the work that has been done. The methodology is very detailed and provides a lot of guidance to inspectors on every step of the on-site visit. It is noteworthy, however, that these tools have not yet been completed. There are many themes for which formalization of methods is still needed (e.g, internal controls, AML risk management, compliance, and training).</p> <p>Off-site work. Off-site oversight largely consists of periodic assessments of the financial information received from subject entities (financial statements, policies manuals, internal control reports) and follow-up from previous examinations. Despite significant efforts since 2007, off-site AML supervision is in a transition phase. CNBV is in the process of improving its off-site surveillance by creating new processes and tools. The objective—to be achieved by 2012—entails the structuring of on-going AML surveillance around 3 pillars: (i) a diagnostic of each supervised institution that is to be made using several criteria (types of products and customers, financial flows, governance structure, etc.); (ii) a Risk Matrix updated annually and aimed at rating each financial institution using multiple factors (type of customer, currency, and geographic location) and 5 levels of risk; and (iii) a regulatory report to be completed by banks using a standardized format. These new processes are still being tested on-site and reviewed by the Methodology Unit of the CNBV (<i>Dirreccion General de Metodos y Proceso de Supervision</i>).</p> <p>To determine its annual program of visits, DGPORPI uses several criteria (the current risk matrix (Matrix CEFER) used by the prudential department (which contains a limited component on AML, information from other national agencies (e.g., the FIU), and other topics of particular relevance. As observed in other areas, CNBV does not have a full cycle of inspections for reviewing all AML related aspects for all banks within a given time frame.</p> <p>As discussed below, DGPORPI needs additional resources to better enable it to support all the other supervisory units, particularly on-site inspections, while at the same time conducting its own specialized visits. In addition, the expansion of the CNBV supervisory perimeter over new nonbank entities will likely constrain resources for routine supervisory activities. This will require careful resource management on the part of the CNBV to ensure that its surveillance of banks is not adversely affected.</p>
EC7	The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its obligations related to criminal activities.
Description and findings re EC7	<p>The regime for AML enforcement meets most of the FATF criteria by offering enough flexibility to the CNBV. The scope of possible sanctions is broad as the regime offers a wide range of measures ranging from fines to restriction, suspension, and revocation of the banking license for the most extreme scenarios. However, the assessors are of the opinion that the enforcement of this regime is weak due to several elements (for more details, see BCP 23):</p> <p>First, fines are not a sufficient deterrent. The amount does not seem dissuasive for very large institutions. Over the last few years, the average fines applied by the CNBV ranged between US\$2,000 and US\$8,000. In this respect, progress has been made to</p>

	<p>increase the amount of fines that can be imposed. Before 2008, fines were capped at 500 days of daily salary (<i>salario minimo</i>, approx. 50 pesos); in 2008 and 2011, the cap was successively raised to 2,000 and 10,000 days of daily salary (100,000 and 500,000 pesos). Also, the collection of fines by the SAT could be more effective; in many cases, the amount of the fines pronounced by the CNBV has been neither fully paid nor collected.</p> <p>Second, the enforcement strategy does not appear adequate and proportionate. Due to several conditions (see BCP 23 for more details), there has been a tradition of forbearance. Sanctions have consisted in fines only and their amount, individually or globally, have been very small. From 2000 to 2006, 30 million pesos of fines were collected (equivalent to approximately US\$2.5 million), which is very low compared with the size of the financial sector. Very few were directed to banks and none of the other tools have been considered (e.g warning to the management, suspension of activities). Revocation of the license was used in one case and against a bureau de change.</p> <p>During the mission, the assessors were told that the Board of the CNBV approved a fine of “historical magnitude” (360 million pesos, equivalent to approx. US\$30 million) against a bank. This is a clearly sign of a more “aggressive” approach toward a serious breach of AML compliance.</p> <p>Enforcement of AML is also hampered by the complexity of the legal process (long delays in the judiciary, questionable legal framework for taking action) and the scarcity of resources at the Legal VP. All sanctions, including for AML, are processed by the CNBV’s legal department; hundreds of files are still being examined and it can take years to complete the cycle. The assessors reviewed several files and observed in one case that it took 4 years for the legal department to require DGPI’s technical opinion on the case.</p>
EC8	<p>The supervisor must be satisfied that banks have:</p> <ul style="list-style-type: none"> - requirements for internal audit and/or external experts³² to independently evaluate the relevant risk management policies, processes and controls. The supervisor must have access to their reports; - established policies and processes to designate compliance officers at the management level, and appointed a relevant dedicated officer to whom potential abuses of the bank’s financial services (including suspicious transactions) shall be reported; - adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; and - ongoing training programs for their staff on KYC and methods to detect criminal and suspicious activities.
Description and findings re EC8	<p>The Mexican regime defines all the requirements that banks should meet in relation to risk management and internal audit. All details can be found in the DCGs. As for banks, the relevant DCG establishes that they must set up a committee (Communications and Control Committee), which determines the related policies and procedures. The Committee must be composed of high ranking employees and, in any case, the general director. Likewise, the Committee will appoint from its members an employee as Compliance Officer, who will carry out a series of duties and obligations and to whom potential abuses of the bank’s financial services (including suspicious transactions) shall be reported. The CNBV uses on-site visits to ensure that financial</p>

	<p>institutions adhere to these rules. In practice, it has been observed that the banks have their Committees and Compliance Officers in place in accordance with the DCGs.</p> <p>Regarding integrity issues, the Mexican regime has established strict screening and fit-and-proper processes. The DCG also establishes that credit institutions must develop training and dissemination programs that contain at least the following: (i) courses at least once a year, directed especially to those officers and employees that are in the front line; (ii) the dissemination of the DCGs and their amendments; and (iii) information regarding techniques, methods, and trends to prevent, detect, and report ML/TF transactions. Banks must also issue certificates that prove the participation of their officials and employees in the training courses.</p>
EC9	The supervisor determines that banks have clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also confirms that banks have adequate management information systems to provide managers and the dedicated officers with timely information on such activities.
Description and findings re EC9	In the course of its supervision of AML, the CNBV examines the policies and processes in place for reporting any abuse of financial services. The LIC specifically provides that the reporting of such abuses and the reported abuse are to be kept confidential.
EC10	Laws and regulations ensure that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.
Description and findings re EC10	The LIC establishes that compliance with the reporting obligations established in said law or in the general provisions that are derived from it, do not constitute a violation of the regulations regarding bank and financial secrecy. Also, the DCGs establish that the reports and all other information that is generated by credit institutions will not be considered as indications of the commission of a crime. Because of this, officials and employees that report suspicious activities in good faith cannot be held responsible in any way for reporting unusual or suspicious transactions to the competent authorities.
EC11	The supervisor is able to inform the financial intelligence unit and, if applicable, other designated authority of any suspicious transactions. In addition, it is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
Description and findings re EC11	Unlike other countries where suspicious activities are directly reported by banks to the FIU, the Mexican regime requires banks to send their STRs to the CNBV. The transmission is made automatically. CNBV then channels all reports to the FIU, without exercising any filter whatsoever.
EC12	The supervisor is able, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.
Description and findings re EC12	There are no limitations that prevent the CNBV from sharing information with other domestic authorities as long as the information requested is within its scope of competence. For example, Art. 97 of the LIC states that " <i>to facilitate the fulfillment of their functions, the Ministry of Finance, the Bank of Mexico, the CNBV, the Commission for the Protection of Users of Financial Services and the Institute for the Protection of Banking Savings, shall be able to request and share the information that they obtain....</i> "

	In addition, Art. 117 Bis of the LIC allows the CNBV to provide overseas financial authorities with information concerning operations and services under the AML provisions of Art. 117 and under Art. 46 (permissible activities for FIs covered by the LIC.).CNBV has been very active in developing international cooperation through MOUs with overseas supervisors. Overseas supervisors have participated in on-site visits of Mexican-licensed entities and CNBV staff has also participated in similar visits abroad. Visits by foreign supervisors to their Mexican subsidiaries covering AML/CFT topics were: 0 in 2010 and 0 in 2011. Overseas visits by the CNBV that covered AML issues were 1 in 2010 and 1 in 2011.
EC13	None
Description and findings re EC13	
Essential criteria	
AC1	If not done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities.
Description and findings re AC1	N/A
Assessment of Principle 18	Largely Compliant
Comments	<p>The assessors commend the CNBV for the significant efforts made to integrate supervision of AML into the CNBV apparatus and thus prevent abuse of financial services. An incredible amount of work has been produced in terms of formalization of processes, methodologies and know-how. CNBV staff appears extremely dedicated and highly skilled. On-site reports are of high quality and surpass by far what has been observed in other comparable countries. The legal and regulatory AML framework for banks is adequate and new regulations have recently been issued in relation to other financial institutions. The supervisory mandate of CNBV is clearly defined and CNBV enjoys full power to inspect banks' premises and access all confidential information. Excellent cooperation has also been developed with both national and international counterparts. Further, several initiatives are underway to reinforce off-site surveillance, in particular through new reporting and rating tools. For these reasons, the assessors are of the view that BCP 18 has to be rated "largely compliant."</p> <p>Nevertheless, many challenges are still ahead and key decisions will have to be made to bring Mexico to a higher level of compliance in terms of preventing abuse of financial services. The CNBV authorities may wish to consider the following recommendations:</p> <ul style="list-style-type: none"> • Increase significantly human resources in the AML area. The AML Unit is clearly understaffed. With only 13 experts dedicated to on-site work, it cannot properly monitor AML compliance in 430 entities, including 41 banks. It is true that the AML Unit relies in practice on the two prudential supervision VPs to perform on-site inspections as well, but this is not satisfactory in the long run. In fact, this situation has already started to worsen due to the transfer of thousands of new entities into the CNBV perimeter. As of today, 3,400 unregulated Sofomes have been added to the list and an equivalent number of other entities (<i>centros cambiarios</i> and remittances) will soon be subject to CNBV oversight. A critical decision has to be made at the government level to resolve this gap in manpower; otherwise, supervision of hundreds of small, nonsystemically important financial

institutions will be done at the expense of the oversight of banks. The integration of these entities will seriously disrupt and compromise CNBV capacity if current resources are not adjusted accordingly. Besides, these activities, previously placed under the SAT radar, are by nature exposed to high ML/TF risks as cash management and international funds transfers constitute the core of their business.

Mindful of the situation, CNBV has requested the competent authorities to provide around 230 additional staff, but, due to budget constraints, it is unlikely that it will be possible to hire so many staff. There is no clear indication about what the final staffing will be. Moreover, additional positions at CNBV will not be filled until a competitive hiring process is completed. This will not be achieved, at the earliest, before the second half of 2012. All things considered, BCP assessors urge the Mexican authority to align the CNBV's resources with its new AML mandate as soon as possible. Commitment of the country to effectively prevent ML—as stated in the 2010 National Strategy—will be measured, among others, on the adequacy of resources in relation to the workload and responsibilities that supervisors are facing.

- **Enforce AML regulations more effectively by using a broader range of sanctions and in a more systematic way.** Enforcement is still weak. CNBV is encouraged to apply sanctions on a larger scale and more systematically whenever serious breaches are observed. Due to the particular local context described at the beginning of this section, CNBV may wish to utilize its enforcement power as an additional tool to deter ML. This power should not be limited to fines but also to other types of sanctions. In this regard, sanctions against the management or compliance officer could be envisaged in case of serious deviations. There are provisions in the law that permit such sanctions but, in practice, CNBV has never used them, unlike other countries. These penalties could also be combined with fines against the bank as the legal entity every time the integrity of the bank or the sector is compromised.

Increase the effectiveness of AML supervision with a more risk-based approach. The current supervisory approach to AML is not the best. One of the main objectives of CNBV has been to shift from compliance to a risk-based approach. This objective, however, has not been completely achieved. Considerable energy and resources were spent to equip CNBV with state of the art instruments to capture and analyze data on banks for supervisory purposes. This commendable work has to be pursued. In practice, supervision is still compliance based. Regulatory reports and the AML risk matrix have been designed but are not operational. As of today, there is no aggregate statistical data on each bank that could be used to fine-tune the risk analysis. CNBV is encouraged to speed up full implementation of the new methodology and the AML risk matrix. In the absence of risk scoring tools, CNBV is not able to carry out consolidated supervision for AML. Doing risk profiling by bank, sector, and geographic location will definitely strengthen AML supervision through the incorporation of additional risk elements into the offsite planning process.

- **Issue industry-specific guidelines on AML.** The CNBV has not yet issued any guidance that would assist banks in complying better with their AML obligations. CNBV may wish to compile frequent and systemic malpractices in the banking industry and issue guidelines to help banks conform better to AML requirements.

	<ul style="list-style-type: none"> • This will also increase the CNBV’s visibility. • Pay more attention to terrorist financing risks in the banking industry. CNBV has focused mainly on ML. It is recommended that equal attention be given to terrorist financing by programming targeted visits across the industry to assess risk exposure and determine corrective actions accordingly. <p>To conclude, improvements have been made since the 2006 BCP assessment. Mexico has also requested and received technical assistance with a view to correcting several deficiencies. Significant efforts have been made to streamline supervisory processes with a view to addressing the main FATF recommendations and make AML/CFT monitoring more effective. However, and as indicated by CNBV’s senior management, “infrastructure for new AML responsibilities” is still to be achieved. This transition phase should be made as brief as possible.</p>
Principle 19	Supervisory approach. An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.
Summary description and findings re Principle 19	Official supervisory policies were approved in January 2005 by an Ordinance of the President of the United States of Mexico (“Reglamento de Supervision”). Further policies and processes as described below and elsewhere in this assessment have been internally adopted with the approval of the ‘Supervisory Group’ (SG), which is an internal CNBV standing committee; these policies and processes are then reviewed and updated periodically as necessary. SG members include CNBV’s president, vice-presidents in charge of institutional and risk supervision, as well as the general directors of these three vice-presidencies. The SG is the main locus for decision making and information sharing regarding CNBV’s risk focused approach to supervision (see CP20) and the definition of its annual inspection program.
Essential criteria	
EC1	The supervisor has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups.
Description and findings re EC1	<p>The Board of the CNBV does not explicitly approve major policies and processes, including the implications for the associated current and anticipated workload and resources needed for implementation. However, the assessors were provided with examples of how the Board is informed periodically about CNBV’s performance.</p> <p>A formal dedicated quality assurance process independent from line activities remains to be organized to provide assurances to the president and the Board of the CNBV of adherence in form and in substance to adopted supervisory policies. This would include periodic assessment of the effectiveness of the supervision delivered in achieving its objectives and managing (mitigating and resolving) supervisory risks.</p> <p>In 2008 the CNBV reviewed its supervisory practices and formalized a renewed “conceptual framework” for supervision (“Marco Conceptual,” September 2008). The CEFER document (“Calificacion de Entidades Financieras con Enfoque de Riesgos,” version 2.0 December 2007) provides the cornerstone ‘risk assessment and rating system’ (see EC3 below) that underpins the risk based approach to supervision adopted by the CNBV as part of the conceptual process.</p> <p>The ‘conceptual framework’ summarizes the supervisory process followed by the CNBV; its risk based approach to supervision; and its operating methods and</p>

	<p>activities. The process, its supporting 'risk assessment and risk matrix' (see EC3 below), as well as the associated criteria, procedures, and guidelines are not made available to the industry. The CNBV is considering publishing on its website an abridged version of these documents to enhance the transparency of its processes in delivering prudential supervision.</p> <p>The 'supervisory framework' contemplates three broad types of supervisory activities: (1) licensing and authorizations (see CP2 to CP5 for more details); (2) onsite inspections (see CP20 for more details); and (3) offsite surveillance activities (see CP20 and CP 21 for more details). The Manual of Institutional Supervision (MIS) provides further detailed guidance through a suite of individual procedures.</p> <p>The MIS is in transformation toward a risk based manual of supervision organized by functional activities ("Guías de Actividad") rather than by rating components as per the previous rating system used until 2007 (MACROS+, organized by CAMELS component as discussed below). Five sections for selected functional activities have already been developed.</p> <p>The sections of the new MIS provided to the assessors would need to contain a more detailed discussion of good banking practice, risks involved, detailed internal control questionnaires, review work programs, and explicit criteria to guide supervisory judgment in approximating the quantity and direction of risk, as well as in deciding whether management processes and controls in operation are reasonably adequate, effective and reliable.</p> <p>Both onsite and offsite activities are integrated and conducted by groups of supervisors under the management of senior lead supervisors with the rank of Director allocated to the three vice-presidencies in charge of institutional supervision. A fourth technical vice-presidency performs supervision by risks. This vice-presidency supports the above groups and hosts specialized supervisors to carry out the review of IT, operational risk, and market and credit risk modeling and risk measurement methodologies. There are around 10 experts per vice-presidency in quantitative risk measurement techniques, mainly with trading VaR skills. Additionally, 30 IT specialists are allocated to the institutional vice-presidencies to inspect Information Systems (IS). Systemic prudential supervision is allocated currently to the technical vice-presidency and consists of the activities summarized in EC2 below.</p> <p>A decision-making supervisory group composed of senior managers (president, vice-presidents, directors of the above vice-presidencies) meets monthly to adopt supervisory policies, review and approve the ratings of institutions and, among other relevant functions, approve the focus of onsite inspections every year as part of the annual program of inspections. This program drives the focus of the work on risk of the institutional and technical vice-presidencies within the resources available for onsite supervision.</p> <p>The assessors would encourage the formation of a smaller standing committee to vet and confirm supervisory ratings and strategies, whose members are independent from the rating process. This committee could be responsible for the quality assurance function suggested above.</p> <p>Overall, 239 staff are allocated to the supervision of banking institutions, out of which 120 are examiners and 109 are banking sector risk experts. The availability of staff in terms of the number and depth of skills allocated to the four vice-presidencies in charge of supervision is discussed in CP20 and remains an area of concern to</p>
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	<p>members serving in the Board of the CNBV and in the FSC, given the potential to undermine the depth of supervisory work. An estimation of the workload associated with operating a full supervisory cycle (see below) would need to be estimated, including a minimum buffer (of about 20 percent) to accommodate special inspections outside the annual approved program.</p> <p>The 'supervisory framework' contemplates three types of onsite inspections: (1) ordinary inspections to execute the plan adopted each year; (2) special inspections targeted at a particular selected issues; and (3) investigations to review conduct that might indicate a lack of compliance with the law and regulations. CP 20 provides a quantification of the onsite work performed.</p> <p>Offsite surveillance activities are performed on a continuous basis by the above vice-presidencies using a broad array of information systems (IS), sources, and prudential reports (see CP 21) and consist of: (1) financial analysis; (2) surveillance; (3) observations; and (4) summons (orders).</p> <p>The assessors were provided with copies of the manual of procedures that describes each procedural stage in the inspection and surveillance process including planning, execution, reporting, and observations. Each subset describes the mandated procedural aspects, including inputs, activities, outputs, mandated templates and internal responsibilities (see CP 20).</p> <p>The CNBV follows an inspection regime where the frequency in months between an inspection, as well as the focus of the inspection is decided every year by the SG based on its understanding of institutional risk profiles and changing systemic issues. Banks that belong to the G-7 group (five subsidiaries of foreign banks and two large banks that are members of local groups) are inspected every year under a risk focus approach (hence, there are no full scope inspections where all significant activities and central functions are inspected). Other banks and nonbank institutions are inspected based on their risk rating, ranging from 12 months for very high risk to 48 months for low risk institutions.</p> <p>Certain policies are either not explicit or not followed in practice, including:</p> <ul style="list-style-type: none"> • The completion of the full scope inspections over a full inspection cycle of for example three years, in which all significant functional activities and central functions of banks should be reviewed.; • The definition of the minimum scope and depth of transactions' to be tested, per explicitly adopted CNBV sampling policies, against which functional activities should be assessed, considering the reliability and effectiveness of the banks' associated management processes and control systems; • The escalation in supervisory activities (not only in the frequency of visits) and in the severity of the response from CNBV considering the risk rating of an institution; and • The buffer above minimum capital requirements with which an institution would be expected to operate given its risk profile, considering the outcome of its internal capital adequacy assessment process (ICAAP). ICAAP is not yet a mandated requirement per regulation. • The CNBV is considering revising its relevant policies regarding the scope of activities across a multi-year cycle along which all relevant business activities
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	<p>and central control functions should be inspected, including policies related to the reliability of management and control processes. Once adopted by the Board of the CNBV, these policies will allow a reasonable estimation of the workload associated with implementation of the mandated activities per cycle, including incremental staff resources to serve current and anticipated work requirements.</p> <p>Besides customary oversight in the normal chain of control by senior inspectors in charge, including their directors, and the deliberations of the Supervisory Committee, the assessors have not identified an independent quality assurance process (QAP) to assess and report to CNBV's president, and to the Board of the CNBV, adherence of actual supervisory practice to mandated policy and procedures, including areas for further improvement.</p> <p>Currently, the CNBV operates a system to monitor the intensity of inspection activities by institution. This system does not allow full calculation of the costs of supervision allocated to units and vice-presidencies, in order to determine the intensity of supervision by activity, by institution, and by overall risk profile, and its components according to the risk matrix adopted (see EC4 below).</p> <p>Moreover, as currently designed, the supervisory framework and the risk rating system CEFER could provide an explicit linkage with the essential elements of the supervisory review and evaluation process advocated under Pillar 2 of the Basel II capital regime. The CNBV would like to establish adequate connectivity within its risk based approach with:</p> <ul style="list-style-type: none"> • the internal capital adequacy assessment process (ICAAP) promoted by the first principle of Pillar 2 (see CP6), which is not yet mandatory per regulation; as well as with; and • the process and criteria to be followed to support the use of the CNBV's powers to require individual capital above the minimum capital adequacy ratio. This would enable risk excesses to be factored into the risk profile of an institution or its group of related entities and associated parties of the broader corporate group to which it might be associated (see EC3 and EC7 below, as well as CP6). <p>Overall, except for the above observations, where further enhancement is still possible, the assessors believe that the information generated through the above activities provides the CNBV with a sufficient understanding of the risk profile of individual banks and banking groups.</p>
EC2	The supervisor monitors and assesses trends, developments and risks for the banking system as a whole. The supervisor also takes into account developments in nonbank financial institutions through frequent contact with their regulators.
Description and findings re EC2	<p>The CNBV uses its supervisory information systems (see CP21) to monitor and assess the developments and trends of the financial and banking sector using aggregate banking data, focusing on asset quality, lending, and other key indicators. Systemic oversight is the responsibility of the technical vice-presidency, which is developing an ad-hoc tool for such purposes.</p> <p>Coordination with the vice-presidencies in charge of institutional supervision is promoted through the deliberations of the Supervisory Group (see above CP1). For such purposes, its technical units utilize a series of tools, including:</p>

	<ul style="list-style-type: none"> • a list of systemic indicators that are routinely monitored; • a panel of stressed measures for credit, market, and liquidity risks estimated at the solo and system level; • a financial model to project financial statements under a chosen base and stress scenarios; and • interaction of the technical vice-presidency with BoM. <p>Moreover, within the evolving macro-prudential surveillance activities of the Financial Stability Committee (FSC), the CNBV exchanges information and analysis with other members of the Committee. This allows the CNBV to monitor the impact of macroeconomic and market developments on the financial and banking systems, using the tools described above.</p> <p>For this purpose, the CNBV communicates with other relevant government agencies responsible for macroeconomic and policy making; such communication is facilitated by means of multiparty and ad-hoc memoranda on cooperation.</p> <p>To address systemic risks, the CNBV cooperates with other financial supervisory agencies (such as the IPAB, CNFS and CONSAR) to obtain a sufficient understanding of the development in the nonbank financial institutions, as well as to share in their respective risk assessments. The CNBV takes into account developments in nonbank financial institutions through frequent contact with their regulators.</p> <p>During 2011, the CNBV has performed a stock-taking of existing regulatory and supervisory asymmetries among the above mentioned agencies in order to minimize them, guide appropriate legal and regulatory reforms, and promote convergence in supervisory activities and risk assessment methods and procedures.</p>
EC3	<p>The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. The methodology should cover, inter alia, the business focus, the risk profile and the internal control environment, and should permit relevant comparisons between banks. Supervisory work is prioritized based on the results of these assessments.</p>
Description and findings re EC3	<p>The CEFER document (“Calificación de Entidades Financieras con Enfoque de Riesgos,” version 2.0 December 2007) provides an overview of the ‘risk assessment and rating’ methodology operated by the CNBV. The CEFER replaced MACROS+ROP, the previous rating system that was used until 2008. The CEFER still needs to be presented to and approved by CNBV’s Board.</p> <p>MACROS+ was more of a ‘ratio’ based rating system. Although it did not use ratios under stress or adjusted ratios, it incorporated an explicit assessment of management and controls, including risk management, systems, and organizational dimensions. MACROS+ ratings were discontinued in 2008.</p> <p>The CEFER rating uses a risk matrix to grade the quantity of risks inherent to each relevant functional activity. It considers the mitigation of the gross risk of each activity through associated management and controls. It compares the aggregated overall net risk of all the significant activities of an institution, as well as the direction of the risks, with the available earnings and capital to reach a conclusion about the risk profile of an institution. The design of the CEFER rating system is based on the system used by the Canadian supervisory agency.</p>

In order to incorporate the experiences accumulated since 2008, in May 2011 the CNBV introduced additional changes to CEFER, most notably to include a separate assessment of liquidity risk and its management, as well as to put in place ratio indicators to assess the risk absorption capacity or earnings and capital, which were not explicit in the 2008 version. The new version provides slightly more concrete criteria to guide the rating than the original 2007 version, which was drafted with a generous level of generality.

The CEFER document endorses three core objectives for rating the risk profile of institutions. These are: (1) allocating scarce supervisory resources; (2) establishing priorities for the annual inspection plan; and (3) determining the frequency with which onsite inspections need to be conducted.

Accordingly, CEFER basically administers the frequency and risk focus of onsite inspections. It could also govern the supervisory response and the escalation of risk minimization actions by the CNBV. In the opinion of the assessors, the consequences of the rating should also lead to the choice of a risk minimization strategy before formal corrective actions mandated by regulation are adopted.

In the view of the assessors, the most relevant features of the CEFER rating are the following:

- The single dimensional rating (probability of failure), which could explicitly consider the impact in case of failure, given the volume at risk (for example insured deposits).
- The focus on credit, market, operational, and more recently liquidity risk, which could explicitly consider Pillar 2 risks and other relevant national environment and business cycle factors.
- The use of five alphanumeric levels of risk (as MACROS+), which could be calibrated to four levels to avoid the tendency to center ratings in the median grade (the 'risk of dirty threes').
- Quantification of risk notes without explicit consideration of indicative risk metrics used in surveillance, as well as the outcomes from stress testing and risk metrics already calculated by the Technical VP.
- Aggregation of risk notes by activity by simple average of notes given to each risk, rather than assigning a higher weighting to the worse notes or using the worse note as the most significant risk level.
- Aggregation of the risk of functional activities converting their alphanumeric notes into numerical notes and subsequently mapping back to alphanumeric notes, rather than using quantitative notes to provide a more granular distribution of ratings among institutions.
- Compensating for the gross risk of business activities (60 percent weight) with the approximated effectiveness of management and controls (40 percent), rather than considering that gaps in systems and controls augment the overall risk as they provide the best advance warning.
- In comparing net risk after mitigation with earnings and capital, alternative measures of pre-provision recurrent profits after stress could be used rather than reported point in time ROA and ROE measures.

	<p>As currently conceptualized, the assessors believe that CEFER may not provide forward looking information to warn about risk accumulation.</p> <p>The assessors believe also that the risk based supervision process adopted by the CNBV should provide more specific criteria to govern the scope and the depth of the supervisory activities and central control functions. All of them should be inspected in depth with an appropriate level of transaction testing at least once per cycle (for example every three years) unless a more frequent inspection is warranted by the rating.</p> <p>CEFER and the risk based process should rely on management process and controls only to a limited degree subject to a clear policy on transactional sampling intimately related not to the existence of systems and controls, but to their tested reliance and established effectiveness.</p> <p>Furthermore, the CEFER document should also establish a relationship between the rating and all the components of Pillar 2 of the Basel II capital adequacy regime, such as the internal capital assessment adequacy process (ICAAP) and the review process for risks, which are not fully captured under Pillar 1.</p> <p>This could explicitly include concentration, interest rate risk, and other risks from the imperfect approximation of risk capital under Pillar 1, including conglomeration risk not captured from association with a broader corporate group.</p> <p>The criteria to grade the quantity of risk under the new system CEFER, as well as to rate the effectiveness of management and controls, would need to provide a more disciplined approach and a more concrete and consistent risk assessment process. Supervisors need more detailed guidance, control points, and benchmark indicators to approximate a judgment on the effectiveness and reliability of controls, systems, and management.</p> <p>Overall, subject to other technical issues described below, the assessors believe that a more detailed regulation is required to govern the determination of the level of capital adequacy (trigger ratio, target ratio, or both) above the minimum CAR of 8 percent, at which the CNBV would expect an institution or a group of regulated institutions to operate, considering their respective risk profiles as rated under CEFER. Such a regulation would enable the CNBV to implement in an objective and transparent manner the powers that have been given to it.</p>
EC4	The supervisor confirms banks' and banking groups' compliance with prudential regulations and other legal requirements.
Description and findings re EC4	The CNBV ensures banks' compliance with laws, regulations, and other supervisory requirements through rulemaking, onsite inspections, and offsite surveillance. There is still room to develop further the use of licensing as a supervisory tool to elicit
	<p>responses from or to impose targeted conditions and risk mitigation undertakings on a broad set of influencing parties (affiliated entities, unregulated intermediary holding parents, and ultimate beneficiary owners).</p> <p>Articles 166 to 169 of CUB (Second Title, Chapter VI) require institutions to operate a compliance function. During onsite examinations, using a specifically designed compliance review protocol, the CNBV ensures banks have the policies and procedures to comply with relevant laws and regulations. It also reviews the effectiveness of the compliance function. The offsite surveillance function identifies institutions whose reported data do not meet regulatory requirements and limits such as the CAR, liquidity ratio, and large exposure limits.</p>

EC5	The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
Description and findings re EC5	<p>Neither the LIC, nor the CUB, explicitly specifies that changes in activities or structure that do not require explicit CNBV approval be notified to the Commission. Further, the Commission does not have explicit powers to oppose such changes if not explicitly regulated.</p> <p>In practice, the assessors are informed that the CNBV gains knowledge of such events through its day-to-day contact with the institutions, through which its supervisors learn about any events that may lead to substantive changes in their activities, structure, and overall condition.</p> <p>As part of its initial and on-going licensing and authorization activities, the CNBV could require such notifications as a condition for maintaining its approval, including that: 1) there should be no significant change in the nature and balance of business conducted without prior consultation with the Commission; and that 2) the Board and senior executives should notify the Commission as soon as they become aware of any material adverse development included in, but not limited to, a comprehensive list of situations. These commitments could be extended to holding companies regulated by the SHCP, as well as to nonregulated mixed-activity holding companies that control some local groups (see CP24).</p>
EC6	The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.
Description and findings re EC6	<p>The CNBV maintains several supervisory information systems for its ongoing supervision of institutions and regulated groups. These facilitate the processing, analyzing, and monitoring of prudential information. The data and information generated from these databases are then used for follow-up supervisory actions.</p> <p>In addition to a uniform institution performance analysis, which enables peer group analysis, supervisors are able to monitor and analyze prudential information through alerts and stress testing results calculated and distributed by the technical vice-presidency. These alerts intend to automatically identify rule breaches or potential risks on data submitted by firms.</p>
Additional criteria	
AC1	The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks.
Description and findings re AC1	<p>Through ongoing risk monitoring and assessment, the CNBV supervisors focus on signs of deterioration or emerging risks in both individual institutions and the financial system under its purview, and take supervisory steps accordingly.</p> <p>As mentioned above in EC3, the CNBV uses (i) the CEFER risk matrix to evaluate each institution's inherent risk level and trend (increasing, stable, or decreasing), and (ii) an early warning system to promptly identify emerging risks. These results serve as important references for supervisors to develop or refine their supervisory strategies.</p> <p>In the view of the assessors, it is important that the CNBV determines whether MACROS+ or the risk rating under CEFER provide today an advanced forward looking indicator that risks are accumulating across the system, in particular business lines or</p>

	<p>products, including systematic components of management process and control systems.</p> <p>For example, the CNBV would like to determine if the ratings identified well in advance the events that led to the 2008 consumer retail and credit card mini-crisis. The CNBV would need to recalibrate the entry notes of CEFER if it finds out that the ratings remained relatively stable over the last few years, as the global crisis evolved. This would indicate that CEFER ratings are not sufficiently sensitive to provide an early indication that risks are starting to move from the idiosyncratic to systemic level.</p>
Assessment of Principle 19	Largely-Compliant
Comments	<p>The following actions are suggested to enhance the implementation of the risk based approach already in operation:</p> <ul style="list-style-type: none"> • Submit the supervisory review process and its relevant policies for the approval of the Board of the CNBV, including a fair estimation of the workload, its associated incremental resource needs for implementation, and the approval of incremental budgetary allocation (EC1). • Institute a formal quality assurance process and a dedicated rating committee to enhance consistency in the implementation of the risk rating methodology which drives the supervisory process (EC1), as well as to highlight to the Board progress and challenges in implementing the risk based approach (EC1). • Explicitly relate the outcomes of the supervisory review process to implementation of Pillar 2, including a mandatory ICAAP and the determination of the criteria to require additional capital above the minimum 8 percent under the fourth principle of Pillar 2 (EC1). • Design for approval by the Board a supervisory cycle along which all significant activities and central control functions should be inspected in full scope, including explicit transaction testing of appropriate extensions as per the reliability and effectiveness of existing controls, both for an institution and the full perimeter of relevant members of a group (EC1). • Provide ‘consequences’ to the risk rating by adopting a formal supervisory strategy made of monitorable actions to resolve (minimize or compensate) high risk rated areas (EC1). • Reinforce the current risk rating methodology, adopting a set of concrete risk metrics to grade the quantity of each risk, including forward looking measures under stress, providing richer criteria to supervisors to grade the effectiveness of management and controls, as well as recalibrating the aggregation of notes by assigning a higher weighting to the worse notes (EC3). • Require institutions by regulation, or by using licensing powers, to notify the CNBV of any major changes planned in business activities, changes in structure, adverse developments, and breaches in regulations (EC5). • Enhance the forward looking view of the rating methodology through a more explicit inclusion of risk stress measures already being estimated (AC1).
Principle 20	Supervisory techniques. An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

<p>Summary description and findings re Principle 20</p>	<p>The architecture for on-site and off-site supervision has changed significantly since the last FSAP. In 2007, a major reform was initiated with the aim of streamlining supervisory techniques and enhancing oversight effectiveness. In the past, there was no clear delineation between regulatory functions and supervision activities. There was also very limited interaction between the different vice-presidencies. Moreover, different intermediaries within the same financial conglomerate were supervised by different teams, making it difficult to have a consolidated view of each group. Lastly, AML functions were delegated to the legal department, which did not have a supervisory role, while the other VPs were doing some basic compliance-based AML work. The new CNBV management initiated an important change consisting in: (i) reorganizing the internal structure of the commission; (ii) creating better interaction between the different departments; and (iii) promoting a staff performance evaluation mechanism. The overarching objective of this new strategy was to enhance the quality of Mexican banking supervision.</p> <p>As part of this process, the distribution of portfolio of banks and other related FIs among the different units has been modified. Supervisory techniques have been improved through the creation of new tools for both on-site and off-site purposes. A dedicated VP has been created to lead all AML functions, including the training of other CNBV staff. Better coordination with other financial supervisors has also been developed. For example, CNBV signed an MOU with the Bank of Mexico in October 2008 that should facilitate stronger coordination in information sharing and joint examinations between the two institutions.</p> <p>This reform, however, is in a transition phase. Several projects are still on-going. New manuals and methodologies have not been completely finalized (e.g., for operational risks) or are in a testing phase (e.g., for AML). Regarding AML surveillance, the integration of the new VP within the internal architecture is not complete and the unit is still relying on the other VPs for on-site activities. Supervisory techniques are still compliance-focused (and not really risk-based) and the macro-dimension of supervision is still lagging in the absence of a real Pillar II. The administration of supervisory activities could be more effective by creating a document database that includes electronic working papers generated during on-site examinations. Budget versus actual costing is still not used to control the intensity and the cost per activity. At a time of budget constraints, this approach would help to bring about a more effective allocation of resources between on-site and off-site activities.</p>
<p>Essential criteria</p>	
<p>EC1</p>	<p>The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. The supervisor has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified.</p>
<p>Description and findings re EC1</p>	<p>CNBV uses a mix of on-site and off-site supervision to evaluate the condition of banks. Banks' off-site and on-site supervision duties are split between two vice-presidencies (VPs); each VP has approximately the same number of departments (<i>Direcciones generales de supervision</i>) and more or less the same number of examiners (130). The only difference is that in one VP, the same staff does both off-site and on-site work, while in the other VP these two activities are split into two different teams. In practice, these two different "business models" for supervision seem to work well, according to the CNBV. Communication, coordination, and information-sharing are not a problem,</p>

	<p>even though management acknowledges the need to improve further the staff's ability to interact with each other and communicate in a more effective way. Discussions with supervision team members showed that they have a good understanding of the risks in the banks in their portfolios.</p> <p>Since the last FSAP, the CNBV has carried out 143 on-site examinations in 43 banks. On average, the CNBV has carried out 3 on-site examinations per bank in the last five years; in the case of the seven largest banks (G7), the CNBV has visited them once per calendar year in the last five years. In the last three years (2008–2010), the CNBV carried out 87 on-site examinations.</p> <p>CNBV has also established some internal quality controls. The objective is to determine the adequacy of the supervisory plan, the quality and effectiveness of onsite examinations and offsite surveillance reports in an attempt to identify areas for improvement. In practice, however, this work has been very informal.</p>
EC2	<p>The supervisor has in place a coherent process for planning and executing on-site and off-site activities. There are policies and processes in place to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.</p>
Description and findings re EC2	<p>CNBV has a coherent process in place for planning and executing on-site and off-site activities, and new manuals have been created to ensure that these are conducted on a thorough and consistent basis. The MIS (<i>Manual Institucional de Supervision</i>) and other related documents (e.g., <i>Mapas de Proceso del Sistema Integral de Organizacion</i>) describe in detail the policies and procedures to ensure that oversight activities are carried out in a consistent way. It is, however, important to mention that these processes are relatively new and that they have not been completely integrated into the previous ones.</p> <p>The rules for determining the inspection strategy and off-site/on-site supervision work are clearly established. At the beginning of an examination cycle, the CNBV determines the supervisory strategies based on previous examination findings, supervisory ratings (CEFER matrix), risk assessments, and other elements that may pose particular concern. The inspection planning is determined by each Deputy General Director in charge of the bank under review and meetings with all staff involved are arranged to explain the examination's objectives.</p> <p>Off-site reviews are used to analyze prudential returns as well as other sources of information such as auditors' reports and published financial statements. This may result in the identification of areas within a bank that require detailed or specialized on-site review. Bank files are updated and monitored to identify which items require follow-up. Off-site work also entails performing a risk assessment. The supervisor analyzes the types, severity, and trends of risks faced by the bank. The Risk Matrix (CEFER) lists several inherent risk categories (e.g., credit, market, liquidity, operational, legal), and identifies the risk level (5 levels), risk trend (increasing, stable, or decreasing), and mitigating factors (internal controls, corporate governance). In case material deficiencies are identified during the supervisory cycle (for example, at the end of the on-site examination), rating results will be adjusted in the Risk Matrix. On-site work is performed according to the inspection plan. Depending on the size of the bank, teams will consist of 3 to 10 persons. The table below shows the average number of days dedicated to on-site examination.</p>

	On-site examination (average number of days)	2008	2009	2010
	G-7	44.86	75.29	60.71
	Consumer banks	33.11	41.40	51.67
	Corporate banks	39.80	47.60	49.75
	Investment banks	28.78	35.83	33.83
	Average	36.26	50.89	49.48
	<p>There is also a coordination and information-sharing mechanism between the on-site and off-site functions. Meetings with staff from both areas are organized at each step of the way to ensure that all people involved can (i) voice their concern on a particular matter; (ii) understand the objectives of the examination; and (iii) receive all relevant information. During the on-site visits, staff from the off-site and on-site areas are in constant communication. Moreover, the memo containing all observations and major findings (<i>Oficio de observaciones</i>) is prepared jointly. For the preparation of the memo for corrective measures (<i>Oficio de medidas correctivas</i>), off-site inspectors can request support or advice from on-site inspectors. Lastly, at a macro level, CNBV has set up a Supervision Committee (<i>Grupo de Supervision</i>) that aims to discuss horizontal and more systemic issues.</p>			
EC3	<p>On-site work, conducted either by the supervisor's own staff or through the work of external experts,³⁴ is used as a tool to:</p> <ul style="list-style-type: none"> • provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks; • determine that information provided by banks is reliable;³⁵ • obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and monitor the bank's follow-up on supervisory concerns. 			
Description and findings re EC3	<p>The CNBV considers the onsite examination as an important supervisory tool as it provides examiners with the opportunity to evaluate management capability and the bank's risk management systems and internal controls. The frequency and scope of onsite examinations depend on the risk profile, size, and complexity of the bank. An "ordinary" examination generally covers an assessment of capital adequacy, risk management practices, liquidity, earnings, and asset quality.</p> <p>Particular attention is paid to corporate governance issues. In its scoring exercise, the CNBV does not only take into consideration quantitative criteria (e.g., liquidity), but also qualitative elements such as corporate governance, internal audit, risk management and control systems. These criteria are used as mitigating factors that may affect, positively or negatively, the overall rating of the bank.</p> <p>As for follow-up mechanisms, BCP assessors reviewed several reports and came to the conclusion that CNBV has put in place strict procedures to monitor banks' follow-up on earlier supervisory concerns. After each inspection in which serious issues are detected, CNBV will communicate constantly with the bank's senior management (and</p>			

	<p>other relevant counterparts, e.g., risk committee, compliance officer, internal auditor) to understand how problems have been addressed; different communication channels are used (conference calls, meetings in the bank's premises or at CNBV headquarters). A follow-up on-site inspection can also be done. Moreover, in every ordinary inspection, examiners follow up on weaknesses identified during the previous examination or during the offsite surveillance process.</p>
EC4	<p>Off-site work is used as a tool to:</p> <ul style="list-style-type: none"> - regularly review and analyze the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information; - follow up on matters requiring further attention, evaluate developing risks and help identify the priorities and scope of further work; and - help determine the priorities and scope of on-site work.
Description and findings re EC4	<p>CNBV makes active use of information provided in prudential returns. The information is thoroughly vetted and visits to the supervised institutions may take place to understand better the context of the information and check its validity. There is also a department within the CNBV responsible for checking the consistency and accuracy of information reported by banks. More precisely, CNBV reviews banks' monthly financial reports, reports on related party transactions, reports on internal and external audit, capitalization index calculations, and other materials generated by the banks relating to risk management. The offsite supervision is conducted quarterly, through financial analysis, based on each bank's main risks derived from its core business activities. In conclusion, prudential returns are actively used in the supervision process and to develop and refine the individual supervisory strategies for each institution.</p>
EC5	<p>Based on the risk profile of individual banks, the supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems.</p>
Description and findings re EC5	<p>The CNBV has established different channels of communication with all levels of bank management. As part of the regular on-going surveillance, CNBV supervision departments meet with banks' management and Board members (see EC8 below for more details). The frequency of the visits depends on the risk profile of the entity. Offsite supervisors also engage in discussions with the internal auditor, Risk Committee members, and compliance officers when they seek to follow up on certain emerging problems or trends.</p>
EC6	<p>On an ongoing basis during on-site and off-site supervisory activities, the supervisor considers the quality of the Board and management.</p>
Description and findings re EC6	<p>During onsite inspections, supervisors focus on an assessment of the role of the Board of Directors (by reviewing the Board minutes, policies and directives) and bank strategies. For this purpose, the CNBV has designed a tool (bitacora) that contains all points of control that examiners should address to review the quality of the Board and management.</p>
EC7	<p>The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.</p>

Description and findings re EC7	The LIC contains detailed provisions regarding banks' internal audit functions (section V "De la Auditoría Interna" of chapter VI "Controles Internos"). Based on these rules, CNBV supervisors evaluate the work of the bank's internal audit function during onsite examinations. The evaluation focuses on the independence of the function, the adequacy of the staffing, staff expertise, the frequency and scope of the coverage, and the adequacy of the audit plan. In addition, the CNBV receives the internal audit plans and quarterly progress reports.
EC8	The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.
Description and findings re EC8	The CNBV communicates findings on its onsite and offsite supervision through both written reports and discussion with management. When there are relevant and significant findings, the CNBV brings these to the attention of the Board of Directors through an official letter; likewise, senior management receives an official letter with all the on-site examination findings. Moreover, the CNBV supervisory team meets with the banking institution's Board members and senior management to advise them of the inspection results and recommendations. These meetings are attended by the supervision vice-president, director general, and deputy director general in charge of the specific banking institution's supervision. If necessary, the president of the CNBV will attend the meeting.
Additional criteria	
AC1	The supervisor meets periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit. The supervisor should also meet separately with the independent Board members, as necessary.
Description and findings re AC1	As indicated above, the CNBV has established a communication mechanism to communicate supervisory findings with bank management and, if necessary, supervisors will meet with Board members individually if there are significant supervisory findings warranting their immediate attention.
Assessment of Principle 20	Compliant
Comments	<p>The assessors reviewed a sample of materials discussed above, such as on-site examination reports, supervisory plans, and banks' financial assessment reports, together with other inspection related documents (letters of observation and corrective measures). These supervisory reports were considered thorough and captured the key supervisory focus and major examination findings. There is, however, some room for improvement:</p> <ul style="list-style-type: none"> • Develop a horizontal approach to risks on a macro level. Due to the fact that CNBV has not fully implemented Basel II, supervisory techniques do not allow staff to have an overview of the risks. It would be useful to speed up the migration toward Basel II so that CNBV can gain a more horizontal view of problems across the industry. The creation of the Group of Supervision is an important improvement in this regard. The authorities are encouraged to pursue this macro-level approach. • Reinforce off-site techniques, particularly for consolidated supervision. The cycle of inspection could be revisited. There is no mechanism that would permit CNBV to review in detail all the core functions of a bank, particularly for the G7, in a specific timeframe.

	<p>Off-site techniques for consolidated supervision could be further strengthened. In particular, where banks are involved, the scope of supervision for corporate groups needs to be reinforced (see BCP 24 for further details).</p> <p>The new risk matrices allow CNBV inspectors to score a bank's risk profile by using 5 different levels of risk (very low, low, medium, high, and very high) as defined in the MIS methodology. The assessors are of the view that 5 levels of risk might be too much and may lead CNBV staff to resort to the so-called "dirty three" (for further details, see BCP 19 above). To ensure an accurate distribution of banks over the different levels of risk, it is advisable either to limit the number of risk categories to 4 or to better clarify the underlying criteria for risk classification. There is indeed a very tiny difference in the factors being used to classify a bank in the category "very low risk" or "low risk." The same observation applies across all ratings.</p> <p>The Risk Matrix CEFER is a major step toward risk-based supervision. While a risk assessment by type of risk and quality of a bank's mitigating factors is an input into supervisory planning, this link appeared a bit weak in the examples reviewed by the assessors. Moreover, the ratings are often backward looking in practice.</p> <ul style="list-style-type: none"> • Adopt workload costing and document administration systems. CNBV may wish to operate a comprehensive costing system by utilizing more fully the features of MS Project Manager (MCPM). CNBV is encouraged to standardize and codify all relevant supervisory activities mandated across a supervisory cycle (see suggestions under CP19), and to enter into MCPM the actual effort dedicated to each, as well as any extensions granted. The CNBV could track the cost of supervision by downloading the planned and actual costs of each relevant onsite inspection and offsite activity into a database. This would also allow the CNBV to: (i) track the workload across a supervisory cycle; (ii) identify functional activities and central functions not fully inspected across a cycle; (iii) identify which areas have an insufficient workload or are below average standard cost; and (iv) estimate the current and anticipated workload and associated needs for varying degrees of depth and scope. <p>Moreover, given the scope of onsite inspection activities, the CNBV should consider storing work papers in a document management system, which would make the administration, custody, and general management of inspections more efficient. The CNBV could acquire a system from a reputable vendor or develop its own system.</p> <ul style="list-style-type: none"> • Promote a better internal Quality Control system. A better Quality Control system would be desirable. The Methodology Department could be used to perform such activity. <p>The CNBV is dedicating many supervisory resources to activities that are not strictly prudential related. For example, the AML unit performs on-site work at the request of the FIU or the Judiciary (this is due to bank secrecy restrictions). At a time when the agency is facing resource challenges, it is advisable for the CNBV to consider a way to minimize the impact of these activities on its core supervisory functions.</p>
Principle 21	Supervisory reporting. Supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.
Summary description and findings re	The CNBV has developed a sophisticated system for collecting, reviewing and analyzing prudential reports and statistical returns from banks. The technological platform designed for regulatory reporting allows proper management of information

Principle 21	comparable across institutions and sectors, and facilitates the analysis and development of aggregated statistical information. It should be mentioned that BoM has related information that is collected through another platform, imposing extra burdens on reporting banks.
Essential criteria	
EC1	The supervisor has the power to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. These reports provide information on such matters as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.
Description and findings re EC1	The CNBV requires periodic financial returns through its inter-institutional information transfer system (SITI). Clear instructions have been disseminated on filling out the regulatory reports. In this regard, the information sent by banks must meet strict quality standards. It would be too long to describe all the financial reports that banks are required to submit. Overall, periodic financial returns allow the CNBV to capture data on and off-balance sheet liabilities and assets, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, foreign and exchange rate related contracts, loan classification, staffing, maturity of on- and off- balance sheet items and deposit currencies.
EC2	The supervisor provides report instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
Description and findings re EC2	In Mexico, banks are required to submit their prudential reports based on the Accounting Standards defined by the CNBV. As referenced in CP22, the requirements are also in line with the relevant accounting principles, which call for banks to adopt prudent valuation methods and use current values as necessary.
EC3	The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant.
Description and findings re EC3	Valuation rules and other accounting and financial statement are contained in the CUB, Annex 33; see also EC2.
EC4	The supervisor collects and analyses information from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.
Description and findings re EC4	The CNBV requires different returns to be submitted on a monthly, quarterly, and semi-annual or annual basis. Most schedules are required to be submitted monthly such as assets and liabilities, loan classification, provisioning, and liquidity. The frequency of the returns is primarily based on the importance and urgency of information.
EC5	In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
Description and findings re EC5	The technological platform designed by the CNBV for regulatory reporting allows off-site examiners to make meaningful comparisons between banks and banking groups. The system permits management of information across institutions and sectors, and facilitates the analysis and development of aggregated statistical data.

EC6	The supervisor has the power to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or banking group, or to the assessment of the risks of the bank or banking group. This includes internal management information.
Description and findings re EC6	The CNBV law (Art. 19) empowers the supervisor to request and receive any relevant information from banks. This power is even broader than for any other agency, including the FIU. CNBV has broad authority to obtain information from supervised banks, including quantitative information like prudential returns and qualitative information such as banks' internal management reports. In addition, CNBV is entitled to receive information on a bank's controlling shareholders (with some exceptions, e.g., in the case of mixed activity groups).
EC7	The supervisor has the power of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.
Description and findings re EC7	The CNBV is vested with the authority to review all the records of the bank that are considered necessary in connection with its mandate (see above EC6).
EC8	The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for misreporting and persistent errors, and can require that inaccurate information be amended.
Description and findings re EC8	According to the law, banks are required to provide all the legal, managerial, financial and additional information required by the CNBV. Failure to comply with these requirements can lead to monetary penalties and other enforcement actions. In practice, the CNBV has imposed penalties on banks for failure to comply with reporting obligations. In this regard, CNBV has made efforts to increase the quality of reporting from banks.
EC9	The supervisor utilizes policies and processes to confirm the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.
Description and findings re EC9	Banks' information is received from specialized areas of the CNBV; its content is quantitatively validated and subsequently processed and stored in the CNBV systems, which are accessible to managers through the Intranet. Subsequently, according to internal guidelines contained in the institutional oversight manual (MIS), off-site supervisors proceed to the analysis of the information and assess the behavior of various basic indicators, such as liquidity, solvency, leverage, ICAP, the percentage of transactions with related parties as well as profitability (ROE). Quarterly reports are prepared containing an analysis of the evolution of the main aspects of the risks incurred by banks, by comparing the trends with the previous 12-month period. If necessary, examiners meet with other specialized areas of the CNBV in order to jointly analyze any relevant issue. With regard to the annual returns, CNBV verifies that they are reported in compliance with the accounting standards established in the CUB, and in conformity with the financial reporting standards issued by the CINIF. It should be added that onsite inspections also corroborate the accuracy of regulatory returns.
EC10	The supervisor clearly defines and documents the roles and responsibilities of external experts, including the scope of the work when they are appointed to conduct

	supervisory tasks, and monitors the quality of the work. External experts may be utilized for routine validation or to examine specific aspects of banks' operations.
Description and findings re EC10	To date there is no verification of such reports by an external expert, but CNBV can hire external consultants and/or instruct an external auditing firm to conduct supervisory tasks and monitor the quality of the work.
EC11	The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.
Description and findings re EC11	See EC 10 above.
Assessment of Principle 21	Compliant
Comments	The CNBV receives a fairly comprehensive set of information on banks.
Principle 22	Accounting and disclosure. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
Summary description and findings re Principle 22	The CNBV is the authority empowered to set accounting standards for banks. CNBV's Accounting Standards recognize and include some principles issued by the <i>Consejo Mexicano de Normas de Información Financiera</i> , commonly referred to as CINIF-Mexican GAAP. The accounting standards are contained in the CUB, Article 173, Annex 33. Valuation rules are also spelled out in the CUB (Article 175 Bis) and finally, disclosure requirements can be found in the same text (Articles 180 – 182). During the last 7 years, Mexico has been working on the convergence of Mexican GAAP with IFRS. Banks and other financial entities should continue to apply accounting standards issued by CNBV, which has the power to adopt those standards which do not involve a risk to the stability of financial institutions.
Essential criteria	
EC1	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that financial record-keeping systems and the data they produce are reliable.
Description and findings re EC1	Under Mexican law, information provided by banks to their supervisors must be accurate and the Board of Directors is responsible for the accuracy of the financial statements. In this regard, banks must have adequate financial record-keeping systems to ensure information accuracy and reliability. According to the CUB, (Article 179), CNBV requires financial statements to be signed by the CEO, CPA, Comptroller, Internal Auditor, or their equivalents. Also, banks must obtain from these senior officers a <i>declaration of truth</i> concerning, inter alia, financial statements and disclosure, operational procedures and internal controls. There are no cases where such responsibilities have been enforced in the past.
EC2	The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that the financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.
Description and findings re EC2	According to the law, banks are subject to a series of obligations in terms of transparency and disclosure. They are required to disclose on their website the following information: (i) the audited financial statements; (ii) the opinion of the external auditor; (iii) comments from the institution's management on the results of its operations and on its financial condition (which shall contain all information that

	<p>facilitates the analysis and understanding of any significant changes in regard to the results of its operations and its financial condition).</p> <p>These statements must be issued annually and updated quarterly.</p> <p>The assessors were shown these publications.</p>
EC3	The supervisor requires banks to utilize valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions.
Description and findings re EC3	According to the CUB, Annex 33, banks can recognize three categories: trading, available for sale, and held to maturity. The trading category is measured at fair value through profit and loss, available for sale is also measured at fair value through other comprehensive income. The held to maturity category is measured at amortized cost through profit and loss. According to the CUB, (Article 175 Bis), fair value is determined by price vendors.
EC4	Laws or regulations set, or the supervisor has the power, in appropriate circumstances, to establish, the scope of external audits of individual banks and the standards to be followed in performing such audits.
Description and findings re EC4	The CNBV cannot exercise its supervisory discretion to establish and extend the scope of external audits of individual banks. As indicated during the mission, current bank rules do not contain any aspects related to the scope of external auditors. However, the Commission can require the financial institutions and external auditors to provide additional specific information in relation to their functions.
EC5	Supervisory guidelines or local auditing standards determine that audits cover such areas as the loan portfolio, loan loss reserves, nonperforming assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, and the adequacy of internal controls over financial reporting.
Description and findings re EC5	The CUB sets the minimum elements for the external audit review. They cover loan classification and provisioning (with a view to ensuring compliance with the CNBV regulation), loan portfolios, liquid assets, investments, deposits, off -balance sheet items, foreign currency transactions, revenues and expenses.
EC6	The supervisor has the power to reject and rescind the appointment of an external auditor that is deemed to have inadequate expertise or independence, or not to be subject to or not to follow established professional standards.
Description and findings re EC6	The Mexican regime does not contain requirements related to the appointment of external auditors. In fact, The CNBV does not have the power to issue a warning or suspend the external auditor in case of failure to comply with auditing standards. Nor does the CNBV have the power to reject and rescind the license of an external auditor.
EC7	The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that are widely accepted internationally and have been audited in accordance with internationally accepted auditing practices and standards.
Description and findings re EC7	Banks are required to audit their annual financial statements and to publish them on their website.
EC8	Laws, regulations or the supervisor require periodic public disclosures of information by banks that adequately reflect the bank's true financial condition. The requirements imposed should promote the comparability, relevance, reliability and timeliness of the information disclosed.
Description and	The disclosure of financial information required by the CNBV's Regulatory Accounting Standards is in line with accounting policies and practices that are widely accepted

findings re EC8	internationally. The CUB requires periodic public disclosure by banks that adequately reflects their financial condition. The information required to be disclosed includes qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, and corporate governance.
EC9	The required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and complexity of a bank's operations.
Description and findings re EC9	See above EC8.
EC10	Laws, regulations or the supervisor provide effective review and enforcement mechanisms designed to confirm compliance with disclosure standards.
Description and findings re EC10	As part of its mandate, the CNBV assesses banks' compliance with information disclosure requirements during its ongoing supervisory process. The LIC and the CUB provide that banks must comply with reporting and information disclosure requirements and that noncompliance will be subject to various enforcement actions depending on the severity of the violations.
EC11	The supervisor or other relevant bodies publish aggregate information on the banking system to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).
Description and findings re EC11	As described in BCP 21, the CNBV receives a huge quantity of information through financial returns. The database contains all relevant information on origination and performance for every single credit. It is possible to identify newly originated loans, restructured loans, delinquent loans, etc. The database is processed and aggregates are published on the CNBV website. The CNBV also has information on the probability of default for each credit and can aggregate information to measure risk at any level (portfolio, institution, banking group or system level).
Additional criteria	
AC1	The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.
Description and findings re AC1	There is no provision in the CUB, or in any guidance from the CNBV, contemplating regular meetings with external audit firms. However, contact is established through different channels (meetings, conference calls) when a particular issue warrants attention.
AC2	External auditors, whether or not utilized by the supervisor for supervisory purposes, have the duty to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, or other matters which they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations ensure that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.

Description and findings re AC2	Auditors are legally required to inform the CNBV about any presumed involvement of bank directors or senior managers in illicit activities, insider abuse, and any other information discovered in an audit that could jeopardize the financial position of the bank.
AC3	Laws, regulations or the supervisor require banks to rotate their external auditors (either the firm or individuals within the firm) from time to time.
Description and findings re AC3	The external auditors as well as the audit team are not allowed to provide audit services for more than 5 consecutive years without a break of at least 2 years.
AC4	The supervisor requires banks to have a formal disclosure policy.
Description and findings re AC4	Banks are required to have policies and procedures for information reporting and disclosure. In addition, the CNBV requires banks' Board of Directors and senior management to formulate and implement disclosure policies.
AC5	The supervisor has the power to access external auditors' working papers, where necessary.
Description and findings re AC5	The auditor is required to keep in its offices, for no less than 5 years, all audit working papers and other information. The CNBV has the power to access this information.
Assessment of Principle 22	Compliant
Comments	<p>The CNBV may wish to consider the following improvements:</p> <ul style="list-style-type: none"> • Strengthen enforcement mechanisms. During the supervisory process, if the CNBV believes that the external auditors do not have the requisite expertise or independence, or fail to follow professional standards, the CNBV should be empowered to recommend to banks that they replace their external auditors; • Set stronger rules for the rotation of auditors. The current rule applies to auditors, not to the auditing firm; • Establish more frequent meetings with the auditors, on a more systematic basis. It would be a good practice to meet with external auditors during or at the end of an on-site visit; and • Complete in a reasonable timeframe convergence with IFRS.
Principle 23	Corrective and remedial powers of supervisors. Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.
Summary description and findings re Principle 23	<p>Mexico has established a corrective and remedial regime that can issue timely corrective actions. Since the last FSAP, major improvements have been made to equip the country with a framework that permits timely corrective actions against banks. Remedial measures range from informal instructions directing a particular response by management, to the severe action of intervention and, if needed, liquidation (through the suspension of the institution's license). The CNBV officials opine that the remedial powers available to them (and the wide discretion to interpret and use these powers) are adequate. The emphasis is on the early detection of problems. In this regard, CNBV has issued rules to classify banks in a particular category based on their CAR (Spanish acronym, ICAP) in order to perform early detection, intervention and resolution of troubled banks.</p> <p>As for sanctions more specifically, the CNBV is the authorized enforcement agency. It can apply both fines and administrative penalties, including revocation of the license in the most severe scenarios. This has been applied on very rare occasions and only</p>

	<p>against nonbank institutions. Sanctions against individuals are also permitted by law. CNBV can apply fines under the LIC to banks' directors, managers, officers, and staff more broadly. Enforcement of corrective measures is still weak due to the excessive discretion on the part of the supervisor. However, recent events indicate that this practice is going to change, particularly with regard to enforcement of AML breaches.</p> <p>Progress has also been achieved with regard to mechanisms to deal with distressed banks. Under the previous regime, the delineation of respective responsibilities between the CNBV and the Institute for the Protection of Bank Savings (IPAB) was not clearly established and their respective roles were not clear. This situation has been addressed. Under the current regime, the CNBV is empowered to take corrective measures against banks while IPAB is the lead agency in case of liquidation. The authorities are working on a regulatory reform to develop a specific and more efficient bankruptcy regime for banks.</p>
Essential criteria	
EC1	<p>The supervisor raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where the supervisor requires the bank to take significant remedial actions, these are addressed in a written document to the Board. The supervisor requires the bank to submit regular written progress reports and checks that remedial actions are completed satisfactorily.</p>
Description and findings re EC1	<p>The Prompt Corrective Action regime (PCA) defined in the LIC (Art. 134 Bis) is as follows. In the course of the supervisory process, the CNBV communicates continuously with the bank management, and on occasion with the bank Board and relevant departments, on the deficiencies brought out by the on-site, off-site or other examinations (external audits and AML inspections), and expects that the issues will be resolved satisfactorily.</p> <p>When there are significant findings, the CNBV notifies the Board of Directors. A supervisory letter called <i>Oficio de Observaciones</i> is issued at the end of the examination to communicate major concerns. Senior management also receives an official letter containing all the on-site examination findings. The rectification of these deficiencies is followed up periodically by the staff in charge of off-site surveillance as well as during subsequent on-site examinations. Actions taken by banks in response are also taken into account in determining the scope of ensuing on-site examinations. When observations have been partially or improperly addressed, CNBV will send another letter (<i>oficio de medidas correctivas</i>) instructing the bank to take prompt actions in a specific timeframe.</p> <p>As part of the on-going surveillance, there is a mechanism to closely monitor corrective measures, through progress reports provided by the bank under scrutiny. In addition, a CNBV team meets with the bank's Board members and senior management to discuss issues of common concern and the status of the corrective measures. These meetings are attended by the CNBV's supervision vice-president, the director general, and deputy director general responsible for overseeing the specific entity. The President of the CNBV also participates whenever it is necessary. distressed banks.</p> <p>Also, CNBV may interact with other supervisory agencies, BoM, and the Secretariat of Finance in order to discuss and plan responses to any possible scenario to address In the case of failure to address the supervisor's concerns, the LIC lays out the different measures that CNBV can take under the PCA regime, particularly when capital begins</p>

	to deteriorate (see below EC. 4). As a whole, all these elements give the CNBV a good framework for its actions and some flexibility to use supervisory judgment and expertise.
EC2	The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).
Description and findings re EC2	<p>The supervisory role in bank intervention and resolution is laid out in the LIC. Bank resolution is not the exclusive competence of the CNBV as it also involves the IPAB, as liquidator and interim manager, as well as the SHCP and BoM (through the Financial Stability Committee). As already observed during the 2006 BCP assessment, the law contains some good features, but a better bankruptcy regime is needed, in particular with regard to banks whose liquidation could have, in the view of the financial authorities, systemic implications.</p> <p>The current regime includes solvency and liquidity criteria as a trigger for bank resolution. If a bank's CAR falls below the regulatory minimum of 8 percent the resolution process begins, unless it maintains its CAR between 8 percent and 4 percent and (i) adheres to the Conditional Operation Regime; (ii) does not incur liquidity problems; and (iii) complies with the applicable PCA measures. The law also contemplates cessation of payments as a trigger for resolution.</p> <p>The Mexican resolution regime also establishes flexible options, including liquidation and payment of insured deposits, P&A, and the creation of a bridge bank (incorporated and operated by IPAB, which would guarantee all its operations and liabilities and could grant it credit). IPAB would decide which method to use based on a "least-cost" criterion. It also leaves the possibility for open-bank resolution in the case of banks considered to be "too-big-to-close" by the Financial Stability Committee.</p> <p>In this latter situation, the authorities may depart from the "least-cost" rule when they consider that the liquidation of a bank may have systemic implications. The decision as to whether a bank is systemic will be made by the Financial Stability Committee, comprising representatives from SHCP, Banco de México, CNBV, and IPAB. The Committee assesses if failure of the bank may have systemic consequences according to two criteria: (i) the risk of contagion; and (ii) impact on the national payment system. If the Committee considers that a bank's liquidation may have systemic implications, it will also set a general percentage of the balance of all non deposit-insured liabilities that needs to be paid to avoid the systemic implications. Based on this decision, IPAB would carry out the resolution of the bank under one of the following methods:</p> <ul style="list-style-type: none"> (i) Open Bank Assistance, if the Committee deems it necessary to pay 100 percent of the nonguaranteed obligations to avoid systemic implications. In this case, IPAB would have to carry out the direct capital investment needed to restore adequacy. (ii) Partial payment of non-insured liabilities, when the Committee decides to pay less than 100 percent of the nonguaranteed obligations. As observed by the CNBV, <i>"the primary advantage of this mechanism is that it minimizes the fiscal cost and creates greater market discipline, by reducing moral hazard."</i> <p>Lastly, the law contains legal protection for supervisors acting under the resolution regime. It is noteworthy that no bank has been closed since the last FSAP.</p>

EC3	The supervisor has available an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or when the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.
Description and findings re EC3	Article 134 Bis of the LIC establishes the basis of the CNBV's system of PCA in line with best international practices. In addition, the CNBV has issued additional rules that provide the general framework for the PCA (" <i>Reglas de Carácter General a que se refiere el Artículo 134 Bis de la Ley de Instituciones de Crédito</i> "). According to the law, CNBV has a range of supervisory tools available to deal with noncompliance with financial laws and regulations, to counter unsafe and unsound practices, and to act in the interests of depositors and public interest. The LIC provides for a wide range of actions to be taken within a prescribed period if a bank fails to correct deficiencies, or if the safety and soundness of the institution or the interests of depositors are threatened. These measures are described below in EC 4.
EC4	The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, Board directors or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license.
Description and findings re EC4	<p>When a bank is in violation of laws or regulations, the CNBV is empowered to impose corrective measures independently of any sanction that can be taken. The most significant measures are listed below:</p> <ul style="list-style-type: none"> • Present observations and order the application of corrective or remedial actions, as a result of its supervisory processes (LIC Article 133); • Impose minimum and additional corrective actions for the reestablishment of capitalization levels (within the PCA regime) (LIC Article 134 Bis); • Limit or order the suspension of operations (LIC Article 137 Bis 1). • Require adjustments to the accounting records (LIC Article 50). • Determine and impose fines (LIC Articles 107, 108, 108 Bis, 108 Bis 1, among others). • Order the dismissal of, and impose a temporary veto on, members of the Board of Directors as well as managers and every employee with powers to obligate the banks (LIC Article 25). • Decide on the viability of plans for capitalization restoration and the entry of a troubled bank into the Conditional Operation Regime (LIC Article 134 Bis 1). • Declare the managerial intervention of a bank by an IPAB employee (LIC Article 138). • If the bank repeats offenses to Article 106 (general prohibitions) or fails to adopt the prompt corrective measures set forth by CNBV, the supervisor can revoke the license.

	(LIC, Art. 28). Banks and their employees can be subject to fines and/or penal sanctions. The CNBV has an internal process by which the Legal Department proposes to the CNBV Board the appropriate sanctions in accordance with the gravity of a situation.
EC5	The supervisor has the power to take measures should a bank fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The supervisor has a range of options to address such scenarios.
Description and findings re EC5	Should a bank fall below the minimal capital requirements, the Prompt Corrective Action (PCA) regime allows the CNBV to react in a timely fashion and instruct the bank to restore its capital. If the bank fails to correct the deficiencies within the given period, the CNBV has the authority to take further enforcement actions that can lead to the revocation of the license.
EC6	The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.
Description and findings re EC6	Sanctions and criminal definitions in LIC can apply to institutions, Board members, shareholders, managers and individuals.
Additional criteria	
AC1	Regulations should guard against the supervisor unduly delaying appropriate corrective actions.
Description and findings re AC1	The regime for guarding against the supervisor unduly delaying corrective action is based on an internal supervisory accountability system that aims to review and monitor the effectiveness of CNBV employees. A Compliance Department of the CNBV monitors and inspects the activities carried out by the different departments. However, the approach is more compliance oriented. The CNBV is also in the process of creating an internal scoring system with a view to achieving better measurement of staff performance. In addition, there are provisions in the LIC stipulating that the failure of staff to discharge their duties carries serious monetary and penal responsibilities for CNBV employees (1.5 times the sanction that would have been applicable to the party committing the offense originally) (LIC 113 Bis 2).
AC2	The supervisor has the power to take remedial actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related companies in matters that could impair the safety and soundness of the bank.
Description and findings re AC2	In Mexico, financial groups are typically led by a holding company licensed by the SHCP whose entities are supervised by the CNBV. The holding company is deemed responsible for capitalizing any losses. Besides, banks in Mexico may not divert capital or engage in any operations that would hamper their ability to comply with capitalization requirements. Nor may they lend support to their parents or affiliates beyond what is permitted in the context of related lending.
AC3	When taking formal remedial action in relation to a bank, the supervisor ensures that the regulators of nonbank related financial entities are aware of its actions and, where appropriate, coordinates its actions with them.
Description and findings re AC3	CNBV has entered into MOUs with other sector supervisors to share information and keep each other apprised of the remedial actions taken.
Assessment of Principle 23	Largely Compliant

Comments	<p>The corrective arsenal in Mexico is consonant with international best practices. The CNBV can impose both fines and administrative sanctions that include barring individuals from participating in the financial systems as owners, officers or employees. However, the assessors are of the opinion that the country does not meet all criteria to earn a “compliant” rating. The authorities may wish to consider the following:</p> <ul style="list-style-type: none"> • Enforce decisions more effectively. Indeed, the CNBV has a long established tradition of forbearance. The analysis of statistics and discussions with staff showed that the CNBV has been rather reluctant to resort to harsh penalties as a means of achieving better market discipline. The case of AML breach is a good example in this regard. The range of fines provides flexibility to apply sanctions but they may not be proportional to the offense nor dissuasive for very large institutions and financial groups (high end of the range is approximately US\$500,000; for more details, see BCP 18). <p>Also, several technical aspects (long delays, scarce resources, etc.) hamper the sanctioning process. The CNBV is mindful of the need to adopt a more aggressive approach and is therefore reinforcing its credibility not only as supervisor but also as enforcement authority. In this regard, among the strategic objectives defined by the CNBV, there is the objective of “timely and exemplary punishment of serious infringing conducts.”</p> <p>In order to meet this objective, the CNBV will have to carry out the following:</p> <ul style="list-style-type: none"> • Define clear and well articulated criteria to support sanctions. First, the clear definition of criteria to support sanctions is essential. The LIC defines the different conducts that are subject to punishment. However, the CNBV is still missing clear and sound criteria to calibrate the level of sanctions according to the seriousness of the offense. Several initiatives have been taken in this respect. The CNBV has set up a Committee of Sanctions (<i>Comite de Sanciones</i>) that comprises representatives from the CNBV, the <i>Procuraduria Fiscal de la Nacion</i> and BoM. Its role is to define guidance to streamline the sanctioning process and avoid an excessive accumulation of cases with very minor infringements. This Committee also determines the cases that should be escalated to the CNBV Board for consideration and sanctioning. The Mexican authorities are encouraged to pursue their efforts in this regard. • Improve the way sanctions are published. Second, due to legal restrictions, the CNBV can publish sanctions only when the decision is considered final; in other words, as long as all avenues of appeal have not been exhausted, the decision is not made public. • Increase the effectiveness of the legal department in processing sanctions. Third, there are about 2,000 cases of sanctions that are still pending in the legal VP and the average timeframe for processing a sanction is still too long (three years). BCP assessors were made aware of a case in which it took four years for the legal department just to request a technical opinion after receiving the request for sanctions from the prudential supervisor. Some progress has been made to reduce the delays. For example, the fact that the CNBV is no longer obliged to sanction all infringements but only the most important ones is a good step forward. Nonetheless, reducing the backlog in sanctions will certainly require additional resources.
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Principle 24	Consolidated supervision. An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
Summary description and findings re Principle 24	
Essential criteria	
EC1	The supervisor is familiar with the overall structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border.
Description and findings re EC1	<p>The CNBV has a good understanding of the structure and the activities of banking groups under its supervision, particularly the structure of regulated financial groups. The scope of the broader corporate groups to which some banks and regulated financial groups are connected should be better mapped. This should include compiling the links and risks from the association of banks and financial groups to the ultimate beneficiary owners (UBO) who control them.</p> <p>As of June 2011, there were 25 regulated financial groups authorized by the SHCP under the Law of Financial Groups ('Ley de Agrupaciones Financieras' or LAF). Under LAF, the parent of a regulated financial group must be a regulated holding company (HCO) licensed at 'level 2' by the SHCP, and above other financial sector institutions placed at 'level 1' (e.g., banks, insurance and brokerage companies, etc.) regulated by CNBV and other financial sector supervisors.</p> <p>HCOs are non-operational companies whose activities are limited to holding the participations of the financial institutions that they control in two or more financial sub-sectors. HCOs cannot borrow to leverage their capital, which must be at least equal to the capital needs of the regulated financial entities under their control. Under LAF, there are no additional prudential rules applicable at HCO level 2, such as consolidated lending limits, related party lending limits, or compliance with other corporate governance and risk management standards.</p> <p>Leverage can take place at a level above that of an HCO. It can be between the HCO and any intermediary unregulated company placed between the regulated HCO and the UBO that controls the HCO. Through licensing and on-going supervision, the CNBV would like to monitor situations where leverage takes place at those higher levels and be informed of the sources and conditions of such lending. This would allow the CNBV to monitor potential risks to banks and financial groups after considering the capacity to serve associated debt, including relevant intra-group and related party transactions conducted above level 2.</p> <p>Intra-group transactions above the highest level of consolidated supervision in Mexico are not explicitly treated and might be an important source of risk in mixed-activity and horizontal groups operating in Mexico.</p> <p>Eleven out of the 25 regulated financial groups are controlled by a well known international bank. In nine cases, the groups can be categorized as mixed-financial groups since, apart from a bank; these groups include insurance and brokerage companies, as well as SOFOMES and other types of companies. The assessors were</p>

	<p>informed that no groups are headed by an insurance company that controls a bank or a brokerage company.</p> <p>The CNBV has good information to monitor regulated financial groups on a regular basis. The CNBV informed the assessors that insurance activities would not exceed the 10 percent threshold of materiality in any of the regulated groups. In most of them, insurance activities contribute less than the relevant 5 percent threshold level. Therefore, most groups can be considered mixed-financial groups rather than financial conglomerates.</p> <p>In addition, the CNBV has identified 9 mixed-activity corporate groups with an associated bank, and in some cases a financial group, linked to a broader commercial corporate group. These mixed-activity groups include the following banks: Compartamos, Facil, Bancoppel, Walmart, Mexico Adelante, Azteca, Famsa, Volkswagen, Autofin Mexico, and Amigo.</p> <p>In these cases, the regulatory and supervisory powers of the CNBV are limited to the regulated bank, including supervision of the leading regulated non-operational HCO when it exists. Two of the financial groups not mentioned above seem to be also part of broader mixed-activity groups (namely Banorte and Inbursa).</p> <p>Mixed-activity groups are not regulated in Mexico. In most cases these groups have either a nonregulated mixed-activity holding company (MAHCO) placed at 'level 3' above a regulated institution, or a series of companies, which control both financial and nonfinancial entities.</p> <p>The detail with which the CNBV has presented to the assessors these mixed-activity groups does not permit a clear understanding of the full corporate structure above the highest regulated level 2. The corporate structure between this level 2 and the UBOs who might exert control in a chain of interposed/inter-linked companies was not fully documented for review.</p> <p>However, the assessors believe that the CNBV should be able to maintain a reasonable level of oversight of any MAHCO at 'level 3' and its links in Mexico with a regulated bank, at least in those cases where the MAHCO has listed securities in the Mexican stock exchange. Through these means, as well as through its licensing activities, the CNBV should be well placed to identify all major intermediary HCOs between a regulated bank, or an HCO at level 2, and their UBOs who exert control over them.</p> <p>The activism with which the CNBV can exert its powers as a licensing authority and require additional undertakings from UBOs and intermediate holding vehicles remains to be established.</p>
EC2	The supervisor has the power to review the overall activities of a banking group, both domestic and cross-border. The supervisor has the power to supervise the foreign activities of banks incorporated within its jurisdiction.
Description and findings re EC2	<p>The powers of the CNBV to review the overall activities of banking groups (whether domestic or cross-border) are complete, including powers to supervise the foreign activities of banks incorporated within its jurisdiction.</p> <p>For those cases where banks, banking and financial groups are connected to a broader corporate group, such as a mixed-activity group, the actual powers conferred on the CNBV are limited. Unless the CNBV decides to use its licensing authority on a</p>

	<p>more substantive ongoing basis, the Commission will continue to find its oversight work limited above the level 2 regulated HCO.</p> <p>A good example is the case of a well known Mexican (parallel) bank and its unregulated holding company that conducts commercial activities domestically and abroad. Both constitute a horizontal mixed-activity banking group with banking subsidiaries across jurisdictions in the Latin American region. All of these banking units are controlled by the unregulated commercial company, and are not consolidated with the Mexican bank. The latter bank and the Latin American subsidiaries have the same banking name, constitute a parallel banking group, and are not supervised on a consolidated basis in Mexico given that the LAF does not empower the CNBV to do so.</p> <p>Articles 45-A to 45-F of the LIC provide the reference set of regulations governing the constitution of financial and banking groups, in addition to the provisions of the LAF, with powers under the latter exerted by the SHCP.</p> <p>The licensing conditions for approval of a subsidiary of a financial conglomerate or a level 2 HCO include well-designed information requirements, which must be submitted to the CNBV for review. These conditions should provide sufficient information for the CNBV to understand the structure of the corporate group as a whole to which the former level 2 HCO might be connected. This includes all associated entities, whether financial or nonfinancial, incorporated in Mexico or abroad, in which a foreign financial institution (e.g., a foreign international bank) or a related nonfinancial entity has a significant participation (at least 10 percent of voting shares).</p> <p>In the view of the assessors, the SHCP and the CNBV would like to interpret the license that is granted as a gracious privilege, rather than as a right to the licensee. Accordingly, both official agencies would like to conceptualize licensing as an ongoing process of continuous fulfillment of the initial conditions.</p> <p>Therefore, under their current licensing authority, the SHCP and the CNBV should require as much additional information from time to time as necessary, to ensure that nonfinancial activities do not pose additional risks by association with regulated financial institutions. These requirements should extend to a demand for changes in the controlling group structure to facilitate the performance of consolidated supervision, as necessary.</p> <p>The CNBV supervises the activities of the HCO authorized by the SHCP under the LAF, including all banks and financial institutions that are not under the direct supervision of other Mexican nonbank financial institutions, such as insurance and pension fund management companies (AFORES), which are regulated and supervised by the CNSF and the CONSAR.</p> <p>The CNBV has additional powers to obtain information on mixed-activity groups in those cases where its MAHCO lists securities in the Mexican stock exchange market. This permits the CNBV to obtain the information prescribed for listing purposes. However, the CNBV has no authority to regulate, inspect and perform full oversight of such MAHCO.</p> <p>In the opinion of the assessors, the SHCP and the Board of the CNBV do not utilize fully their licensing powers upon regulated entities of a group to extract undertakings or to impose additional licensing conditions regarding mixed-activity groups and their structure.</p>
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EC3	<p>The supervisor has a supervisory framework that evaluates the risks that nonbanking activities conducted by a bank or banking group may pose to the bank or banking group.</p>
Description and findings re EC3	<p>The CNBV is implementing a framework to factor in the contribution to group risk of each entity that envisages relevant nonbanking activities conducted by a bank or banking group. The CNBV is now considering extending this framework to those financial groups it supervises under the control of a regulated HCO, including weighting the risk ratings of each entity, considering their contribution to the total risk of the full consolidated group.</p> <p>The challenges faced by the CNBV start at level 2 of a financial group. Beyond that point, including the issues discussed in EC2, the CNBV does not have effective powers to investigate relationships which can give rise to potential risks for a regulated group and its bank members. In addition, there is the need to achieve further consistency (lack of consistent regulation among sectors and at the consolidating point of the HCO) and supervision and regulation at level 3 of unregulated MAHCO. The resolution of these issues requires adopting amendments to the LAF, the LIC, and other sectoral legislations as deemed necessary.</p>
EC4	<p>The supervisor has the power to impose prudential standards on a consolidated basis for the banking group. The supervisor uses its power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures, exposures to related parties and lending limits. The supervisor collects consolidated financial information for each banking group.</p>
Description and findings re EC4	<p>The CNBV has full powers to impose prudential standards on a consolidated basis up to the level of a banking group. All additional powers at level 2 of the HCO at the head of a regulated financial group belong to the SHCP.</p> <p>A financial group at level 2 has few explicit prudential rules. Capital adequacy is calculated as the sum of the respective capital needs of its members as per their respective sectoral regulations. If there are unregulated entities, or financial entities without explicit capital adequacy rules, there is no precise notional capital charge for them. In addition, the scope of intra-group transactions and potential eligible cross-holdings of capital instruments that need to be deducted from capital are not fully specified or known.</p> <p>In addition, the CNBV does not have effective powers to require changes in the shareholding and control structure of mixed-financial and mixed-activity groups to make them fully subject to comprehensive consolidated supervision.</p> <p>However, within the scope of its supervision, the CNBV discusses and negotiates the above mentioned changes. In those instances where the SHCP exerts the licensing</p>

	<p>authority, the CNBV does not have effective powers to impose additional undertakings and impose conditions, including in those cases where a mixed-activity unregulated company is the parent or a significant owner of a mixed-activity or horizontal group.</p> <p>The CNBV has completed a thorough evaluation of the regulatory asymmetries among financial sectors and sectoral groups. The CNBV has adopted a plan to resolve the asymmetries that are under its control and to achieve as much convergence as possible. This includes a compilation of secondary regulation for financial groups under the supervision of CNSF (insurance) and CONSAR (pensions).</p> <p>Concerted amendments to the laws regulating HCO and sectoral financial institutions are required to mitigate the asymmetries detected, foster convergence among sectors, as well as to extend prudential supervision to mixed-activity groups and their MAHCO, including dealing with horizontal and parallel groups.</p>
EC5	The supervisor has arrangements with other relevant supervisors, domestic and cross-border, to receive information on the financial condition and adequacy of risk management and controls of the different entities of the banking group.
Description and findings re EC5	<p>The authority of the CNBV to obtain information from foreign supervisors is supported in Article 4 (XXIV and XXV) of the LIC. Article 97 of this law regulates information exchange with other Mexican financial supervisors. The statutes of the CNBV provide broad powers to exchange information with both groups. However, the statutes of other local financial supervisors do not provide such broad powers to exchange information with the CNBV, thereby not permitting them to serve all the needs of the CNBV. This applies, in particular to CNSF (insurance) and CONSAR (pensions). Thus, CONSAR and CNSF will need to standardize their respective regime to that of the CNBV.</p> <p>However, in practice, through the participation of the CNBV in the Boards of these two local nonbank financial supervisors, the CNBV mitigates some of the restrictions encountered.</p> <p>In addition, Article 32 of the LAF establishes the information requirements from regulated holding companies under the LAF requested by the SHCP, the BoM, and the CNBV, CNSF, and CONSAR.</p> <p>As required by this EC, the CNBV has entered into a number of international agreements and implements them well.</p>
EC6	The supervisor has the power to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted; the supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank are not compromised.
Description and findings re EC6	The CNBV confirms that this power is limited to the groups regulated by the LAF and subject to the conditions discussed in EC2 to EC5. However, the CNBV cannot confirm this power as being effectively carved out in the LIC or other enforceable legal instrument such as the LAF for other forms of conglomeration such as the mixed-activity groups and their MAHCO as discussed in EC2.
EC7	The supervisor determines that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. The supervisor also determines that banks' policies and processes ensure that the local management of any cross-border operations has the necessary expertise to manage those operations in a safe and sound manner and in compliance with supervisory and regulatory requirements.

Description and findings re EC7	The CNBV confirms that this power is limited to the groups regulated by the LAF and subject to the conditions discussed in EC2 to EC5. However, the CNBV cannot confirm this power as being effectively carved out in the LIC or other enforceable legal instrument such as the LAF for other forms of conglomeration such as the mixed-activity groups and their MAHCO as discussed in EC2.
EC8	<p>The supervisor determines that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes: (i) information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified; (ii) assessing in an appropriate manner compliance with internal controls; and (iii) ensuring effective local oversight of foreign operations.</p> <p>For the purposes of consolidated risk management and supervision, there should be no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. Transmission of such information is on the understanding that the parent bank itself undertakes to maintain the confidentiality of the data submitted and to make them available only to the parent supervisory authority.</p>
Description and findings re EC8	Except for the case of a horizontal mixed activity banking group, referred to elsewhere in this CP, which is not under its jurisdiction, the CNBV confirms compliance. Such compliance is achieved through its contact with senior management in Mexico of the parent of the foreign subsidiaries of such parent, and a common inspection together with foreign host supervisors of the subsidiaries located abroad.
EC9	<p>The home supervisor has the power to require the closing of foreign offices, or to impose limitations on their activities, if:</p> <ul style="list-style-type: none"> - it determines that oversight by the bank and/or supervision by the host supervisor is not adequate relative to the risks the office presents; and/or - it cannot gain access to the information required for the exercise of supervision on a consolidated basis.
Description and findings re EC9	The CNBV confirms that this power is limited to the groups regulated by the LAF and subject to the conditions discussed in EC2 to EC5. However, the CNBV cannot confirm this power as being effectively carved out in the LIC or other enforceable legal instrument such as the LAF for other forms of conglomeration such as the mixed-activity groups and their MAHCO discussed in EC2.
EC10	The supervisor confirms that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.
Description and findings re EC10	The CNBV performs this oversight in all cases considering the relevance and materiality of the foreign operations to the banking group, and in certain cases the financial group, under its supervision. This includes contact with the foreign supervisor who might have licensed such operation, as well as periodic meetings with senior management of the parent bank as deemed necessary. The CNBV informed the assessors that there are no relevant institutions subject to this EC.
Additional criteria	

AC1	<p>For those countries that allow corporate ownership of banking companies:</p> <ul style="list-style-type: none"> - the supervisor has the power to review the activities of parent companies and of companies affiliated with the parent companies, and uses the power in practice to determine the safety and soundness of the bank; and - the supervisor has the power to establish and enforce fit-and-proper standards for owners and senior management of parent companies.
Description and findings re AC1	The CNBV has no explicit powers to review the activities of unregulated parent companies acting as MAHCO and other associated companies. Moreover, the CNBV has not established and is not enforcing fit-and-proper standards to owners and senior management of parent companies different from those applicable to any other institutions it has licensed.
AC2	The home supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.
Description and findings re AC2	<p>As a home supervisor, the CNBV achieves this purpose through different means, including initial and subsequent contacts with host supervisors, as well as the ongoing operation of bilateral MOUs (see CP25). The CNBV also participates in supervisory colleges and is aware of the quality of supervision exerted by host supervisors through this means.</p> <p>The CNBV advised the assessors that foreign supervisory agencies acting as host supervisor of licensed banking units abroad of a parallel mixed-activity banking group (for example, Local Bank XYZ) whose parent is located in Mexico (Parent Co. of Mexico) have always been informed punctually for the purposes covered under this CP.</p> <p>More precisely, the CNBV always clarifies to the host authorities the following: "Since (the Parent Co. of Mexico) is the ultimate parent of a nonregulated mixed-activity holding entity outside the scope of consolidated supervision of the CNBV, the agency will not be acting as the ultimate consolidating supervisor of such group."</p>
AC3	The supervisor arranges to visit the foreign locations periodically, the frequency being determined by the size and risk profile of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.
Description and findings re AC3	<p>The CNBV determines the relevance of the foreign operations of Mexican banks and, in the case of banking and financial groups as described in EC1 above, by means of the information reported to the agency as indicated in EC2 above.</p> <p>The assessors received confirmation from the CNBV that there is no relevant off-shore financial entity or bank outside of Mexico known to the agency that is currently associated with or under the control of a bank, banking or financial group, having been licensed by the CNBV or the SHCP, where such an entity or bank would currently escape the scope of its authority and powers as home consolidating supervisor.</p> <p>The only exception to the above situation would be the case of the mixed-activity banking horizontal group discussed above.</p>
Assessment of Principle 24	Largely Compliant
Comments	The opinion of the assessors is that the following actions are necessary to extend essential elements of prudential regulation and varying degrees of supervision to mixed-activity groups and to unregulated mixed-activity and other intermediary

	<p>holding companies to strengthen compliance with the essential and additional criteria of this principle:</p> <ul style="list-style-type: none"> • Amend the LAF to provide full powers to the CNBV for regulating financial groups, in addition to its current supervisory function (EC2); • Fully capture in the LAF and in the LIC other forms of financial conglomeration, such as mixed-activity and horizontal groups (EC2); • Provide powers to the CNBV to regulate and supervise mixed-activity holding companies that control or exert significant influence on the above groups (EC1 to AC3); • Include among the above powers, explicit authority to order changes in a group structure that are necessary to enable effective consolidated supervision of a group (EC5); • Extend to regulated HCOs and unregulated MAHCO appropriate prudential regulations (capital, risk limits, leverage, governance, risk management and fit-and-proper tests) consistent with those currently applied by the CNBV to other regulated institutions (all ECs above); • Explicitly factor into the risk rating system (CEFER, see CP19) group risks from the association of a bank with a broader corporate group so that such risks are fully captured in supervisory ratings.
Principle 25	<p>Home-host relationships. Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.</p>
<p>Summary description and findings re Principle 25</p>	<p>The law empowers CNBV to exchange information with foreign counterparts based on bilateral MOUs. These MOUs cover not only banking but also securities market activities and provide, among other things, for the exchange of public and nonpublic information, surveillance visits, and the provision of technical assistance. CNBV also participates in the supervisory colleges of large cross-border financial firms that have a significant presence in Mexico.</p> <p>In recent years, the CNBV has been very active on the international cooperation front. Eleven MOUs have been signed to strengthen cross-border consolidated supervision for banks. Also, an inter-agency coordination body to monitor and assess system-wide risks was recently established, which is intended to strengthen macro-prudential regulation. Since the last FSAP, the CNBV has coordinated five onsite inspections by foreign supervisory agencies (including an inspection of outsourced services).</p> <p>Special emphasis has been placed on coordination mechanisms with overseas noncounterparts in the field of AML/CFT. Taking into account the increasing relevance of AML/CFT concerns and considering that different authorities are involved in this effort, the CNBV has been participating in the creation of coordination mechanisms between different authorities (i.e., banking, securities and insurance supervisors, and FIUs) from different jurisdictions in order to cooperate within their respective scope of competence and in observance of the applicable laws and regulations.</p>
Essential criteria	

EC1	Information to be exchanged by home and host supervisors should be adequate for their respective roles and responsibilities.
Description and findings re EC1	<p>The assessors are of the view that information to be exchanged by home and host supervisors is adequate for their respective roles and responsibilities. There are no legal impediments for cooperation among the various supervisory bodies and other domestic and overseas authorities.</p> <p>The Mexican international mechanisms for cooperation allows the CNBV to enter into cooperation arrangements with foreign regulatory and supervisory organizations, including for the exchange of information protected by secrecy provisions and for information obtained from the performance of its surveillance powers (Article 4, of the CNBV Law). Article 9 of this Law allows the CNBV to provide legal assistance to its foreign counterparts regarding confidential information, provided that such assistance is clearly established by MoUs and under conditions of reciprocity. MoUs may be either bilateral or multilateral, and cover banking or securities, or both.</p> <p>The law allows for the CNBV to investigate and perform inspection visits with respect to individuals and legal entities who may be conducting unauthorized financial activities. The abovementioned law also allows for reciprocal inspection visits by the CNBV and overseas supervisors. Such visits shall be subject to Mexican legal provisions and to terms and conditions specified in the MoU. During such visits, foreign authorities may have access to all the information needed to perform their supervisory powers, including all information and documents related to AML/CFT.</p>
EC2	For material cross-border operations of its banks, the supervisor identifies all other relevant supervisors and establishes informal or formal arrangements (such as memoranda of understanding) for appropriate information sharing, on a confidential basis, on the financial condition and performance of such operations in the home or host country. Where formal cooperation arrangements are agreed, their existence should be communicated to the banks and banking groups affected.
Description and findings re EC2	<p>The CNBV has entered into bilateral MoUs with financial authority counterparts in 11 countries, including: Argentina, Canada, Guatemala, Panama, Peru, Spain, The Netherlands, United States of America, and Venezuela. With respect to the United States, it has MoUs with five counterpart supervisors including the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (in process), the Federal Deposit Insurance Corporation (in process), and the New York State Banking Department.</p> <p>The CNBV has also negotiated a specific agreement for joint Banking and Securities supervision. MoUs have been signed with six countries including Brazil, British Virgin Islands, El Salvador, Honduras, Switzerland, and Uruguay. The CNBV indicated that it has actively cooperated with some of these counterparts, particularly those from the United States. The CNBV has conducted inspection visits of overseas Mexican financial institutions on several occasions. Foreign supervisors have participated in the inspections in Mexico only three times since the last FSAP. There were 20 AML-specific visits by overseas supervisors over the same period. Most of these visits involved banks.</p>
EC3	<p>The home supervisor provides information to host supervisors, on a timely basis, concerning:</p> <ul style="list-style-type: none"> • the overall framework of supervision in which the banking group operates;

	<ul style="list-style-type: none"> • the bank or banking group, to allow a proper perspective of the activities conducted within the host country's borders; • the specific operations in the host country; and • where possible and appropriate, significant problems arising in the head office or other parts of the banking group if these are likely to have a material effect on the safety and soundness of subsidiaries or branches in host countries. <p>A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of a bank's or banking group's activities to the financial sector of the host country. In this context, the host supervisor will inform the home supervisor when a local operation is material to the financial sector of the host country.</p>
Description and findings re EC3	<p>The interaction of the CNBV with its foreign counterparts takes place through different channels. The MoUs allow the exchange of relevant information in the context of, for example, (i) an application for a banking license, or (ii) oversight activities (e.g., an on-site cross-border inspection). Conference calls are also frequently used to update one another in respect of any event or trend that could represent a risk for a cross-border entity or for the sound development of the financial system.</p> <p>In particular, the CNBV has implemented a bilateral mechanism to follow up on the financial condition of the foreign financial institutions that have investments in Mexican affiliates. Through conference calls or more formal communication channels, the main discussion items include liquidity, capital, and corporate structure. In case of serious concerns regarding a specific bank, supervisors on both sides will discuss (i) the causes of the problem and measures to be taken; (ii) details of the government's support mechanism; and (iii) the potential impact on the Mexican subsidiaries.</p> <p>In addition to bilateral contacts, the CNBV has also established close relationships on a multilateral basis, i.e., through colleges of supervisors for the following banks: Bank of Nova Scotia, Deutsche Bank Group, ING, BBVA, Santander, and Citi Group. The CNBV, along with BoM also participates in crisis management colleges.</p>
EC4	<p>The host supervisor provides information to home supervisors, on a timely basis, concerning:</p> <ul style="list-style-type: none"> • material or persistent noncompliance with relevant supervisory requirements, such as capital ratios or operational limits, specifically applied to a bank's operations in the host country; • adverse or potentially adverse developments in the local operations of a bank or banking group regulated by the home supervisor; • adverse assessments of such qualitative aspects of a bank's operations as risk management and controls at the offices in the host country; and <p>any material remedial action it takes regarding the operations of a bank regulated by the home supervisor.</p> <p>A minimum level of information on the bank or banking group, including the overall supervisory framework in which they operate, will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of the cross-border operations to the bank or banking group and financial sector of the home country. In this context, the home supervisor will inform the host</p>

	supervisor when the cross-border operation is material to the bank or banking group and financial sector of the home country.
Description and findings re EC4	Mexico, as a host supervisor, has the legal authority to share information and has developed internal procedures and processes to guide the exchange of information. According to the law, communication of confidential information requires a formal agreement between the CNBV and its counterpart; otherwise, bank secrecy cannot be lifted.
EC5	A host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.
Description and findings re EC5	Foreign banks are subject to the same prudential requirements, such as CAR, liquidity ratios, large exposure limits, loan loss provisioning, and reporting requirements, as domestic banks.
EC6	Before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practices global consolidated supervision.
Description and findings re EC6	As indicated in BCP 2, the CNBV establishes that no objection (or a statement of no objection) from the home supervisor has been received before issuing a banking license, if this is required by the home supervisor.
EC7	Home country supervisors are given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of banking groups.
Description and findings re EC7	As host supervisor, the Mexican regulation permits overseas supervisors to make on-site visits to local operations. Article 45-N states that when the home supervisor wishes to conduct an on-site inspection in Mexico, it should make the request to the CNBV. Such cross-border inspection visit can be carried out jointly with the CNBV or on a solo basis. It also provides the requirements and formalities applicable to such visits, i.e., a request letter to be sent at least 30 days ahead of the visit; the description of the scope of the intended visit; and the legal provision applicable for the inspection. At the request of the CNBV the foreign supervisor will share the main findings of the visit. In practice, CNBV always participates in the on-site visits led by foreign supervisors. Since the last FSAP, the CNBV has coordinated six visits by foreign supervisors related to onsite inspections and outsourced-related services.
EC8	The host supervisor supervises shell banks, where they still exist, and booking offices in a manner consistent with internationally agreed standards.
Description and findings re EC8	There are no shell banks and booking offices in Mexico.
EC9	A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.
Description and findings re EC9	This case has not materialized.
Additional criteria	

AC1	Where necessary, the home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy should reflect the size and complexity of the cross-border operations of the bank or banking group.
Description and findings re AC1	BCP assessors did not find any such “agreed communication strategy.”
Assessment of Principle 25	Compliant
Comments	International cooperation has been high on the CNBV agenda. An intensive policy has been pursued to consolidate home-host supervision through the signing of multiple MOUs and participation in supervisor colleges, among others.

1/ UDI refers to the regularly updated minimum daily wage in the Federal District, and is used throughout the legal framework as an index for sanctions.

2/ IPAB is also the agency responsible for protecting deposits. In addition to the deposit insurance, it manages liabilities inherited from the depositor bail-out made for banks after the 1995 financial crisis. Unlike the previous scheme, the IPAB only guarantees deposits per customer per bank for up to UDIs 400,000 (equivalent to roughly USD146,000 at present).

Table 3. Mexico: Recommended Actions

Reference Principle	Recommended Action
1. Objectives, Independence, Powers, Transparency and Cooperation	
1.1. Responsibilities and Objectives	<ul style="list-style-type: none"> • State in the LIC the fiduciary responsibilities of directors. • Mandate in the LIC the performance of the ICAAP • Transfer from the LIC to CNBV all regulations on risk limits
1.2. Independence and accountability	<ul style="list-style-type: none"> • Provide terms of tenure and removal for Sr. management • Review and transfer powers retained by the CNBV's Board • Estimate current/anticipated workload to adjust the head-count • Align budget/salaries to current needs to stop staff attrition
1.3. Legal Framework	
1.4. Legal Powers	
1.5. Legal Protection	<ul style="list-style-type: none"> • Institute an effective legal protection regime
1.6. Coordination	
2. Permissible Activities	
3. Licensing Criteria	<ul style="list-style-type: none"> • Provide more autonomy to CNBV for decision making • Supplement the Fit-and-proper mechanisms with additional criteria • Define more clearly the concept of UBO
4. Transfer of Significant Ownership	<ul style="list-style-type: none"> • Supplement the Fit-and-proper mechanisms with additional criteria
5. Major Acquisitions	
6. Capital Adequacy	
7. Risk management process	<ul style="list-style-type: none"> • Formalize in the LIC the responsibilities of directors • Mandate ICAAP to support the implementation of Pillar 2 • Make public more detailed guidelines on risk management • Require risk management at the holding company level
8. Credit risk	
9. Problem assets, provisioning and reserves	<ul style="list-style-type: none"> • Factor in an anti-cyclical component for loan provisioning
10. Large exposure limits	<ul style="list-style-type: none"> • Include 'economic interdependence' to connected borrowers • Review and monitor exclusions from risk aggregation • Adopt an aggregated risk limit for all large exposures • Factor "concentration risk" into capital through Pillar 2
11. Exposure to Related Parties	<ul style="list-style-type: none"> • Amend the LIC to reduce the 50 percent aggregated lending limit • Include all related party transactions as per IAS 14.2
12. Country and transfer risk	<ul style="list-style-type: none"> • Update the reporting system for end-borrowers/end-counterparties
13. Market risks	
14. Liquidity risk	<ul style="list-style-type: none"> • Adopt the newly drafted regulations on liquidity risk • Require reporting of residual gaps and forecasted funds flows
15. Operational risks	<ul style="list-style-type: none"> • Achieve full implementation of operational risk supervision

Reference Principle	Recommended Action
	<ul style="list-style-type: none"> • Increase on-site visits targeting operational risks for all banks
	<ul style="list-style-type: none"> • Incorporate operational risk within the CNBV architecture
16. Interest rate risk in the banking book	<ul style="list-style-type: none"> • Require reporting of roll-over gaps and sensitivity tests
	<ul style="list-style-type: none"> • Bring this risk formally into Pillar 2 (when adopted)
17. Internal control and audit	<ul style="list-style-type: none"> • Provide clearer criteria for risk classification
	<ul style="list-style-type: none"> • Adopt benchmarks to evaluate the intensity of internal audit
18. Abuse of financial services	<ul style="list-style-type: none"> • Increase human resources in the AML area
	<ul style="list-style-type: none"> • Enforce AML using a broader range of sanctions
	<ul style="list-style-type: none"> • Pay more attention to terrorist financing in the industry
	<ul style="list-style-type: none"> • Issue industry-specific guidelines on AML
19. Supervisory Approach	<ul style="list-style-type: none"> • Complete Pillar 2, its supervisory review process and risks
	<ul style="list-style-type: none"> • Adopt a supervisory cycle and a quality assurance process
	<ul style="list-style-type: none"> • Reinforce the rating process: criteria, metrics and outcomes
	<ul style="list-style-type: none"> • Pursue outcomes in terms of risk reduction strategies
20. Supervisory Techniques	<ul style="list-style-type: none"> • Develop a horizontal approach to risks on a macro level
	<ul style="list-style-type: none"> • Reinforce off-site techniques for consolidated supervision
	<ul style="list-style-type: none"> • Adopt workload costing and document administration systems
	<ul style="list-style-type: none"> • Promote a better internal Quality Control system
21. Supervisory Reporting	
22. Accounting and disclosure	<ul style="list-style-type: none"> • Strengthen enforcement mechanisms over audit companies
	<ul style="list-style-type: none"> • Set stronger rules for the rotation of auditors
	<ul style="list-style-type: none"> • Meet more frequently with external auditors
	<ul style="list-style-type: none"> • Harmonize accounting norms to converge toward IFRS
23. Corrective and remedial powers	<ul style="list-style-type: none"> • Enforce decisions more effectively
	<ul style="list-style-type: none"> • Define clear and well articulated criteria to support sanctions
	<ul style="list-style-type: none"> • Improve the way sanctions are published
	<ul style="list-style-type: none"> • Make the processing of sanctions more effective
24. Consolidated supervision	<ul style="list-style-type: none"> • Amend LAF to transfer to CNBV group regulatory powers
	<ul style="list-style-type: none"> • Regulate mixed-activity and horizontal groups and their HCOs
	<ul style="list-style-type: none"> • Require the application of prudential regulations to regulated and mixed HCOs
25. Home-host relationships	

Authorities' response

The Mexican financial authorities agreed, in general, with the conclusions, observations, and recommendations of the assessment regarding the implementation of Basel Core Principles in the Mexican financial sector. Financial authorities do not consider that their respective mandates overlap under an appropriate understanding of the Mexican legal system that clearly defines the respective powers granted to such authorities, and the close coordination maintained in practice by such authorities. Most of the written comments provided by the authorities on the preliminary draft were included in the final report. Authorities consider that the exercise represented a good opportunity to discuss both strengths and weaknesses on the banking system, as well as to draw attention to main issues that should be addressed in the future.

The authorities found the assessment both comprehensive and useful. Also, they believe that assessors' advice and proposals will become part of their agenda for the upcoming years, and that the assessment rightly identifies opportunities for improvement. The report identifies the main concerns that the authorities currently have. Regarding the comments on CNBV independence, authorities acknowledge that improvements to corporate governance, in particular achieving a more balanced Board composition are desirable, but would like to note that the current arrangement has so far worked adequately since the Ministry of Finance has relied on technical considerations when deciding on matters of regulation and supervision. Also, they want to mention that there is not enough evidence to affirm that the current salary levels at CNBV are inadequate to attract high-caliber staff; what is a cause for concern is that they have been frozen in the last several years. If this trend is not reversed soon, the human capital of the institution will be severely impaired. Authorities are concerned that there is a risk that when implementing legal changes to grant CNBV more autonomy, an adverse outcome can occur that results in the institution being subject to political interference by Congress. However, authorities agree that providing a fixed term for the President of CNBV (with well-specified reasons for removal), and to allow CNBV to keep the fees collected is desirable.

In addition, they agree that it is necessary to review, improve, standardize, fully Document, and formalize supervisory procedures at the CNBV and will move forward to address these issues, although they consider that lack of standardization and formalization does not reflect in any way the quality of ongoing supervision of banks. Also, the authorities agree that high concentration of loan portfolios might raise concerns, although they consider that this should not be seen as a problem unique to the banking institutions and credit markets, but that should be considered as a reflection of a feature of the Mexican economy as a whole.

Authorities share the assessors' point of view regarding that some enhancements should be made to CNBV's powers in some matters like the ability to take some discretionary decisions, to impose fines and to publish information on legal proceedings, but it should be noted that some of these powers might not be easily included in CNBV's regulation due to the characteristics of the Mexican legal framework, considering the civil code and the law of judicial appeals and injunctions (amparos). On the other hand, they acknowledge that there are several opportunities to enhance consolidated supervision in Mexico, but will stress that to do so it is necessary to issue a law to regulate and supervise financial conglomerates as well as economic conglomerates that contain a banking institution.

Regarding the adoption of Basel III in Mexico, they agree that one main challenge faced by CNBV is the full and thorough implementation of Pillar II. Nevertheless, it should be noted that significant progress has been made on current regulation on Pillar I—Mexico will be one of the early adopters—and that important steps have been taken to complete implementation of all three pillars, although there are still several issues to address that are already part of the authorities' agenda for the upcoming year.

With respect to the possible overlap between different authorities, while the law sets forth similar goals for the BoM and the CNBV (inter alia, to maintain and promote the sound development of the financial system), it grants each of such authorities different and distinctive powers to achieve such objectives. As an example, the CNBV is in charge of issuing prudential regulations and the BoM is responsible for defining the characteristics of transactions that banks can carry out. Furthermore, in respect of derivatives negotiated by banks, the BoM has the legal power to issue technical and operational regulations applicable to such transactions. In any case, both authorities have observed a coordination agreement between them to avoid any duplication in the regulations or in requesting information from financial institutions. The authorities hold frequent consultations and discussions with respect to regulations applicable to issues that may be covered by both authorities within their respective areas of competence. Moreover, with respect to the supervision carried out by each authority, coordination agreements ensure that any actions taken in connection therewith by one authority supplements the work carried out by the other. Concerning the participation of the central bank in the licensing of banks, authorities do not consider that the favorable opinion from such authority that is needed to grant a bank license could impinge on the process carried out by the CNBV. This is because the analysis carried out by the BoM for the opinion it needs to provide to the CNBV reinforces the analysis that the CNBV conducts. Such participation by the central bank also contributes to an appropriate and deeper fit-and-proper analysis that needs to be conducted with respect to any new financial institution. In any case, the role that the central bank may perform as lender of last resort lays down an appropriate basis for the intervention of the BoM in the bank licensing process.