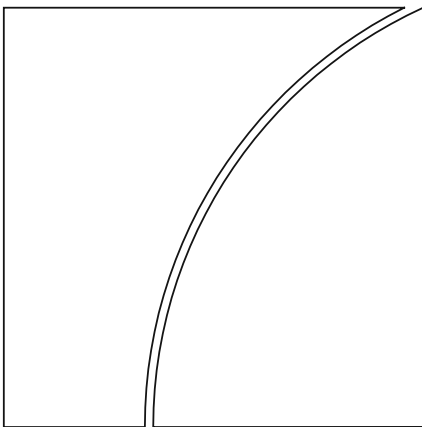


# Basel Committee on Banking Supervision



## Regulatory Consistency Assessment Programme (RCAP)

### Assessment of Basel III risk-based capital regulations – Mexico

March 2015



BANK FOR INTERNATIONAL SETTLEMENTS

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ISBN 978-92-9197-068-1 (print)

ISBN 978-92-9197-067-4 (online)

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## Glossary

ABCP	Asset-backed commercial paper
AMA	Advanced Measurement Approach
APRA	Australian Prudential Regulation Authority
ASA	Alternative Standardised Approach
BCBS	Basel Committee on Banking Supervision
BdM	Bank of Mexico (Banco de México)
BIA	Basic Indicator Approach
CAR	Capital adequacy ratio
CCP	Central counterparty
CET1	Common Equity Tier 1
CEM	Current exposure method
CNBV	Comisión Nacional Bancaria y de Valores
COFEMER	Comisión Federal de Mejora Regulatoria
CVA	Credit valuation adjustment
D-SIBs	Domestic systemically important banks
DTAs	Deferred tax assets
EL	Expected loss
FAQs	Frequently asked questions
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
G-SIB	Global systemically important bank
IMA	Internal Models Approach
IMM	Internal Models Method
IRB	Internal Ratings-Based Approach
LGD	Loss-given-default
MDB	Multilateral development bank
MFAs	Mexican Financial Authorities
MR	Market risk
MXN	Mexican peso
OTC	Over-the-counter
PD	Probability of default
PON	Point of non-viability
RCAP	Regulatory Consistency Assessment Programme

RW	Risk weight
RWA	Risk-weighted assets
TSA	The Standardised Approach
UDI	Unidad de Inversión (Mexico's investment unit)
VaR	Value-at-risk

## Preface

The Basel Committee on Banking Supervision (Basel Committee) sets a high priority on the implementation of regulatory standards underpinning the Basel III framework. The prudential benefits from adopting Basel standards can only fully accrue if these are implemented appropriately and consistently by all member jurisdictions. The Committee established the Regulatory Consistency Assessment Programme (RCAP) to monitor, assess, and evaluate its members' implementation of the Basel framework.

This report presents the findings of the RCAP Assessment Team on the domestic adoption of the Basel risk-based capital standards in Mexico and its consistency with the minimum requirements of the Basel III framework.<sup>1</sup> The assessment focuses on the adoption of Basel standards applied to the Mexican banks that are internationally or regionally active and of significance to its domestic financial stability.

Over recent years, the Mexican authorities have undertaken several noteworthy initiatives designed to strengthen the prudential framework relating to bank capital. The Mexican authorities issued the Final Rule on Basel III risk-based capital in November 2012. A number of new rules and policies have also been put in place subsequently, in April and June 2013. In association with this RCAP assessment, the Mexican authorities have elected to further strengthen their prudential framework, with material reforms coming into effect from January 2015.

The RCAP Assessment Team was led by Mr Charles Littrell, Executive General Manager of the Australian Prudential Regulation Authority (APRA). The Assessment Team comprised seven technical experts drawn from Canada, India, Malaysia, Singapore, Spain, Sweden and the United States (Annex 1). The main counterpart for the assessment was the *Comisión Nacional Bancaria y de Valores* (CNBV). The Bank of Mexico (BdM) was also closely engaged in the assessment process.

The assessment relied upon the data, information, translations and materiality computations provided by the Mexican authorities for the period ended December 2014. The assessment findings are based primarily on an understanding of the current processes in Mexico as explained by the counterpart staff and the expert view of the Assessment Team on the documents and data reviewed. The overall work was coordinated by the Basel Committee Secretariat with support from APRA staff.

The assessment began in July 2014 and consisted of three phases: (i) completion of an RCAP questionnaire (a self-assessment) by the Mexican authorities; (ii) an off- and on-site assessment phase (July to November 2014); and (iii) a post-assessment review phase (January to mid-February 2014). The off- and on-site phases included an on-site visit for discussions with Mexican counterparts and representatives of Mexican banks. These exchanges provided the Assessment Team with a deeper understanding of the implementation of the Basel risk-based capital standards in Mexico. The third phase consisted of a two-stage technical review of the assessment findings: first by a separate RCAP Review Team and feedback from the Basel Committee's Supervision and Implementation Group; and secondly, by the RCAP Peer Review Board and the Basel Committee. This two-step review process is a key instrument of the RCAP process to provide quality control and ensure integrity of the assessment findings. The focus of the assessment was on the consistency and completeness of the domestic

<sup>1</sup> See also the separate RCAP assessment report on Mexico's adherence with the Basel III Liquidity Coverage Ratio.

regulations in Mexico with the Basel minimum requirements. Issues relating to prudential outcomes, capital levels of individual banks, the adequacy of loan classification practices, or the Mexican authorities' supervisory effectiveness were not in the scope of this RCAP assessment exercise.<sup>2</sup>

Where domestic regulations and provisions were identified to be not in conformity with the Basel framework, those deviations were evaluated for their current and potential impact (or, non-impact) on the reported capital ratios for a sample of internationally active Mexican banks. Some findings were evaluated on a qualitative basis. The assessment outcome was based on the materiality of findings and use of expert judgment. The Assessment Team also identified areas for follow-up action (Annex 12).

The report has three sections and a set of annexes: (i) an executive summary with a statement from the Mexican authorities on the material findings; (ii) the context, scope and methodology, and the main set of assessment findings; and (iii) details of the deviations and their materiality along with other assessment-related observations.

The RCAP Assessment Team acknowledges the professional cooperation received from Mexican counterparts throughout the assessment process. In particular the team sincerely thanks the staff of CNBV for playing an instrumental role in coordinating the assessment exercise. The Assessment Team would also like to thank the staff of the Bank of Mexico involved with the RCAP assessment work, as well as representatives of Mexican banks that provided data and information to the Assessment Team. The series of comprehensive briefings and clarifications provided by the Mexican counterparts helped the RCAP assessors to arrive at their expert assessment. The Assessment Team is hopeful that the RCAP assessment exercise will contribute to the sound initiatives that have been taken by the Mexican authorities and to further strengthening the prudential effectiveness and full implementation of the recent reform measures in Mexico.

<sup>2</sup> The last assessment of Mexico's financial system under the IMF-World Bank FSAP was published in 2012. A detailed assessment of Mexico's compliance with *Basel Core Principles* on supervisory issues was also carried out as part of the FSAP assessment and published.



## Executive summary

The Mexican framework for bank risk-based capital requirements came into force in 2007 through the *General Provisions Applicable to Credit Institutions* (Annex 2). It applies to all credit institutions, including commercial banking institutions and state-owned institutions. The framework has since been periodically updated to include Basel 2.5 and Basel III standards and was further amended in December 2014.

In early 2014, the Mexican authorities completed an extensive self-assessment of their capital regime as part of their preparation for the RCAP exercise. This self-assessment identified several material elements where the Mexican framework was inconsistent with the Basel requirements. The RCAP Assessment Team identified additional but typically less material variations from the Basel framework, which the Mexican authorities resolved to rectify. The Mexican authorities, led by CNBV, used the discipline of the RCAP exercise to undertake reform and upgrade their prudential capital framework – to the extent feasible and consistent with Mexican national interests. This was done in close coordination with BdM and the Ministry of Finance and has resulted in a significant strengthening of the Mexican capital regime.

As of the cut-off date for the RCAP assessment, the amended risk-based capital requirements issued on 31 December 2014 make Mexico compliant with the minimum Basel capital standards. Twelve of the 15 components of the Basel framework were assessed as being compliant. In all, the Mexican capital framework benefited from 55 improvements during the course of the RCAP assessment work, most of which became effective in December 2014. The additional regulatory initiatives undertaken by the CNBV considerably improved the level of compliance with the Basel minimum standards. In the absence of these reforms, the RCAP assessment would have generated a considerably less positive result.

Several elements of the Basel capital framework, notably the Internal Ratings-Based Approach for credit risk, Internal Models Approach for market risk, and Advanced Measurement Approach for operational risk, at this point have either minimal or no current participation by Mexican banks. The RCAP team is confident that Mexican rules in these areas comply with the Basel framework, but notes that these regulations have yet to be applied in substantial practice to a Mexican bank and should be kept under follow-up review.

The Mexican capital framework, while upgraded and compliant with the Basel capital framework, faces several challenges. Given the nature of some of the recent amendments, effective and ongoing implementation will continue to pose a material challenge for both the Mexican authorities and the Mexican banking industry. Although the RCAP exercise focused mainly on the consistency and completeness of prudential requirements, it became evident that intended prudential outcomes in Mexico will critically depend on how effectively the regulations are put into practice, monitored, and supervised.

Several important elements in CNBV's tool box, including Pillar 2 adjustments and increases in the countercyclical capital buffer, are subject to arguably unusual constraints including restrictions upon CNBV's supervisory flexibility. Although these constraints allow for compliance with the Basel capital framework, as a practical matter they may impede CNBV's ability to effectively impose those measures.<sup>3</sup>

<sup>3</sup> The 2012 Mexican FSAP assessment of the Basel Core Principles identified supervisory independence and empowerment as critical areas for improvement.

The RCAP team's experience as it relates to the implementation of the Basel framework suggests that statutory support for greater flexibility in its regulatory and Pillar 2 powers would help the CNBV more easily meet or exceed international regulatory expectations.

The Assessment Team compliments the Mexican authorities for their substantial reforms and alignment with the Basel capital framework. The implementation work on many reforms, however, has only just begun. Looking ahead, the Assessment Team also noted a few items for post-RCAP follow-up, or for when another RCAP assessment is undertaken, to ensure that they do not become material (Annex 12). This will help ensure that Mexico deploys its reformed capital framework effectively in supervising the Mexican banking system and maintaining financial stability. The team also identified a few items that would benefit from further clarification by the Basel Committee (Annex 13).

## Response from the Mexican authorities

The Mexican Financial Authorities (MFAs) largely agree with the assessment and would like to thank the Assessment Team and its leader Charles Littrell for their detailed and comprehensive evaluation of Mexican regulation implementing the capital and liquidity frameworks.

This evaluation allowed us to improve the consistency of our capital framework with international standards and to enhance the strength of the Mexican capital framework. At the same time, it will serve to appropriately address the particular characteristics of the environment in which Mexican banks operate and the risks they face.

The Mexican authorities take the opportunity to point out that, as one of the fundamental aspects of the Basel standards is to promote a level playing field, the Regulatory Consistency Assessment Programme should help to foster the alignment of regulations with those of the various members of the Basel Committee on Banking Supervision in order to prevent distortions due to the asymmetric treatment of similar risk exposures by home and host jurisdictions. This latter point is very relevant for jurisdictions, such as Mexico, that host subsidiaries of large international banks, especially when those subsidiaries rank among the largest banks in host countries.

An asymmetric treatment of similar risk exposures between home and host jurisdictions could affect the business models of subsidiaries of global banks and their capital allocation. In countries in which international banks have a material presence, the asymmetric application of the Basel standards will result in an unlevel playing field. One example in this regard is the capital requirements of sovereign exposures booked by subsidiaries (denominated and funded in the host currency). As subsidiaries have to consolidate their balance sheets with those of their parent banks, home country regulations and criteria for treating foreign sovereign exposures end up prevailing over host country regulations.

Moreover, consolidated supervision implicitly embodies the idea that the regulatory capital of the consolidating entity will absorb all losses originating from the consolidated institutions. However, this is not necessarily the case: the subsidiary model gives the parent bank the limited liability option. Therefore only the capital of the subsidiary would automatically absorb losses. A by-product of the RCAP assessment should be a greater reliance by home regulators on host regulation when it is compliant with BCBS standards, including risk weights, as a bottom-up approach.

Notwithstanding its compliance with the Basel framework, MFAs acknowledge there are certain practical constraints regarding the use of Pillar 2 adjustments and the increase of the countercyclical capital buffer. However, we do not foresee any impediment to imposing these if needed, as the Credit Institutions Law grants powers to the CNBV to impose capital requirements above the minimum as well as a conservation buffer for banking institutions. Nevertheless, MFAs will look for ways to reduce these constraints and ensure an effective use of these regulatory tools as part of their commitment to preserving financial stability in the Mexican financial system, as well as to maintaining a capital framework aligned to international standards.

Regarding the treatment of bank exposures to the Mexican sovereign that are denominated in foreign currencies, for which a lower risk weight is applied, MFAs will continue closely monitoring these exposures. Notwithstanding, MFAs would like to stress that the Mexican regulatory framework imposes strict limits on exposures in foreign currency with the aim of keeping these exposures under control.

# 1 Assessment context and main findings

## 1.1 Context

### Status of implementation

The National Banking and Securities Commission (Cómision Nacional Bancaria y de Valores; CNBV) is empowered by Mexican law to issue banking regulation, in close consultation with the Bank of Mexico (Banco de México; BdM).<sup>4</sup> CNBV has adopted the Basel risk-based capital standards through the General Provisions Applicable to Credit Institutions which were issued in 2007 and subsequently updated through various rounds of reforms (Annex 2). They are all in effect as on the date of the assessment.<sup>5</sup>

	Advanced approach approved by Mexican authorities	Application submitted and under review by Mexican authorities	Pre-application phase (bank is in process of developing models for approval)	Intention to start pre-application phase
Credit risk (IRB)	2 <sup>6</sup>	4	-	-
Market risk (IMA)	NA	NA	NA	NA
Operational risk (AMA)	NA	NA	NA	NA

Source: CNBV.

### *Regulatory system, model of supervision, and binding nature of prudential regulations*

In Mexico all credit institutions, including commercial banking institutions and state-owned institutions, are subject to the Basel III standards. Additionally, the Basel III regulations are applicable to multiple-purpose financial institutions (non-banks) which are considered regulated entities, eg due to maintaining equity ties with banking institutions. In evaluating the materiality of their findings, the RCAP Assessment Team focused on the five banks subject to this review (see below).

<sup>4</sup> CNBV is a decentralised agency of the Ministry of Finance and Public Credit, with technical autonomy and executive powers under the terms of its own law. Its duty is to supervise and to regulate Mexican banks, development banks, brokerage houses and mutual funds. BdM is the autonomous central bank of Mexico. According to Mexican law, CNBV must obtain the opinion of the central bank when issuing general provisions regarding capital requirements, as well as for the provisions that set forth the procedure for calculating capital ratios applicable to credit institutions.

<sup>5</sup> For the assessment, the Assessment Team relied on English translations provided by the Mexican authorities of the domestic regulations and regulatory documents. In a few specific instances, the team assessed the appropriateness of the English translation of the Mexican rules through comparison with the original text in Spanish. For those sections, the translation was generally found to be appropriate.

<sup>6</sup> At present, two Mexican banks have approval for partial use of IRB models for corporate and financial entities and credit card loans. For those banking organisations, approximately 6.6% and 3.4% of total assets are subject to IRB model-based requirements. This translates into 22% and 12% of total RWA that is based on the IRB approach for these banks.

The following chart provides an overview of the legal hierarchy of banking regulations in Mexico.

Hierarchy of banking regulations in Mexico		Table 2
Laws and regulation	National Banking and Securities Commission Law	
	Banking Institutions Law	
	National Banking and Securities Commission Internal Regulation	
	National Banking and Securities Commission Supervision Regulation	
	Financial Groups Law	
Internal regulation derived from the above laws and regulations	Instrument by which the CNBV's president delegates authority to various CNBV officers	
	Institutional Manual for Supervision	
	Ratings for financial entities based on their risks	
	On-site visit annual programme	
Official communications		
Regulation issued by the CNBV	Regulation applicable to banking institutions (General Provisions Applicable to Credit Institutions)	

The provisions containing the Basel standards are established by law and regulation, and are binding for all credit institutions (Annex 7). The rule-making process involves different rounds of internal and external consultation. Pursuant to Article 50 of the Banking Institutions Law, CNBV must obtain the opinion of BdM before issuing general provisions regarding capital requirements. After the opinion of BdM has been received, the draft rule is submitted for external consultation with parties that will be subject to its application. Depending on the scope of the proposed regulation, the opinion of other financial authorities may be requested as well. After this consultation, and pursuant to the Federal Law on Administrative Procedures, the CNBV must submit a proposed regulation with an impact analysis to the Federal Commission of Regulatory Improvement (COFEMER by its acronym in Spanish). After COFEMER has received a proposed rule and impact analysis from an executive agency such as the CNBV, COFEMER reviews both items and assesses whether additional information or modifications are necessary. This should occur at least 30 business days before the envisaged publication date of the rule. Once submitted to COFEMER, the draft is made available for public comment. COFEMER will then issue a final opinion, after which the rule is finalised and published in the official Gazette of the Federation of Mexico. The rule-making process typically takes at least four months. Additionally, after reviewing the comments on a proposed rule, COFEMER may conduct its own analysis. Based on its analysis and the comments, COFEMER may recommend that the issuing agency make changes to its proposed rule or impact analysis. Importantly, any such recommendations are not binding, and the CNBV may issue a final rule without accepting them. However, the CNBV takes any such recommendations seriously and generally makes the requested changes.<sup>7</sup>

<sup>7</sup> For example, CNBV explained that when it proposed to implement reforms to align the definition of regulatory capital with the Basel III capital framework, the CNBV initially proposed requiring banking organisations to immediately deduct from Common Equity Tier 1 capital the full amount of any DTAs that rely on the future profitability of a banking organisation upon

In rare cases, COFEMER may object to the issuance of a final rule. Although COFEMER's recommendation is not binding, in past cases where COFEMER has objected, the rule-making agency has withdrawn the proposed rule and worked to develop and issue a new one.

Regarding the regulatory compliance of banking institutions, CNBV can report "observations" and ultimately impose sanctions in case of non-compliance. Sanctions imposed on financial entities or persons for violations of the law are made publicly available on CNBV's website.

In addition to the Basel III Pillar 1 regulations, CNBV applies a Pillar 2 framework (see Annex 14). CNBV has the powers to set additional capital requirements for individual banking institutions. Such decisions would require consultation with BdM, and may depend on different considerations such as equity integration and assets composition; internal control system efficiency; fulfilment of the compensation system for employees (only for commercial banks); and exposure and risk management.

## 1.2 Structure of the banking sector

At the end of 2013, 46 banks were registered in Mexico, with total bank assets (including off-balance sheet equivalents) amounting to MXN 6.5 trillion (approximately USD 450 billion – see Annex 8 for an overview of selected key indicators of the Mexican banking sector). The financial system is dominated by the five largest internationally active commercial banks, which hold about 71% of total banking assets. There are no global systemically important banks (G-SIBs) in Mexico, but four of the five internationally active banks are subsidiaries of foreign G-SIBs. The Mexican authorities have not finalised yet the framework for identification of domestic systemically important banks (D-SIBs).

Under the new Basel III standards, the weighted average total capital ratio of the five largest banks stood at 15.2% in 2013. The Tier 1 ratio and the CET1 ratio were 12.6% and 12% respectively. Credit risk is the main type of risk for Mexican banks, and amounts to approximately two thirds of total risk-weighted assets, followed by market risk and operational risk. Market risk contributes considerably to total risk-weighted assets, with approximately 24%. Mexican regulations make no distinction between a trading book and banking book and require banks to calculate market risk charges for banking book business.

The Mexican authorities have been cautious in allowing banks to engage in complex financial activities. One example is correlation trading, which has not been permitted so far (see also Annex 11 for regulatory approaches not permitted by the Mexican authorities).

## 1.3 Scope of the assessment

### Scope

The RCAP Assessment Team has considered all documents that effectively implement the risk-based Basel capital framework in Mexico as of end-December 2014, the cut-off date for the assessment (Annex 4).

The assessment focused on two dimensions:

the effective date of the final rule. COFEMER recommended that the CNBV revise the rule so the deduction would be phased in over a longer period of time consistent with the Basel framework, and the CNBV revised the rule accordingly.

- A comparison of domestic regulations with the capital standards under the Basel framework to ascertain that all the required Basel provisions have been adopted (*completeness* of the Mexican domestic regulation); and
- Whether there are any differences in substance between the domestic regulations and the capital standards under the Basel framework and their significance (*consistency* of the Mexican regulation).

In carrying out the above, the RCAP Assessment Team considered all binding documents that implement the Basel framework in Mexico as discussed above. Any identified deviation was assessed for its materiality (current and potential) by using both quantitative and qualitative information. For potential materiality, in addition to the available data, the assessment used expert judgment on whether the domestic regulations met the Basel framework in letter and spirit (see further Section 1.4).

### Bank coverage

For the purposes of assessing the materiality of deviations, data were collected from the following five banks: BBVA Bancomer, Banamex, Santander, HSBC and Banorte. These banks are internationally or regionally active and are the largest banks in Mexico. They hold approximately 71% of total assets of the Mexican banking system (31 December 2013).<sup>8</sup>

### Assessment grading and methodology

As per the RCAP methodology approved by the Basel Committee, the outcome of the assessment was summarised using a four-grade scale, both at the level of each of the 15 key components of the Basel framework and overall assessment of compliance: compliant, largely compliant, materially non-compliant and non-compliant.<sup>9</sup>

The materiality of the deviations was assessed in terms of their current or, where applicable, potential future impact (or non-impact) on capital ratios of the banks. The quantification was, however, limited to the agreed population of internationally active banks. Wherever relevant and feasible, the Assessment Team, together with the Mexican authorities, attempted to quantify the impact based on data collected from the agreed sample of banks (see Annex 9). The non-quantifiable aspects of identified deviations were discussed and reviewed in the context of the Mexican authorities' prevailing regulatory practices and processes.

Ultimately, the assignment of the assessment grades was guided by the collective expert judgment of the Assessment Team. In doing so, the Assessment Team relied on the general principle that the burden of evidence rests with the assessed jurisdiction to show that a finding is not material or not potentially material. A summary of the materiality analysis is given in Section 2 and Annex 9.

In a number of areas, the Mexican rules go beyond the minimum Basel standards. Although these elements provide for a more rigorous implementation of the Basel framework in some aspects, they have not been independently verified by the Assessment Team or taken into account for the

<sup>8</sup> The Assessment Team is highly appreciative of the collaboration extended by the banks on data relevant for the RCAP assessment and in providing insights on implementation practices.

<sup>9</sup> This four-grade scale is consistent with the approach used for assessing countries' compliance with the Basel Committee's *Core principles for effective banking supervision*. The actual definition of the four grades has been adjusted to take into account the different nature of the two exercises. In addition, components of the Basel framework that are not relevant to an individual jurisdiction may be assessed as not applicable (N/A). For further details, see [www.bis.org/publ/bcbs264.htm](http://www.bis.org/publ/bcbs264.htm).

assessment of compliance under the RCAP methodology, as per the agreed assessment methodology (see Annex 10 for a listing of areas of super-equivalence).

## 1.4 Main findings

A summary of the main findings is given below.

Summary assessment grading		Table 3
Key components of the Basel capital framework	Grade	
Overall grade:	C	
Scope of application	C	
Transitional arrangements	C	
Pillar 1: Minimum capital requirements		
Definition of capital	C	
Credit risk: Standardised Approach	C	
Credit risk: Internal Ratings-Based Approach	C	
Securitisation framework	C	
Counterparty credit risk framework	C	
Market risk: Standardised Measurement Method	C	
Market risk: Internal Models Approach	NA	
Operational risk: Basic Indicator Approach and Standardised Approach	C	
Operational risk: Advanced Measurement Approaches	C	
Capital buffers (conservation and countercyclical)	LC	
Pillar 2: Supervisory review process		
Legal and regulatory framework for the Supervisory Review Process and for taking supervisory action	C	
Pillar 3: Market discipline		
Disclosure requirements	LC	

Compliance assessment scale (see Section 1.3 for more information on the definition of the grades): C (compliant), LC (largely compliant), MNC (materially non-compliant) and NC (non-compliant). One Basel component has been assessed as not applicable (NA) as it has not been implemented by the Mexican authorities.

### Main findings by component

#### *Scope of application*

As a general matter, the Basel III capital framework should apply on a fully consolidated basis to all internationally active banks at every tier within a banking group, and to any holding company that is the parent entity within a banking group, to ensure that the requirements capture the risk of the whole banking group. However, as an alternative to full subconsolidation, the Basel III capital framework does contemplate the application of capital requirements to internationally active banks on a standalone basis if doing so would achieve the same objective and provided that the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the banks' capital.



Consistent with the alternative approach to full subconsolidation, Mexico applies the Basel III capital framework on a standalone basis to all credit institutions (regardless of whether they are internationally active), including all commercial banking institutions and state-owned institutions. All investments in the capital of a financial entity subsidiary are fully deducted from Common Equity Tier 1 capital, and minority interests are not includable in the regulatory capital of the subsidiary's parent organisation.

Under Mexican law, regulatory capital requirements also apply to bank holding companies that are considered parents of banking organisations. Pursuant to Article 91 of the Law for Regulating Financial Groups, bank holding companies must maintain net capital in an amount no less than the result from adding the permanent investments into the subsidiaries of the financial group. Furthermore, bank holding companies are required to ensure that all entities in the financial group comply with their respective regulatory capital requirements.

Although the Mexican capital framework applies on a standalone basis, rather than a fully consolidated basis, Mexican rules ensure that the capital requirements applied to bank holding companies capture the risk of the whole banking group. The Mexican capital framework provides that the amount of any shortage of minimum regulatory capital required by the CNBV for a financial subsidiary must be deducted from the Common Equity Tier 1 capital of its parent organisation proportional to its share ownership of the financial subsidiary. Furthermore, all entities within a banking group are subject to prudential supervision and visitation either by the CNBV or another prudential regulatory authority; Mexican law and regulations place strict limits on intragroup transactions; and Mexican law ensures that the capital counted toward the satisfaction of minimum regulatory requirements of credit institutions and bank holding companies is not double levered. The CNBV and BdM explained that, under Mexican law, the regulatory capital of a credit institution may not be funded through borrowing by its parent holding company. Were this the case, a credit institution would be pressured to upstream capital to its holding company to allow the holding company to service the debt.

Data reviewed by the Assessment Team confirmed that the bank holding company parents of Mexican banking organisations have only insignificant amounts of liabilities. The Assessment Team reviewed the consolidated and unconsolidated balance sheets of the relevant Mexican bank holding companies, and confirmed that the regulatory treatment described above applies in practice.

The Assessment Team has therefore determined that the scope of application set out in the Mexican capital requirements is consistent with the Basel III capital framework.

### *Minimum requirements and transitional arrangements*

The minimum capital requirements set forth in the Mexican regulations are generally consistent with Basel III. The transition arrangements are generally more conservative because they move banking organisations toward full compliance more quickly than provided for in the Basel III capital framework. For example, Mexican regulations do not apply a phase-in period for regulatory deductions, except for DTAs, and have not adopted the step-wise increase in minimum regulatory capital ratios (see also further below). Mexican regulations also include higher transitional floors than the Basel standard.

### *Definition of capital*

The Mexican capital framework is fully aligned with the Basel III capital framework with regard to the definition of capital. All investments (direct and indirect) in the capital of financial companies and all intangible assets (including mortgage servicing assets) are deducted in full from Common Equity Tier 1 capital. Most deductions and adjustments are currently applicable and are not phased in, except for the deduction for deferred tax assets (DTAs) that do not arise from prior losses. Prior to the adoption of the Basel III capital framework, DTAs that rely on the future profitability of the banking organisation were required to be deducted to the extent that they exceeded 10% of the amount of the banking organisation's Common Equity Tier 1 capital, as adjusted for deductions. The Mexican framework

maintains the existing deduction and phases in the deduction for the remaining amount consistent with the Basel III capital framework.

Additionally, consistent with the standalone application of the Basel III capital framework, banking organisations must fully deduct investments in the capital of all financial subsidiaries from Common Equity Tier 1 capital, and minority interests in financial subsidiaries are not eligible to be included in the regulatory capital of the subsidiary's parent organisation. Further, the Mexican capital framework provides that any shortage of minimum regulatory capital required by the CNBV for a financial subsidiary must be deducted from the Common Equity Tier 1 capital of the parent organisation proportional to its share ownership of the financial subsidiary.

#### Point of non-viability

The Basel capital requirements provide that all additional Tier 1 and Tier 2 capital instruments issued must include a contractual principal loss absorption mechanism unless the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss. In addition, if a banking organisation issues an additional Tier 1 or Tier 2 instrument from a foreign subsidiary, and the banking organisation wishes for the instrument to be included in the regulatory capital of both the subsidiary and the consolidated banking group, the Basel capital requirements specify that the relevant authority in the consolidated banking group's jurisdiction must have the power to trigger the write-down or conversion of the instrument.<sup>10</sup> The Basel capital requirements also provide that any common stock paid as compensation to the holders of the instrument must be common stock of either the issuing bank or the holding company.

The Mexican capital framework is applied on a standalone basis, and regulatory capital instruments issued by financial subsidiaries are not counted in the regulatory capital of their parent organisations. The Mexican rules do not include any authority to trigger the write-down or conversion of additional Tier 1 or Tier 2 capital instruments issued by the foreign subsidiary of a Mexican banking group.

Additionally, the Mexican capital framework generally provides that non-Common Equity Tier 1 capital instruments may be included in a banking organisation's regulatory capital only if the instruments are convertible into common equity of the issuing bank that is listed with the Mexican National Registry of Securities, or, if the bank's common equity is not so listed, into common equity of the bank's holding company that is listed with the National Registry of Securities. Four of the five banks subject to RCAP review are unable to meet this condition, as they are wholly owned subsidiaries of foreign banking groups.

If neither the bank's, nor its holding company's common equity is listed with the National Registry of Securities, the total amount of additional Tier 1 and Tier 2 capital instruments includable in the bank's regulatory capital is limited to 400 million UDIs (approximately USD 140 million).<sup>11</sup>

<sup>10</sup> See FAQ no 4 on the PON press release, [www.bis.org/publ/bcbs211.pdf](http://www.bis.org/publ/bcbs211.pdf)

<sup>11</sup> Mexico's Investment Units (UDIs) are units based on price increases and are used to settle mortgage obligations or commercial acts. They are designed to retain purchasing power and not be subject to inflation. They were created in 1995 to protect banks and focused mainly on mortgage loans. BdM publishes the value in pesos of the UDI in the Official Federal Gazette.

Therefore, above the 400 million UDI limit, an issuing bank or its holding company will need to be listed with the National Registry of Securities in order for the bank to raise regulatory capital through the issuance of additional Tier 1 or Tier 2 capital instruments. During meetings with the Assessment Team, representatives of Mexico's banking industry asserted that this listing requirement may create an unlevel playing field between publicly listed and unlisted Mexican banks.

The Assessment Team considered this additional requirement in the Mexican rules and determined that, whatever the competitive effect, it is compliant with the Basel III capital framework.

### *Capital buffers (conservation and countercyclical)*

#### Capital conservation buffer

The Basel III capital framework phases in minimum capital requirements, ultimately requiring banking organisations to maintain a Common Equity Tier 1 capital to risk-weighted assets ratio of at least 4.5%; a Tier 1 capital to risk-weighted assets ratio of at least 6%; and a total capital to risk-weighted assets requirement of at least 8% by 2019. On top of the minimum requirements, the Basel III capital framework includes a capital conservation buffer, which also is phased in by 2019, ultimately requiring banking organisations to maintain an additional 2.5% of Common Equity Tier 1 capital to avoid constraints on capital distributions and discretionary bonus payments.

Under currently effective rules, Mexico requires banking organisations to maintain minimum capital requirements equivalent of a Common Equity Tier 1 capital to risk-weighted assets ratio of at least 7%, a Tier 1 capital to risk-weighted assets of at least 8.5%, and a total capital to risk-weighted assets ratio of at least 10.5%. Thus, the Mexican rule incorporates the capital conservation buffer into the overall minimum requirements. Furthermore, when one of a banking organisation's regulatory capital ratios drops below the regulatory minimum, the Mexican regulations provide for graduated restrictions on the banking organisations' ability to pay dividends and make certain bonus payments in a manner consistent with the Basel capital framework. Mexico thus has not phased in its minimum capital requirements, and it has introduced a more conservative alternative to the capital conservation buffer required under the Basel framework.

#### Countercyclical capital buffer

Mexico has implemented countercyclical capital buffer requirements. The national countercyclical buffer or the bank-specific countercyclical buffer requirements adopted in the Mexican regulations differ from the strict application of the Basel framework (see below).<sup>12</sup> As a result, the Mexican capital framework is assessed as largely compliant.

#### National countercyclical buffer requirements

The Basel III national countercyclical buffer requirement provides for a temporary increase in the capital conservation buffer – up to an additional 2.5% – to take into account the macrofinancial environment.

The Basel III capital framework provides that a national jurisdiction shall have the ability to deploy a national countercyclical buffer based on its observations of credit growth and other indicators

<sup>12</sup> In terms of the agreed international timeline the buffers are to be in place and functioning in 2016. The RCAP teams therefore assess this requirement where member jurisdictions have already issued regulations. The Committee is meanwhile developing more detailed guidance on countercyclical buffers.

that may signal a build-up of system-wide risk. Once a national jurisdiction determines that deployment of a national countercyclical buffer is necessary, the Basel III capital framework provides that any increases in the countercyclical buffer then need to be preannounced by up to 12 months to give banking organisations time to meet the additional capital requirements before they take effect, while reductions in the buffer would take effect immediately. At the expiration of the 12-month period, the capital conservation buffer shall be increased by the amount provided for by the national jurisdiction in the announcement.

The Mexican arrangement is that, with the concurrence of BdM, the CNBV holds a general authority to require credit institutions to hold capital above the minimum requirements when appropriate. In exercising this authority, the CNBV may take into account several factors, such as the need to have a capital margin to operate above the minimum, the economic cycle and the systemic risks that each institution, due to its characteristics or the characteristics of its transactions, might pose to the stability of the financial system or of the economy as a whole.

No Mexican rule currently references the specific increases to the conservation buffer contemplated in the Basel III capital framework (0 to 2.5%), nor do existing Mexican regulations provide for the basic procedure for deployment of the countercyclical buffer set forth in Basel III capital framework (ie a determination of the relevant authority followed only by the publication of an announcement and a 12-month ramp-up period after which the buffer takes effect).

Under existing Mexican law, even if the CNBV, with the concurrence of BdM, determines that economic conditions warrant the deployment of the countercyclical buffer, the CNBV may not publish a binding announcement increasing the capital conservation buffer for internationally active banking organisations before first proposing and then finalising a regulation deploying the buffer. Thus, the decision to deploy a national countercyclical buffer would have to be vetted through an administrative rule-making process.

Because the countercyclical capital buffer requirement was designed to be deployed during a time of high credit growth, the Assessment Team noted that a proposal to implement the buffer likely would draw strong objections from regulated entities, and other interested parties such as real estate developers and brokers, home builders, farmers, and others reliant upon the supply of credit.

The Assessment Team met with the COFEMER to better understand the relevant practices and administrative arrangements. The COFEMER regards the CNBV as among the most important Mexican agencies engaged with the administrative rule-making process. In fact, COFEMER has never rejected a CNBV proposal, although it has from time to time has suggested amendments. It is possible for CNBV to proceed despite any COFEMER suggestions or objections, and in fact CNBV has done so on some aspects of Basel III implementation. It was also clarified that COFEMER is not a political agency, and focuses on the technical elements of a proposed rule and whether the potential benefits of the proposal outweigh any potential costs. Finally, and as it relates to capital buffers, the COFEMER is highly likely to place considerable credence upon the joint opinion of the CNBV and BdM as and when a countercyclical capital adjustment becomes necessary.

The Basel III capital framework contemplates the implementation of the national countercyclical buffer when the “relevant national authority judges a period of excess credit growth to be leading to the build-up of system-wide risk” (Basel III paragraph 139). The relevant national authority need not be the supervisor: it could be the supervisor, the central bank, both acting in conjunction, or a financial stability committee formed by a national jurisdiction. In this sense, the combination of CNBV, BdM, and COFEMER described above could be interpreted as a Basel-compliant relevant national authority.

The Assessment Team has not accepted this interpretation. Because the CNBV may be slowed or impeded from deploying a national countercyclical buffer in times of excessive credit growth, the Assessment Team has determined that this deviation is potentially material. Leaving aside the fine details of the process, the requirement to invite public consultation together with the need to seek the review

and ultimate sign-off by COFEMER, seems to the Assessment Team to raise a substantial practical hurdle to countercyclical intervention.

On the other hand, it is clear that the CNBV and BdM working together could as a matter of law impose a countercyclical capital increase, provided that both were determined to do so. There is also the consideration that, unlike the capital conservation buffer, the countercyclical arrangements are meant to be used infrequently.

#### Bank-specific countercyclical buffer

The Basel III capital framework also includes a bank-specific countercyclical buffer requirement that requires each internationally active bank to look at the geographic location of its private sector credit exposures and calculate a countercyclical capital buffer requirement as a weighted average of the capital requirements that are being applied in jurisdictions to which it has credit exposures.

The Mexican rules do not provide for such increased capital requirements for foreign exposures in geographic locations where the relevant local authority has activated the countercyclical capital buffer. This is clearly at variance with the Basel framework. The Assessment Team was able to confirm, however, that Mexican banking organisations hold relatively small and declining amounts of credit exposures in foreign jurisdictions. The level of external claims of Mexican banks as percentage of total assets declined from approximately 6% in 2008 to less than 3% in 2013. This variance is immaterial.

#### *Credit risk: Standardised Approach*

Generally, CNBV's regulatory requirements for the credit risk Standardised Approach are compliant with the Basel Standards. The domestic regulations prescribe risk weights for retail exposures, residential mortgage exposures and commercial real estate that are generally more conservative than the Basel standards.

The Assessment Team noted that CNBV allows the application of lower risk weights to bank exposures to their sovereign or central banks that are denominated in domestic currency as well as foreign currencies, whereas the Basel framework only allows for the application of the lower risk weights to exposures denominated in domestic currency. This approach in Mexico has historical origins in the foreign exchange reserve management strategy of the Ministry of Finance. To mitigate the risks, BdM imposes a foreign currency net open position limit to banks of 15% of core capital as well as a regulatory limit of 1.83 times core capital on the size of a bank's foreign currency liabilities. From a materiality point of view, the Assessment Team found that the impact of concessional risk weights for non-peso sovereign exposures is not material, either on an individual or a collective basis. The weighted average capital ratio impact across Mexican banks in the sample is 2 basis points, while the impact for the most affected Mexican bank is about 4 basis points. Its potential materiality is further limited by close FX monitoring by CNBV and BdM. The team suggests, however, that the materiality of this issue is followed up under a future RCAP assessment (Annex 12).

#### *Credit risk: Internal Ratings-Based Approach*

CNBV's Prudential Standards are assessed as compliant with the Basel Framework for measuring and capitalising credit risk under the IRB. Currently, Mexican banking organisations are permitted to adopt IRB models only for some portfolios on a permanent basis. Only two of the 45 banking organisations (representing two of the five banks in the RCAP assessment process) have been authorised to use IRB models to calculate capital requirements, in those two cases for credit card exposures and for exposures to corporate entities. For those banking organisations, 6.6% and 3.4% of total assets are subject to IRB model-based requirements. The CNBV stated that it expects both banking organisations to apply IRB model-based requirements to all of their material credit exposures within the next two years.

The Assessment Team found a number of differences in the Mexican regulations, particularly as related to asset class definitions. These are not considered material due to the limited use of IRB

approaches by banks generally as well as across asset classes within banks, combined with the generally more conservative treatment where IRB usage for an asset class is not available. In the Mexican IRB regulation, there is no specialised lending asset class, nor is a treatment for purchased receivables identified. Purchased receivables are treated under the class applicable to the receivables. Currently there are no approvals for use of IRB for specialised lending classes. Therefore the standardised credit approach would be applicable. It is unclear how specific Basel operational requirements would be met in developing models, in particular for purchased receivables. As the use of IRB models expands, these issues will benefit from follow-up in future assessments.

Equity positions are not defined as an IRB exposure class. Mexican regulations do not permit such exposures to be treated under the Basel framework IRB or market-based approach. They will instead remain risk-weighted under the standardised credit approach. Equity investments in financial entities must be deducted from capital while non-financial/commercial equity positions are risk-weighted at 1250%. This is equivalent to or more conservative than required under the Basel framework for IRB.

Other Mexican IRB exposure class definitions do not necessarily follow the definitions in the Basel framework. Asset classes are grouped based on the applicable standardised credit risk weights. For example, corporates and foreign banks and insurance companies are grouped together while domestic banks, insurance companies and other financial subsidiaries of Mexican banks are in another group. In addition, Basel guidance requires that retail exposures be divided into three subclasses: qualifying revolving retail, residential mortgages and other retail exposures. CNBV has identified residential mortgages as an asset class separate from other retail, but qualifying revolving retail is not specifically identified. However there is recognition of the asset value correlation factor for credit cards only, not the broader revolving retail category.

The definition of residential mortgages used under the IRB credit approach is the same as used under the Standardised Approach for credit risk and extends to construction loans for residential purposes, which is outside the Basel definition. Currently, no banks are using IRB credit models for residential mortgages, and as the standardised risk weights for such mortgages are more stringent than required under Basel, the impact would be more onerous for capital requirements. In addition, the Basel definition of residential mortgages has been noted as requiring additional clarity in other RCAP reviews.

The impact of the variations in asset class definition is unlikely to be material. The LGD, PD, and EAD factors associated with specific IRB credit models should reflect these differences. As IRB credit model usage expands, there may be a lack of consistency in asset class definition or operational requirements for the risk parameters included in the Basel standards. The team therefore suggests keeping this issue under review in a future RCAP assessment (see Annex 12).

### *Credit risk: Securitisation framework*

CNBV's Prudential Standards are compliant with the Basel framework for measuring the credit risk of securitisation exposures, despite the requirement that only Standardised Approaches can be used for risk-weighting securitisation exposures. The Basel framework expects that banks applying IRB models to specific asset classes will also use IRB approaches for determining risk-weighted asset amounts on the securitisation exposures of those same asset classes. The restriction to the use of the Standardised Approach only is more conservative in general than the Basel framework. The definition of re-securitisation exposures broadly complies with the Basel framework, but is lacking the detailed supporting description from the 2009 Basel enhancements that is intended to clarify the application of the definition. Given the low level of securitisation activity in Mexico presently, the lack of precision in the definition of re-securitisation exposures will not have a material impact on Mexican banks. Further, there is no specific reference in Mexican regulation that swaps and reserve accounts are securitisation exposures. While CNBV considers that swaps and reserve accounts of a securitisation structure are such exposures, the risk of incorrect capital treatment is possible due to lack of explicit wording. The team therefore suggests keeping this issue under review in a future RCAP assessment (see Annex 12).

### *Counterparty credit risk framework*

Mexican requirements for counterparty credit risk are broadly aligned with those of the Basel framework and the Assessment Team considers that the regulatory implementation is compliant. It may be noted that the Mexican authorities have not implemented the sophisticated Basel approaches for counterparty credit risk, including the Internal Models Method (IMM) and the advanced CVA charge. These components have therefore not been assessed. The Mexican authorities issued the final capital standards for exposures to central counterparties in December 2014.

### *Market risk: Standardised Measurement Method*

CNBV's current Prudential Standards are assessed as compliant with the Basel Framework for measuring and capitalising market risk under the standardised measurement method. A notable aspect of the Mexican market risk regulations is the absence of a distinction between a trading book and a banking book. All positions on the balance sheet are subject to a market risk capital charge and a credit risk capital charge, thus making the Mexican approach more conservative than Basel minimum requirements. The Mexican authorities have not adopted the Basel requirements for correlation trading as banks are not permitted to invest in such instruments. A few deviations have been identified that pertain to the computation of foreign exchange exposures in a single-currency, specific-risk capital charge for non-domestic currency-denominated sovereign debt, and specific risk for underlying credit derivatives. Collectively these items are considered immaterial at the moment and for the next several years, but they should be re-assessed in any future RCAPs.

### *Market risk: Internal Models Approach*

CNBV's Prudential Standards do not allow the Internal Models Approach (IMA) for computing the capital charge for market risk capital requirements. No such introduction is foreseen by CNBV. For purposes of the RCAP assessment, the component is considered "not applicable".

### *Operational risk: Basic Indicator Approach, Standardised Approach, and Advanced Measurement Approaches*

Overall, the Assessment Team finds the Mexican regulations to be compliant with the Basel operational risk standards. The recent reforms introduce the Advanced Measurement Approach (AMA), and include several changes that bring the BIA and SA into line with the Basel standards.

The team noted that the Mexican authorities have not adopted the possibility of using an allocation mechanism for the purpose of determining the AMA capital requirement for subsidiaries that are not deemed to be significant relative to the overall banking group but are themselves subject to the Basel standards (Basel para 656). Mexican regulators indicated they would not allow this possibility, as they are not comfortable allowing banks that are subsidiaries of large international banking groups to calculate their capital requirements based on a calculation made at the home or group level. For purposes of the assessment, the team considered this treatment to be conservative and therefore not a deviation.

In its review, the team also noted that the Mexican regulations are more conservative than required by the Basel standards. Examples include the requirements for operational risk databases and qualitative requirements for operational risk management (Annex 10).

### *Supervisory review process*

The RCAP assessment of the supervisory review process covered the adoption of prescribed standards under Pillar 2 of the Basel II framework and the Supplementary Pillar II Guideline.

Generally, the domestic regulations have adequately addressed the requirements under the four Principles of Pillar 2 covered under the RCAP.<sup>13</sup> The power to conduct supervisory review is provided under the Supervisory Regulation of the National Banking and Securities Commission and regulatory expectations are reflected in the domestic legislation. The Financial Reform Credit Institutions Law provides CNBV the power to require banks to maintain supplementary capital above the minimum capital requirement.

In the exercise of supervisory powers to require banks to provide additional capital above the regulatory minimum, the domestic regulations are compliant with Principle 3 requirements under Pillar 2. Banks must maintain supplementary capital above the minimum amount required as well as provide adequate powers for CNBV to require banks to hold regulatory capital in excess of the minimum requirement.

The law further states that these powers can be exercised on the consideration of diverse factors such as the economic cycle and the systemic risks that a bank might pose to the stability of the financial system or of the economy as a whole. While CNBV has discretion to exercise the power, the law requires CNBV to seek the opinion of BdM before a formal requirement for additional capital is imposed on a bank. However, given the impact of additional capital requirements under Pillar 2 is specific on the identified bank rather than banking industry wide as in the case of countercyclical capital buffer, the process of requiring capital under Pillar 2 also differs from the latter as it does not require a public consultation as well as consultation with COFEMER to be conducted.

Notwithstanding the adequacy of the powers provided under the law, the review team wishes to highlight that CNBV has never exercised its formal powers. The assessment team review of past cases reveals that CNBV had deployed supervisory suasion to achieve capital increases in some smaller banks. In this regard, CNBV has asserted, and the Assessment Team has no reason to disbelieve, that the large banks have for many years been adequately capitalised, and that there has been no need for any Pillar 2 adjustments to this population (see also Annex 14 Mexico's implementation of the Pillar 2 supervisory review process).

### *Disclosure requirements*

The Mexican authorities apply the Basel capital standards on a standalone basis to banks and not on a consolidated banking group-wide basis (see also above under "Scope of application"). Correspondingly, Pillar 3 disclosure requirements are implemented on a standalone bank basis only and some of the Basel disclosure requirements, eg regarding bank structure, consolidation approaches and insurance subsidiaries, have not been implemented. Also, disclosure requirements related to the approach being

<sup>13</sup> The four key principles of supervisory review are (1) Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels; (2) Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process; (3) Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum; (4) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.



followed for the operational risk charge, as well as the description of AMA and use of insurance for operational risk have not been implemented. The impact of these omissions is collectively considered as potentially material. Overall, the team assesses CNBV's Pillar 3 regulations as largely compliant with the Basel standard.

## 2 Detailed assessment findings

The component-by-component details of the assessment of compliance with the risk-based capital standards of the Basel framework are set out below. The focus of Sections 2.1 to 2.5 is on findings that were assessed as deviating from the Basel minimum standards and their materiality. This section is based on the assessment of the rules as at 31 December 2014 including the published amendments.

### 2.1 Scope of application

Section grade	Compliant
Summary	<p>As a general matter, the Basel III capital framework should apply on a fully consolidated basis to all internationally active banks at every tier within a banking group, and to any holding company that is the parent entity within a banking group, to ensure that the requirements capture the risk of the whole banking group. However, as an alternative to full subconsolidation, the Basel III capital framework does contemplate the application of capital requirements to internationally active banks on a standalone basis if doing so would achieve the same objective, and provided that the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the banks' capital.</p> <p>Consistent with the alternative approach to full subconsolidation, Mexico applies the Basel III capital framework on a standalone basis to all credit institutions (regardless of whether they are internationally active), including all commercial banking institutions and state-owned institutions.</p> <p>Because the Mexican framework appropriately captures the risk of the whole banking organisation, and because the Basel standards do not set clear criteria as to how to assess the appropriateness of the scope of application of prudential regulations, the Assessment Team has determined that any deviation in this regard with the Mexican framework is not material.</p>
Basel paragraph no	Basel II paragraphs 20–23, 24–27
Reference in domestic regulation	Credit Institutions Law, Article 2, paragraph 1 and Article 89, paragraph 3; Financial Reform Credit Institutions Law, Article 50 paragraphs 1 and 3; General Provisions Applicable to Credit Institutions, Article 2 Bis and Article 2 Bis 6, fraction I item f), paragraph 1; Article 91, Law for Regulating Financial Groups
Findings	The Mexican regulatory capital framework applies on a standalone basis, but not a fully consolidated basis to credit institutions and to the parent holding companies of Mexican banking organisations.
Materiality	<p>Not material.</p> <p>The Mexican rules provide that the amount of any shortage of minimum regulatory capital required by the CNBV for a financial subsidiary must be deducted from the Common Equity Tier 1 capital of the parent organisation proportional to its share ownership of the financial subsidiary. Furthermore, the Assessment Team notes that the CNBV is authorised to supervise and visit all entities within a banking group; that Mexican law and regulations place strict limits on intragroup transactions; and that Mexican law ensures that the capital counted toward the satisfaction of minimum regulatory requirements of credit institutions and bank holding companies is not double levered. Under Mexican law, the regulatory capital of a credit institution may not be funded through borrowing by its parent holding company. Were this the case, a credit institution would be pressured to upstream capital to its holding company to allow the holding company to service the debt. Data reviewed by the Assessment Team confirmed that the bank holding company parents of Mexican banking organisations have insignificant liabilities. The aggregate value of the liabilities of Mexican bank holding companies is MXN 0.416 billion compared with a total value of equity of MXN 5,283 billion.</p> <p>Because the Mexican capital framework ensures that the capital requirements applied to bank holding companies capture the risk of the whole banking group, and because</p>

	the Basel standards do not set clear criteria as to how to assess the appropriateness of the scope of application of prudential regulations, the Assessment Team has determined that any deviation in this regard in the Mexican framework is not material.
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## 2.2 Transitional arrangements

Section grade	Compliant
Summary	The calculation of minimum capital requirements set forth in the Mexican regulations is consistent with the Basel III capital framework, and the transition arrangements are generally more conservative. For example, Mexican regulations do not apply a phase-in period for regulatory deductions, with the exception of DTAs.

## 2.3 Pillar 1: Minimum capital requirements

### 2.3.1 Definition of capital

Section grade	Compliant
Summary	The Mexican risk-based capital framework meets and goes beyond the minimum requirements under the Basel III capital framework. All investments (direct and indirect) in the capital of financial companies and all intangible assets (including mortgage servicing assets) are fully deducted from Common Equity Tier 1 capital. Most deductions and adjustments are not phased in, except for a portion of the amount of deferred tax assets that do not arise from prior losses, which is phased in consistent with the Basel III capital framework. Additionally, consistent with the standalone application of the Basel III capital framework, investments in the capital of financial entity subsidiaries, as well as any regulatory capital shortfalls at such subsidiaries, are fully deducted from Common Equity Tier 1 capital, and minority interests in such entities are not included in regulatory capital.
Basel paragraph no	Minimum requirements to ensure loss absorbency at the point of non-viability (PON) – paragraphs 6–7
Reference in domestic regulation	Annex 1-R, fraction VI, item a), numeral 3 and item b) numeral 3 and fraction XI; Annex 1-S, fraction V, item a), numeral 2 and item b), numeral 2 and fraction IX
Findings	Because the Mexican capital framework is applied on a standalone basis, and regulatory capital instruments issued by financial subsidiaries are not counted in the regulatory capital of their parent organisations, the Mexican rules do not include the authority to trigger the write-down or conversion of an additional Tier 1 or Tier 2 capital instrument issued by a foreign subsidiary of a Mexican banking group.  The Mexican capital framework also provides that non-Common Equity Tier 1 capital instruments may be included in a banking organisation's regulatory capital only if the instruments are convertible into common equity of the issuing bank that is listed with the National Registry of Securities, or, if the bank's common equity is not so listed, into the common equity of the bank's holding company that is listed with the National Registry of Securities. Although this additional requirement may limit the ability of certain Mexican banks to raise regulatory capital through the issuance of additional Tier 1 or Tier 2 capital instruments, the Assessment Team determined that this aspect of the Mexican requirements is more conservative than, and thus compliant with, the Basel III capital framework.
Materiality	Not material

### 2.3.2 Capital buffers (conservation and countercyclical)

Section grade	Largely compliant
Summary	Mexican regulations incorporate the capital conservation buffer into the overall minimum requirements and, consistent with the Basel III capital framework, provide for restrictions in a banking organisation's ability to pay dividends and make

	<p>discretionary bonus payments.</p> <p>However, although the CNBV may publish a regulation that would require credit institutions to hold capital above the minimum requirements when appropriate to address systemic concerns, such as excessive credit growth, Mexico has not incorporated either the national countercyclical capital buffer or the bank-specific countercyclical buffer into its regulations.</p>
Basel paragraph no	Basel III paragraphs 122–132
Reference in domestic regulation	Financial Reform Credit Institutions Law, Article 50; General Provisions Applicable to Credit Institutions, Article 2 Bis 9; General Provisions Applicable to Credit Institutions, Articles 220 to 225 Bis
Findings	<p>The Mexican capital framework requires banks to maintain the equivalent of a Common Equity Tier 1 capital to risk-weighted assets ratio of at least 7%; a Tier 1 capital to risk-weighted assets of at least 8.5%, and a total capital to risk-weighted assets ratio of at least 10.5%. Thus, the Mexican rule incorporates the capital conservation buffer into the overall minimum risk-based requirements, rather than as a buffer on top of the minimum requirements.</p> <p>The Mexican capital framework provides for a number of mandatory corrective actions, including restrictions against making capital distributions and paying certain “extraordinary compensations” in the General Provisions Applicable to Credit Institutions, Articles 220 to 225 Bis. These restrictions are established at capital levels consistent with the capital conservation buffer set forth in the Basel III capital framework.</p>
Materiality	Not material
Basel paragraph no	Basel III paragraphs 136–141
Reference in domestic regulation	Financial Reform Credit Institutions Law, Article 50, paragraph 6
Findings	<p>Mexico has not incorporated the national countercyclical capital buffer into its regulations. With the concurrence of BdM, the CNBV is empowered by statute with the authority to prescribe a regulation that would require credit institutions to hold capital above the minimum requirements when appropriate for systemic reasons, such as excessive credit growth.</p> <p>However, under existing Mexican law, the CNBV may not publish a binding announcement increasing the capital conservation buffer for internationally active banking organisations without first proposing and then finalising a regulation. Thus, the decision to deploy a national countercyclical buffer would have to be vetted through an administrative rule-making process.</p>
Materiality	<p>Potentially material.</p> <p>As described to the Assessment Team by senior representatives from the CNBV, BdM, and COFEMER, the procedures in place in Mexico for deploying a national countercyclical buffer deviate from the procedures set forth in the Basel capital framework. They incorporate levels of executive review and public comment that may impede or discourage the deployment of the buffer requirement.</p> <p>Therefore, because the CNBV may be slowed or impeded from deploying a national countercyclical buffer in times of excessive credit growth, the Assessment Team has determined that this deviation is potentially material.</p>
Basel paragraph no	Basel III paragraphs 142–145
Reference in domestic regulation	N/A
Findings	The Mexican rules do not provide for increased capital requirements for foreign exposures in geographic locations where the relevant local authority has activated the countercyclical capital buffer. The Assessment Team confirmed that Mexican banking organisations hold relatively small amounts of credit exposures in foreign jurisdictions.
Materiality	<p>Not material.</p> <p>The amount of foreign credit exposures held by Mexican banking organisations is relatively small. According to the BIS locational statistics, the total amount of foreign</p>

	<p>claims of banking organisations reporting in Mexico is below 3% of total assets. Because the countercyclical capital buffer likely will be deployed at different times in different jurisdictions, this amount is a loose upper bound for credit exposures located in jurisdictions that have deployed a countercyclical buffer. Using the BIS consolidated statistics, the largest foreign exposure amount in a single jurisdiction (the United States), as of June 2014, was 0.54% of total assets.</p> <p>The data further show that the amount of foreign credit exposures has been declining in recent years, and CNBV staff informed the Assessment Team that foreign credit exposures are very unlikely ever to become a significant portion of any particular Mexican banking organisation's credit exposures.</p> <p>For these reasons, the Assessment Team has determined that this deviation is not material.</p>
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### 2.3.3 Credit risk: Standardised Approach

Section grade	Compliant
Summary	Generally, CNBV's regulatory requirements for the credit risk Standardised Approach are found to be consistent with the Basel Standards. The Assessment Team finds that the main issue identified does not result in a material impact on the capital adequacy ratios of the banks in the RCAP sample.
Basel paragraph no	Basel II paragraphs 53–56
Reference in domestic regulation	General Provisions Applicable to Credit Institutions Article 2 Bis 11, Article 2 Bis 12 and Article 2 Bis 13 Annex 1-B
Findings	CNBV allows the application of lower risk weights to bank exposures to the sovereign or central bank that are denominated in domestic currency as well as foreign currencies. Basel Standards only allow for the application of the lower risk weights to be applied to exposures denominated in domestic currency.
Materiality	Not material. The quantitative assessment shows that the impact is not material to the total capital ratios of the sampled banks. The weighted average impact across the RCAP sample of banks is 2 basis points. The impact for the most affected bank is 4 basis points. The issue has been listed for a follow-up assessment (see Annex 12).

### 2.3.4 Credit risk: Internal Ratings-Based Approach

Section grade	Compliant
Summary	The Mexican regulatory capital rules permit banks to apply the IRB approach to credit risk, and standards are compliant with Basel requirements. Only two of 45 banking organisations (two of the five banks assessed for RCAP purposes) are authorised to use IRB models to calculate capital requirements for credit risk. Credit card and corporate exposures are the portfolios approved for IRB use. A number of minor deviations or omissions were noted during the review. None are considered to materially impact the capital ratios of the banks in the RCAP assessment.
Basel paragraph no	Basel II paragraphs 231–234
Reference in domestic regulation	General Provisions Applicable to Credit Institutions Article 2, Bis 69, IV, b), which references Article 2, Bis 17
Findings	Under the noted Basel II paragraphs, IRB asset class definition requires that retail exposures be divided into three subclasses: qualifying revolving retail, residential mortgages and other retail. This differentiation is recognised in the capital calculation provisions Article 2, Bis 83 and 85, where different asset value correlation factors for the three subclasses are recognised. In addition, para 231, residential mortgage exposures are eligible for IRB retail treatment as long as the credit is extended to an individual that is an owner-occupier of the property. Mexican regulations define residential mortgage loans as "direct credits ... granted to individuals for residential property acquisition, construction,

	remodelling or improvement, without the purpose of commercial speculation... ". The CNBV regulations state that the purpose of the loan cannot be for commercial speculation. This implies that mortgages considered under this group are to be occupied by the owner or be rental units. However, because the rule does not explicitly require that the property be owner-occupied, and because the rule allows for construction loans to be considered in this category, it does not appear that the definition in the Mexican regulation is consistent with the Basel framework.
Materiality	Not material. In any event, the BCBS is examining the inconsistencies in the definition of retail residential mortgages between the standardised and IRB credit approaches (see also Annex 13).
Basel paragraph no	Basel II paragraph 358
Reference in domestic regulation	NA
Findings	Mexican regulation does not include IRB models for equity positions. The CNBV stated that it does not contemplate permanent application of the standardised approach for equity positions. However, according to the CNBV, there is no a plan at this time to develop the IRB framework for equity exposures.
Materiality	Not material at present According to the CNBV, for both banks with authorised IRB models at present, the threshold set forth in Basel II para 358 applies because their equity holdings represent less than 10% of Tier 1 plus Tier 2 capital. However, six other banks in Mexico would exceed the threshold in Basel paragraph 358 and thus be required to use IRB models for equity exposures if these banks were to receive approval for using the IRB approach. The team has listed the matter for a future follow-up assessment. The team also notes that, under current Mexican regulations, equity positions in financial entities must be deducted from capital while non-financial/commercial equity positions are risk-weighted at 1250%. This is equivalent or more conservative than required under the Basel framework for IRB.

### 2.3.5 Securitisation framework

Section grade	Compliant
Summary	The Mexican regulations generally conform to Basel framework expectations and, in fact, are more stringent in a number of applications. Of note, CNBV currently does not permit IRB treatment for securitisation exposures, which would generally be considered more conservative. Basel provisions that have not been completely incorporated in Mexico include a more detailed description of re-securitisations and how they should be determined for particular types of exposures and clear inclusion of swaps and reserve accounts as securitisation exposures.
Basel paragraph no	Basel II paragraphs 538–542
Reference in domestic regulation	General Provisions Applicable to Credit Institutions, Article 2, Bis 50-53 and Bis 55
Findings	The Basel framework, as modified in July 2009, specifically defines re-securitisations and provides a description of how the definition is applicable to ABCP conduits. In addition, the definition of senior re-securitisation exposures was added. While Mexican regulations include a definition of re-securitisation as "securitisation of securitisations", there is no additional explanation to clarify the application to specific types of exposures. This omission may lead to certain types of exposures not being risk-weighted at the higher risk weights applicable to re-securitisations. Similarly, Basel para 541 defines securitisation exposures as including swaps, reserve accounts and the like. These specific exposure types are not included in Mexican regulations. While CNBV considers the definition of securitisation exposures broad enough to capture these types, it is not clear that industry would treat swaps and reserve accounts as securitisation exposures.
Materiality	Not material.

Basel paragraph no	Basel II paragraph 560–564
Reference in domestic regulation	General Provisions Applicable to Credit Institutions, Article 2, Bis 6(k) and Article 2 Bis 7(III) reference the treatment of the difference of EL and provisions in regulatory capital.
Findings	Paragraph 563 of Basel prohibits the inclusion of EL and specific provisions held for securitisation exposures in determining the amount of provisions that can be counted in Tier 2 capital. Article 2 Bis 92 of the General Provisions for Credit Institutions outlines how provisions and EL are calculated and references those amounts for transactions subject to credit risk, which includes securitisation positions (all of Chapter III of this legislation determines credit risk). As a result, Mexican regulations do not explicitly exclude EL or specific provisions on securitisation exposures from the deduction from, or inclusion in, either CET1 or Tier 2 capital, respectively.
Materiality	Not material. The limited size of the securitisation market and exposures in Mexico, combined with the fact that Mexico only permits 0.6% of any excess to be included in Tier 2 capital, renders this deviation not material.
Basel paragraph no	Basel securitisation framework
Reference in domestic regulation	General Provisions Applicable to Credit Institutions Article 2 Bis 57
Findings	Mexican rules contain a specific treatment for infrastructure projects that provides for exposures to securitisations of infrastructure assets. If the risk-weighted asset requirement for the subordinated tranche exceeds the risk-weighted assets for all of the underlying assets, then the senior position is risk-weighted at 0%. CNBV has removed the special treatment mentioned above for commercial banks and only allows it for development banks, none of which are internationally active (Annex 6).
Materiality	Not material.

### 2.3.6 Counterparty credit risk framework

Section grade	Compliant
Summary	Mexican requirements for counterparty credit risk are broadly aligned with the Basel framework. The Assessment Team considers the regulatory implementation as compliant. It may be noted that the Mexican authorities have not implemented the advanced Basel approaches for counterparty credit risk, including the Internal Models Method (IMM) and the advanced CVA charge. These components have therefore not been assessed.

### 2.3.7 Market risk: The Standardised Measurement Method

Section grade	Compliant
Summary	CNBV's current Prudential Standards are assessed compliant with the Basel Framework for measuring and capitalising market risk under the standardised measurement method with a few exceptions, which are listed for a follow-up assessment (Annex 12). A notable aspect of the Mexican market risk regulations is the absence of a distinction between the trading book and the banking book. All positions on the balance sheet are subject to a market risk capital charge and credit risk capital charge, thus making the Mexican approach more conservative than the Basel minimum requirements. The Mexican authorities have not adopted the Basel requirements for correlation trading as banks are not permitted to invest in such instruments.
Basel paragraph no	Basel II para 683(v) – Scope of application
Reference in domestic regulation	Chapter IV of General Provisions Applicable to Credit Institutions – Capital requirements for market risk
Findings	Market risk capital requirements are applicable at the level of standalone banks only

	and not at the level of the consolidated global group.
Materiality	Not material. The market risk activities of subsidiaries are not within the purview of banking capital requirements. This may leave scope for regulatory arbitrage. However, as noted under the scope of application part of the assessment, financial subsidiaries are supervised by CNBV and any shortfall of capital is deducted from the capital of parent bank. Considering these factors, this deviation does not appear to be material at this point of time.
Basel paragraph no	Basel II para 689(iv) Correlation Trading Portfolio
Reference in domestic regulation	No provision
Findings	There is no provision for the computation of capital requirements for a correlation trading portfolio. CNBV has stated that no bank has been approved for taking positions in CTP.
Materiality	Not material. Banks are presently not allowed to have CTP positions.
Basel paragraph no	Basel II 701(iv) – Options exposure
Reference in domestic regulation	Chapter IV, Article 2 Bis 99 IV(j) of General Provisions Applicable to Credit Institutions- Capital requirements for market risk
Findings	The Basel provision requires that the more a bank is involved in writing options, the more sophisticated its methods need to be for measuring risk. No such provision is made in the CNBV Prudential Standards.
Materiality	Not material. Banks' exposures to options are not significant at present. However, the need was discussed with the CNBV to introduce more sophisticated methodologies for measuring option risks when banks become more active in trading options.
Basel paragraph no	Basel II para 701(vi)
Reference in domestic regulation	Chapter IV of General Provisions Applicable to Credit Institutions – Capital requirements for market risk
Findings	In the Mexican regulation, there is no explicit requirement that banks are expected to manage market risk in their trading book in such a manner that capital requirements are being met on a continuous basis. Further, there is no explicit requirement to maintain strict risk management systems to ensure intraday exposures are not excessive (during discussions CNBV agreed to provide exact references covering this aspect).
Materiality	Not material. CNBV and BdM clarified that banks are required to report their market risk positions on a daily basis. This substantially ensures that banks cannot window-dress their capital numbers at the time of regulatory reporting. Also, Mexican regulations require that market risk information must be provided on a daily basis to senior management of the bank and on an intraday basis during periods of high financial volatility.
Basel paragraph no	Basel II paragraph 711 specific risk capital
Reference in domestic regulation	General Provisions Applicable to Credit Institutions Article 2 Bis 14
Findings	The Basel standard allows a lower specific risk capital charge to only those sovereign securities that are issued by the government, denominated in domestic currency and funded by the bank in the same currency. Under Mexican regulations, all exposures to the Mexican Federal Government attract a 0% credit risk capital charge (see also finding for Basel paragraphs 53–56).
Materiality	Not material at present. CNBV states that at present exposures to government debt denominated in foreign currency are limited and this deviation is not material at present. However, as such exposures may grow in future, this deviation has been listed for a follow-up



	assessment (Annex 12).
Basel paragraph no	Basel II paragraph 713–718
Reference in domestic regulation	General Provisions Applicable to Credit Institutions Article 2 Bis 22
Findings	Mexican regulations do not specify a risk charge for the underlying on which protection has been purchased using credit derivatives or for exposures that arise through credit derivatives.
Materiality	Not material. At present exposures to credit derivatives are limited. Current authorisations limit banks to trading credit derivatives on Mexican sovereign debt only. Impact analysis on banks showed that the impact on RWA numbers and capital ratios is not material at present. However, as banks' exposures to credit derivatives may increase in the future, this deviation is considered potentially material, and should be monitored in future RCAPs.
Basel paragraph no	Basel II paragraph 718(xxxii) Measuring the exposure in a single currency
Reference in domestic regulation	---
Findings	The Basel standards specify a number of items that need to be included in the banks' net open position in foreign currency exposures. These include accrued interest and expenses. There is no specific requirement in the Mexican regulations that specifies all the items which should be taken into account for the computation of the foreign exchange currency exposure. The General Provisions reference a circular from the Bank of Mexico (3/2012) which mentions some of the items that should be taken into account but it was not found to specify each and every item mentioned in the Basel standards. Specifically, the treatment of interest, other income and expenses has not been included. The circular also provides a list of exemptions that are not taken into account in the foreign exchange risk charge. These exemptions could potentially be significant.
Materiality	Not material. While current foreign currency exposures are relatively limited (on average less than 5% of total assets), it cannot be excluded that in future the foreign currency exposure of Mexican banks will increase. Collectively these items are considered immaterial at the moment and for the next several years, but they should be re-assessed in any future RCAPs.

### 2.3.8 Market risk: Internal Models Approach

Section grade	NA
Summary	CNBV has not implemented the Internal Models Approach (IMA)

### 2.3.9 Operational risk: Basic Indicator Approach and the Standardised Approach

Section grade	Compliant
Summary	Overall, the Assessment Team finds the Mexican regulations to be compliant with the Basel operational risk standards. In its review, the team noted that the Mexican regulations are more conservative in a number of areas than required by the Basel standards (Annex 10). Examples are the requirements for operational risk databases and qualitative requirements for operational risk management.

### 2.3.10 Operational risk: Advanced Measurement Approaches

Section grade	Compliant
Summary	The Assessment Team finds the Mexican regulations to be compliant with the Basel

	operational risk standards. The recent reforms introduce the Advanced Measurement Approach (AMA) in a manner consistent with the Basel standard.
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## 2.4 Pillar 2: Supervisory review process

Section grade	Compliant
Summary	<p>Generally, the domestic regulations have adequately addressed the requirements under the four Principles of Pillar 2 covered under the RCAP. The power to conduct supervisory review is provided under the Supervisory Regulation of the National Banking and Securities Commission and regulatory expectations are reflected in the domestic legislations. The financial Reform Credit Institutions Law provides CNBV the power to require banks to maintain supplementary capital above the minimum capital requirement. However, given the impact of additional capital requirement under Pillar 2 is specific on the identified bank rather than banking industry wide, as in the case of countercyclical capital buffer, the process of requiring capital under Pillar 2 also differs from the latter as it does not require a public consultation as well as consultation with COFEMER to be conducted.</p> <p>Notwithstanding the adequacy of the powers provided under the law, the review team wishes to highlight that CNBV has never exercised its formal powers. The assessment team review of past cases reveals that CNBV had deployed supervisory suasion to achieve capital increases in some smaller banks. In this regard, CNBV has asserted, and the Assessment Team has no reason to disbelieve, that the major banks have for many years been adequately capitalised, and there has been no need for any Pillar 2 adjustments to this population (see also Annex 14 Mexico's implementation of the Pillar 2 supervisory review process).</p>

## 2.5 Pillar 3: Market discipline

Section grade	Largely compliant
Summary	Mexico applies Basel capital regulations to standalone banks and not on a consolidated banking group-wide basis. Correspondingly Pillar 3 disclosure requirements are implemented on a standalone bank basis only (see also Scope of application). Disclosure requirements regarding the scope of application of the Basel framework have not been implemented. Disclosure requirements related to the approach followed for operational risk, the description of AMA and use of insurance for operational risk have also not been implemented.
Basel paragraph no	Basel II Pillar 3 Table 1 – Scope of application.
Reference in domestic regulation	---
Findings	Basel Pillar 3 requirements apply to the top consolidated level of the banking group, and include certain requirements regarding disclosure of scope, consolidation approach, insurance subsidiaries etc. These disclosure requirements, mentioned in Basel Pillar 3 Table 1, have not been implemented.
Materiality	<p>Potentially material.</p> <p>Disclosures on scope of application, differences in the basis of consolidation for accounting and regulatory consolidation, information on insurance subsidiaries etc have not been implemented in Mexican regulation. Whilst the team acknowledges that this follows from the Basel-compliant scope of application of the Mexican regulatory framework (see "Scope of application") it considers that potentially important information may not be available to market participants. At present, the minimal nature of the Mexican bank holding company activities leads the team to consider the finding potentially material.</p>
Basel paragraph no	Basel II Pillar 3 Table 12 – Operational Risk
Reference in domestic regulation	---

Findings	Disclosures requirements specified in Basel Table 12 have not been implemented.
Materiality	Potentially material. CNBV introduced the Advanced Measurement Approach (AMA) for computing the operational risk capital charge. However, the disclosure requirements pertaining to Table 12 on operational risk have not been implemented. This item is currently a null set, as no banks are on the AMA, but over time the issue may become material.

## 2.6 List of observations and other findings

### 2.6.1 Operational risk: Advanced Measurement Approaches

Basel paragraph no	Basel II paragraph 656
Reference in domestic regulation	---
Observation	The team noted that the Mexican authorities have not adopted the possibility of using an allocation mechanism for the purpose of determining the AMA capital requirement for subsidiaries that are not deemed to be significant relative to the overall banking group, but are themselves subject to the Basel standards (Basel para 656). Mexican regulators indicated they would not allow this possibility, as they are not comfortable allowing banks that are subsidiaries of large international banking groups to calculate their capital requirements based on a calculation made at the home or group level. For purposes of the assessment, the team considered this to be conservative and therefore not a deviation.

### 2.6.2 Pillar 2: Supervisory review process

Basel paragraph no	Basel II paragraphs 757–758
Reference in domestic regulation	Financial Reform Credit Institutions Law Article 19, Article 50 and Article 121 paragraph 1 General Provisions Applicable to Credit Institutions Article 219, Article 220 and Article 221
Observation	The domestic regulations are compliant with Principle 3 requirements under Pillar 2. This principle explicitly states that banks must maintain supplementary capital above the minimum amount required as well as provide adequate powers for CNBV to require banks to hold regulatory capital in excess of the minimum requirement. The law states that these powers can be exercised on the consideration of diverse factors such as the economic cycle and the systemic risks that a bank might pose to the stability of the financial system or of the economy as a whole. While CNBV has discretion to exercise the power, the law requires CNBV to seek the opinion of BdM before a formal requirement for additional capital is made to a bank.

### 2.6.3 Pillar 3: Market discipline

Basel paragraph no	Basel II paragraph 822
Reference in domestic regulation	---
Observation	Following the Mexican standalone supervision approach, disclosure requirements are applicable at the level of standalone bank and not at the consolidated level (see also Scope of application).

## Annexes

### Annex 1: RCAP Assessment Team and Review Team<sup>14</sup>

#### Assessment Team

Mr Charles Littrell, Australian Prudential Regulation Authority (Team Leader)

Name	Affiliation
Ms Johanna Eklund	Riksbank, Sweden
Mr Carl Kaminski	Office of the Comptroller of the Currency, United States
Mr Gim Hoe Lim	Monetary Authority of Singapore
Ms Marian Nieto	Bank of Spain
Mr Santosh Kumar Pandey	Reserve Bank of India
Mr Hafiz Abu Samah	Central Bank of Malaysia
Ms Mary Thomas	Office of the Superintendent of Financial Institutions, Canada

#### Supporting members

Ms Jane O'Doherty	Australian Prudential Regulation Authority
Mr Maarten Hendrixx	Basel Committee Secretariat

#### Review Team

Mr Neil Esho	Basel Committee Secretariat
Mr Nkosana Mashiya	South African Reserve Bank
Mr Karl Reitz	Federal Deposit Insurance Corporation
Ms Claire Renoirte	National Bank of Belgium

<sup>14</sup> The RCAP Assessment Team worked closely with Mr Udaibir Das, Head of Basel III Implementation at the Basel Committee Secretariat. It has also benefited from the feedback of the RCAP Review Team and the Peer Review Board. The Review Team is separate from the Assessment Team, and provides an additional level of quality assurance for the report's findings and conclusions.

## Annex 2: Implementation of the Basel framework as of cut-off date

Overview of adoption of capital standards

Table 4

Basel III regulation	Date of issuance by BCBS	Transposed in Mexican rule	Date of implementation in Mexico	Status
<b>Basel II</b>				
Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	June 2006	General Provisions Applicable to Credit Institutions	First published in November 2007 with subsequent updates in March 2008, June 2009, April 2010, March, April and December 2011 and June 2012.	
<b>Basel 2.5</b>				
Enhancements to the Basel Framework Guidelines for computing capital for incremental risk in the trading book Revisions to the Basel II market risk framework	July 2009	General Provisions Applicable to Credit Institutions	Published in November 2012	
<b>Basel III</b>				
Basel III: A global regulatory framework for more resilient banks and banking systems –revised version	June 2011 (Consolidated version)	General Provisions Applicable to Credit Institutions	Published in November 2012 with subsequent updates in April and June 2013 and December 2014.	
Pillar 3 disclosure requirements for remuneration	July 2011	General Provisions Applicable to Credit Institutions	See above for Basel III	
Treatment of trade finance under the Basel capital framework	October 2011	General Provisions Applicable to Credit Institutions	See above for Basel III	
Composition of capital disclosure requirements	June 2012	General Provisions Applicable to Credit Institutions	See above for Basel III	
Capital requirements for bank exposures to central counterparties	July 2012	General Provisions Applicable to Credit Institutions	Published in December 2014	

Colour code: **Green** = implementation completed; **Yellow** = implementation in process; **Red** = no implementation.

## Annex 3: List of capital standards under the Basel framework used for the assessment

- (i) International Convergence of Capital Measurement and Capital Standards: A Revised Framework (Basel II), June 2006
- (ii) Enhancements to the Basel II framework, July 2009
- (iii) Guidelines for computing capital for incremental risk in the trading book, July 2009
- (iv) "Basel Committee issues final elements of the reforms to raise the quality of regulatory capital" Basel Committee press release, 13 January 2011
- (v) Revisions to the Basel II market risk framework: Updated as of 31 December 2010, February 2011
- (vi) Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010 (revised June 2011)
- (vii) Pillar 3 disclosure requirements for remuneration, July 2011
- (viii) Treatment of trade finance under the Basel capital framework, October 2011
- (ix) Interpretive issues with respect to the revisions to the market risk framework, November 2011
- (x) Basel III definition of capital – Frequently asked questions, December 2011
- (xi) Composition of capital disclosure requirements: Rules text, June 2012
- (xii) Capital requirements for bank exposures to central counterparties, July 2012
- (xiii) Regulatory treatment of valuation adjustments to derivative liabilities: final rule issued by the Basel Committee, July 2012
- (xiv) Basel III counterparty credit risk – Frequently asked questions, November 2011, July 2012, November 2012

## Annex 4: Local regulations issued by the Mexican authorities for implementing Basel capital standards

Overview of issuance dates of important Mexican capital rules

Table 5

Domestic regulations	Name of the document, version and date
Domestic Regulations implementing Basel II	<i>General Provisions Applicable to Credit Institutions</i> First published by CNBV in November 2007 with subsequent updates to incorporate Basel 2.5 and Basel III. The framework was further amended in December 2014.
Domestic Regulations implementing Basel II.5	
Domestic Regulations implementing Basel III	

Hierarchy of Mexican laws and regulatory instruments

Table 6

Level of rules (in legal terms)	Type
Laws and regulation	Enacted by the General Congress of the United Mexican States (Congress of the Union)
Regulation issued by CNBV	Issued by CNBV and published in the official Gazette of the Federation of Mexico
Internal regulation derived from the above laws and regulations	Regulatory documents issued internally by CNBV

## Annex 5: Details of the RCAP assessment process

### A. Off-site evaluation

- (i) Completion of a self-assessment questionnaire by the Mexican authorities
- (ii) Evaluation of the self-assessment by the RCAP Assessment Team
- (iii) Independent comparison and evaluation of the domestic regulations issued by the Mexican authorities with corresponding Basel III standards issued by the BCBS
- (iv) Identification of observations
- (v) Refinement of the list of observations based on clarifications provided by the Mexican authorities
- (vi) Assessment of materiality of deviations for all quantifiable deviations based on data and non-quantifiable deviations based on expert judgment
- (vii) Forwarding of the list of observations to the Mexican authorities

### B. On-site assessment

- (viii) Discussion of individual observations with the Mexican authorities
- (ix) Meeting with selected Mexican banks, accounting firms and a credit ratings agency
- (x) Discussion with the Mexican authorities and revision of findings to reflect additional information received
- (xi) Assignment of component grades and overall grade
- (xii) Submission of the detailed findings to the Mexican authorities with grades
- (xiii) Receipt of comments on the detailed findings from the Mexican authorities

### C. Review and finalisation of the RCAP report

- (xiv) Review of comments by the RCAP Assessment Team, finalisation of the draft report and forwarding to the Mexican authorities for comments
- (xv) Review of the Mexican authorities' comments by the RCAP Assessment Team
- (xvi) Review of the draft report by the RCAP Review Team
- (xvii) Review of the draft report by the Peer Review Board
- (xviii) Reporting of findings to SIG by the team leader



## Annex 6: List of rectifications by the Mexican authorities

The following amendments were made to the Mexican regulation in December 2014.

Basel paragraph	Reference to Mexican document and paragraph	Brief description of the correction
Definition of capital		
Basel II paragraphs 14 and 44, footnote 11.	General Provisions Applicable to Credit Institutions, Articles 2 Bis 71, 2 Bis 83 and 2 Bis 85	The scaling factor 1.06 has been included in the amendment as a multiplier in the formula used to calculate the RWA under the IRB approach.
Basel III paragraphs 122–32	Article 50 of the Credit Institution Law	During 2015, based on the empowerment that CNBV has under Article 50 of the Credit Institution Law, CNBV with BdM's concurrence will develop the capital framework in order to better reflect the countercyclical capital buffer in its regulation.
Credit risk: Standardised Approach		
Basel II paragraph 59	Article 2 Bis 13 last paragraph, Annex 1-C and Annex 1-B	In order to clarify the treatment of MDBs, in the reforms to the General Provisions Applicable to Credit Institutions of December 2014, only MDBs that have a 0% RW are those included in the list published in the following link: <a href="http://www.cnbv.gob.mx/Normatividad/Lista_de_organismos_multilaterales_de_desarrollo_o_fomento.pdf">http://www.cnbv.gob.mx/Normatividad/Lista de organismos multilaterales de desarrollo o fomento.pdf</a> . MDBs other than those with a 0% RW are risk-weighted as Group VII (please see Annex 1-B of the General Provisions Applicable to Credit Institutions)
Basel II paragraphs 60–64	General Provisions Applicable to Credit Institutions, Articles 2 Bis 14, Article 2 Bis 18 and Annex 1-B	The treatment for banks (local and foreign) has been aligned in the amendment with option 1 of the Basel framework. Additionally, all RWs are aligned with the Basel framework.
Basel II paragraph 65	General Provisions Applicable to Credit Institutions, Articles 2 Bis 14, Article 2 Bis 18 and Annex 1-B	The treatment for securities firms (local and foreign) has been aligned in the amendment with option 1 for banks of the Basel framework. Additionally, all RWs are aligned with the Basel framework.
Basel II paragraphs 66–68	General Provisions Applicable to Credit	The treatment for corporates has been aligned in the amendment and is subject to the sovereign floor whereby no claim on an unrated corporate may receive a RW preferential to that assigned to claims on the sovereign of

	Institutions, Article 2 Bis 18 and Annex 1-B	incorporation. Additionally, all RW are aligned with the Basel framework.
Basel II paragraphs 75–78	General Provisions Applicable to Credit Institutions, Article 2 Bis 20	With the amendment, the RW for past due loans with specific provisions that are less than 20% of the outstanding amount of the loan is 150%.
Basel II paragraphs 79–80	General Provisions Applicable to Credit Institutions, Annex 1-G	With the amendment, the RW of securitisations rated between BB+ to BB– is 350%.
Basel II paragraphs 166–172	General Provisions Applicable to Credit Institutions, Article 2 Bis 38	As CNBV only permits the use of standard supervisory haircuts, the 10-business day haircuts provided in paragraph 151 of the Basel framework will be the basis and the haircut will be scaled up or down depending on the type of transaction and the frequency of remargining or revaluation. This treatment is reflected in the reforms to the General Provisions Applicable to Credit Institutions of December 2014
Basel II paragraphs 182–187	General Provisions Applicable to Credit Institutions, Article 2 Bis 22 fraction I and II, Article 2 bis 37 fraction II and Annex 1-L	The Current Exposure Method has been included in the reforms to the General Provisions Applicable to Credit Institutions of December 2014.
Credit risk: IRB		
Basel II paragraphs 218–228, 229, 230	General Provisions Applicable to Credit Institutions, Article 2 Bis 71 fraction III.	The increase factor for the asset valuation correlation has been included in the reforms to the General Provisions Applicable to Credit Institutions of December 2014, in Article 2 Bis 71 fraction III.
Basel II paragraph 229	General Provisions Applicable to Credit Institutions Article 2 Bis 69 II (references Article 2 Bis 13)	The 0% RW criteria for MDBs under IRB approaches has been aligned with the standardised approach. The only MDBs that have a 0% RW are those included in the list published in the following link: <a href="http://www.cnbv.gob.mx/Normatividad/Lista_de_organismos_multilaterales_de_desarrollo_o_fomento.pdf">http://www.cnbv.gob.mx/Normatividad/Lista de organismos multilaterales de desarrollo o fomento.pdf</a> .
Basel II paragraphs 256–262	General Provisions Applicable to Credit Institutions Article 2 Bis 66 fraction I	The roll-out plan requirement has been included in the reforms to the General Provisions Applicable to Credit Institutions of December 2014; banks wishing to use IRB models must present an implementation plan to their supervisor that demonstrates how they will roll out IRB models across all material portfolios.
Basel II paragraph 415	General Provisions Applicable to Credit Institutions, Annex 15 Section 3	Borrower rating must represent the bank's assessment of the borrower's willingness and ability to pay despite adverse economic conditions or the occurrence of unexpected events. This requirement is included as part of the reforms to the General Provisions Applicable to Credit Institutions of December 2014

Basel II paragraph 445	General Provisions Applicable to Credit Institutions, Article 2 Bis 67 fraction IV.	The term of previous use of the internal methodology for the IRB approach has been increased to three years of previous use as set by the Basel framework.
Credit risk: Securitisation Framework		
Basel II paragraphs 566–605	General Provisions Applicable to Credit Institutions, Article 2 Bis 53, Article 2 Bis 56 fraction I, item a) last paragraph and 2 Bis 57	With the amendment, the cap on the capital requirements for a securitisation exposure has been removed.
Basel II paragraphs 560–564	General Provisions Applicable to Credit Institutions, Article 2 Bis 50.	The amendment clarifies that repurchased securitisation exposures are treated as retained exposures.
Basel II paragraphs 566–576	General Provisions Applicable to Credit Institutions, Articles 2 Bis 55, 2 Bis 56 fraction I, item a), Annex 1-G.	The RW of securitisations rated between BB+ to BB– is 350%. Additionally, it was clarified that originators which have other securitisations positions rated below BBB– are treated as unrated positions and then a RW of 1250% is applied.
Basel securitisation framework	General Provisions Applicable to Credit Institutions, Article 2 Bis 57 fraction I, item d).	The reforms to the General Provisions Applicable to Credit Institutions of December 2014 removed the preferential treatment of infrastructure projects by development banks (state-owned banks).
Counterparty credit risk		
Basel II paragraph 92(i) of Annex 4	General Provisions Applicable to Credit Institutions, Article 2 Bis 22 (I,II) and Annex 1-L	The add-on factor of the Current Exposure Method (CEM) is included to fully apply the Basel method. Bilateral netting is also recognised.
Basel II paragraph 97 of Annex 4	General Provisions Applicable to Credit Institutions, Articles 2 Bis 64, 2 Bis 98 a–d	The Basel capital requirement for CVA risk is introduced.
Basel II paragraphs 110–119, 120-125, 126-127 of Annex 4	General Provisions Applicable to Credit Institutions, Articles 2 Bis 64,	Capital requirements for trade exposures and default fund exposures to central counterparties (CCPs) are introduced following the interim framework for exposures to CCPs published in 2012.

	2 Bis 12 a, 2 Bis 98 e–g	For default fund exposures, both methods of the referred framework are introduced.
Basel II paragraphs 106, 107 of Annex 4	General Provisions Applicable to Credit Institutions, Articles 2 Bis 12 a, 2 Bis 117, 2 Bis 117 a (VI)	A definition for Qualifying CCPs (QCCPs) is introduced in line with the Basel framework. Additionally, a requirement for banks acting as clearing members to assess through appropriate scenario analysis and stress testing whether the level of capital held against exposures to CCPs adequately addresses the inherent risk of those transactions is introduced. The assessment includes potential future or contingent exposures resulting from future drawings on default fund commitments in line with the Basel rules text.
Market risk		
Basel II paragraph 683(i)	General Provisions Applicable to Credit Institutions, Articles 1 (C), 2 Bis 99 (IX) and 2 Bis 109 a	Market risk capital requirements for commodities are introduced.
Basel II paragraph 709(ii)	General Provisions Applicable to Credit Institutions, Article 2 Bis 22 (VII)	Specific risk capital requirements for net short positions are introduced.
Basel II paragraph 710	General Provisions Applicable to Credit Institutions, Article 2 Bis 14 and Annex 1-B	Specific risk treatment of exposures to banks is aligned to the Basel standards.
Basel II paragraph 718(ii)	General Provisions Applicable to Credit Institutions, Article 2 Bis 105	A separate interest risk capital charge computation for each major currency is introduced.
Basel II paragraph 718(xvi)	General Provisions Applicable to Credit Institutions, Article 2 Bis 100 (IV-I)	Specific risk requirements for debt securities used as underlying assets in derivatives positions are introduced.
Basel II paragraph 718(xxii)	General Provisions Applicable to Credit Institutions, Articles 2 Bis 109	The preferential treatment for equity positions held on account of debt capitalisation programs was removed in order to align with Basel standards.
Basel II para 718(xxvi–xxvii)	General Provisions Applicable to Credit Institutions, Article 2 Bis 109 (V)	Changes have been introduced to emphasise that for positions on equity indexes, the execution risk charge is taken into account. The clarification states that derivatives on equity indexes are subject to a 4% specific risk charge and to a 4% execution risk charge, totalling an overall charge of 8%.

Basel II paragraph 718(xxx)	General Provisions Applicable to Credit Institutions, Article 2 Bis 108	Gold is included in the capital requirements within the foreign exchange risk capital requirement computation.
Basel II paragraph 718(xLiii)	General Provisions Applicable to Credit Institutions, Articles 1 (C), 2 Bis 99 (IX) and 2 Bis 109 a	Market risk capital requirements for commodities are introduced.
Basel II paragraph 718(lvi)	General Provisions Applicable to Credit Institutions, Articles 2 Bis 100 (k) and 2 Bis 109b	Capital requirements for gamma and vega risk are introduced consistent with the delta-plus method.
Basel II paragraph 718(cii)	General Provisions Applicable to Credit Institutions, Article 175 Bis 8	It is explicitly stated that banks must establish and maintain adequate systems and controls to give the confidence that their valuation estimates are prudent and reliable, and that the reporting lines are clear and independent from the department accountable for the valuation process.
Basel II paragraph 718(ciii–cvii)	General Provisions Applicable to Credit Institutions, Articles 175 Bis 3 and 175 Bis 6	The need to inform senior management of the elements which are subject to mark to model and the uncertainties in the model valuation is explicitly stated. Initial and periodic validations (including the prescription to check the reasonableness of the valuations) of the internal models have been introduced, which are to be undertaken by parties independent of those who develop the models, and of the front office. A requirement for periodic validation of the market variables and prices obtained from price vendors is introduced, which should be undertaken independently from the front office.
Basel II paragraph 718(cviii–cx)	General Provisions Applicable to Credit Institutions, Article 2 Bis 2	Prescribes market valuation adjustments. The requirement to establish and maintain procedures for assessing the necessity for and making valuation adjustments for less liquid positions for regulatory capital purposes is also introduced.
Operational risk		
Basel II paragraphs 645–648	General Provisions Applicable to Credit Institutions, Articles 2 Bis 111, 2 Bis 112, 2 Bis 113, 2 Bis 114 and 2 Bis 115 and Annex 1-D and 1-E	The reforms to the General Provisions Applicable to Credit Institutions of December 2014 include the Standardised Approach (SA), the Alternative Standardised Approach (ASA) and the option of the Advanced Measurement Approach (AMA). In order to use one approach, credit institutions must use the less sophisticated approach for at least one year prior to progressing to a more sophisticated approach. Additionally banks must satisfy the requirements for each approach.
Basel II paragraphs 649–663	General Provisions Applicable to Credit Institutions, Articles 2 Bis 112 and 2 Bis 113	The Basic Indicator Approach was aligned with Basel framework by removing the partial reduction due to insurance and reserves for operational risk; and the operational risk capital requirements floor and cap of 5% and 15%, respectively.

Basel II paragraph 669	General Provisions Applicable to Credit Institutions, Annex 1-E, Section II	For AMA the possibility of a capital reduction for expected loss provisions is introduced.
Basel II paragraphs 677–683	General Provisions Applicable to Credit Institutions, Annex 1-E, Section II	For AMA the possibility of the use of insurance is introduced.
Pillar 2: Supervisory review process		
Basel II paragraphs 719–725	General Provisions Applicable to Credit Institutions, Article 2 Bis 117 a	The Pillar 2 framework was amended in order to reflect the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile; and to foster an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital.
Basel II paragraphs 726–728	General Provisions Applicable to Credit Institutions, Articles 2 Bis 117, 68, 69, 71, 74, 76 and 78.	Specific requirements of the capital adequacy assessment process were included as an additional function for the governance bodies in a bank in order to explicitly reflect in domestic regulations paras 726–728 of the Basel II Standards.
Basel II paragraph 738(ii)	General Provisions Applicable to Credit Institutions, Annex 12-B Section II fraction II.	Areas relating to the use of stress testing to supplement banks' market risk VaR models were included.
Basel II paragraph 738(v)	General Provisions Applicable to Credit Institutions, Annex 13	As part of the amendments, banks must demonstrate how banks combine the risk measurement approaches to arrive at their overall internal capital (including market risk).
Basel II paragraph 741	General Provisions Applicable to Credit Institutions, Articles 65, 75 fraction II, 81 fraction I and VIII, and Annex 12-B and Annex 13	Banks are required to have adequate systems for measuring, monitoring and controlling liquidity risks. Additionally, banks must also evaluate the adequacy of capital given their risk profile (including the liquidity profile and the liquidity of the markets in which they operate).
Basel II paragraphs 753–755	General Provisions Applicable to Credit Institutions, Article 2 Bis, Article 2 Bis 30, Article 2 Bis	Minimum requirements for credit risk mitigation and asset securitisations are required to be met on an ongoing basis by the banks.

	50, Article 2 Bis 119 paragraph 1 and Article 88	
Basel II paragraphs 777(i)–777(xiii)	General Provisions Applicable to Credit Institutions, Chapter IV of Title 2	The counterparty credit risk framework is currently in national regulation. All the minimum guidelines of the Framework for Comprehensive Risk Management set forth in the Chapter IV of Title 2 of the General Provisions Applicable to Credit Institutions are also applicable for this risk.
Basel II paragraph 795	General Provisions Applicable to Credit Institutions, Article 78 XI, and Article 2 Bis 117.	Banks are required to put in place adequate processes to recognise protection and identify residual risks, as well as taking into consideration the residual risks in determining economic capital.
Supplemental Pillar 2 Guidance paragraph 16	General Provisions Applicable to Credit Institutions, Article I fractions IV, LXXXI, LXXXII, LXXXIII and CXXIX, Article 67, fraction I and III, Article 68, Article 69, Article 70 fraction I, Article 74 and Article 78 fraction I	Regulation requires that banks have a Comprehensive Risk Management that cover the full gamut of risks to which the institutions and their financial subsidiaries are exposed, and the relationship between these risks. The risk management process includes reputational, legal and strategic risks, as well as risks that do not appear to be significant in isolation, but when combined with other risks could lead to material losses.
Pillar 3: Market discipline		
Basel II Pillar 3 Table 3 on Capital positions	General Provisions Applicable to Credit Institutions, Annex 1-O	There is a requirement to disclose the capital positions of subsidiaries and the credit risk capital requirements and their portfolio value in granular fashion.
Basel II Pillar 3 Tables 4–6	General Provisions Applicable to Credit Institutions, Annex 33 and 1-O, Article 88	Certain elements of Basel Pillar 3 Tables 4–6 regarding credit risk have now been included in the Mexican disclosure requirements under the Risk Management Framework applicable to credit institutions.
Basel II paragraphs 825–826 and Tables 7, 8, 9, 13, 14	General Provisions Applicable to Credit Institutions and 1-O, Article 88	Certain elements in Basel Pillar 3 Tables 7, 8, 9, 13 and 14 have now been included in the disclosure requirements under the Risk Management Framework applicable to credit institutions.
Pillar 3 disclosure requirements on remuneration	General Provisions Applicable to Credit Institutions, Article 88	Regulations to implement disclosure requirements on remuneration have been implemented

## Annex 7: Assessment of the binding nature of regulatory documents

The following table summarises the Mexican authorities' self-assessment of the seven criteria used to determine the eligibility of the Mexican regulatory documents. The Assessment Team concluded that the regulatory instruments issued and used by the Mexican authorities as set out in Table 5 in Annex 4 are eligible for the RCAP assessment.

Criterion	Assessment
(1) The instruments used are part of a well defined, clear and transparent hierarchy of legal and regulatory framework.	<p>The regulation that establishes capital requirements for credit institutions such as commercial banking institutions as well as for state-owned banks is included in the General Provisions Applicable to Credit Institutions. According to the legal framework, these provisions are issued by the CNBV under Article 50 of the Credit Institutions Law, which empowers the CNBV to set the procedure for calculating the capital ratio applicable to banking institutions.</p> <p>Article 50 of the Credit Institutions Law establishes that banking institutions shall at all times maintain a net capital expressed through an index which may not be lower than the amount resulting from summing the capital requirements established by the CNBV in terms of the general provisions issued with the approval of its Governing Board. Such capital requirements will be referenced to the following: (i) the market risk, credit risk, operational risk and other risks which banking institutions incur during their operations, and (ii) the balance between their assets and liabilities.</p> <p>Pursuant to Article 50 of the Credit Institutions Law, the CNBV must obtain the opinion of the BdM to issue the general provisions regarding capital requirements, as well as for the provisions that set forth the procedure to calculate the capital ratio applicable to credit institutions.</p>
(2) They are public and easily accessible.	<p>The General Provisions Applicable to Credit Institutions are available on the website of the CNBV on the following link: <a href="http://www.cnbv.gob.mx">www.cnbv.gob.mx</a>.</p>
(3) They are properly communicated and viewed as binding by banks as well as by the supervisors.	<p>In order to issue regulation or amendments thereto, the CNBV has to follow the procedure established in the Federal Law on Administrative Procedures (LFPA by its acronym in Spanish), and submit certain documentation and information to the COFEMER so that the COFEMER may analyse its possible impact (MIR by its acronym in Spanish), before the date that the CNBV intends to issue the regulation or amendment.</p> <p>Once the CNBV sends the project to the COFEMER, the COFEMER publishes the project and its MIR in its website in order that anyone may submit comments (public consultation). If the CNBV has to answer those comments by filing the corresponding answers to COFEMER, those answers are published too.</p> <p>When the public consultation process is concluded, and no further comments are received by COFEMER, this agency issues its final opinion of the project and the CNBV requests the publication of the regulation or amendment in the Official Gazette of the Federation.</p> <p>Once the regulations or amendments are published in the abovementioned Official Gazette, these are binding for credit institutions.</p>



<p>(4) They would generally be expected to be legally upheld if challenged and are supported by precedents.</p>	<p>The General Provisions Applicable to Credit Institutions (including capital requirements) have been in place since 2005. No legal challenges have been made to them. CNBV expects that its General Provisions Applicable to Credit Institution would be upheld if challenged.</p>
<p>(5) Consequences of failure to comply are properly understood and carry the same practical effect as for the primary law or regulation.</p>	<p>As General Provisions Applicable to Credit Institutions are derived from the Credit Institution Law, the consequences of failure to comply with their requirements are known and accepted and have the same practical effect as legislation. In the event of non-compliance with whole or part of the General Provisions Applicable to Credit Institutions, CNBV may issue a directive under Chapter II of Title Five of the Credit Institutions Law to the non-compliant bank, which is obliged to remedy the situation. This is in addition to any other applicable prompt corrective actions according to the early warning system prescribed in the General Provisions Applicable to Credit Institutions.</p>
<p>(6) The regulatory provisions are expressed in clear language that complies with the Basel provisions in both substance and spirit.</p>	<p>The General Provisions Applicable to Credit Institutions are written to be clear and concise so as to remove misinterpretation and aid enforcement. CNBV achieves compliance with the Basel rules text by using the Basel language where it is appropriate within the Mexican legal framework.</p>
<p>(7) The substance of the instrument is expected to remain in force for the foreseeable future</p>	<p>CNBV has responsibility for making any amendment to the General Provisions Applicable to Credit Institutions and fully intends that they will remain in force for the foreseeable future.</p>

## Annex 8: Key financial indicators of Mexican banking system

Overview of Mexican banking sector as of end-December 2013

Table 7

Size of banking sector (MXN millions)	
Total assets all banks operating in the jurisdiction (including off-balance sheet assets)	6,523,381
Total assets of all locally incorporated internationally active banks	4,627,211
Total assets of locally incorporated banks to which capital standards under Basel framework are applied (ie excludes foreign bank branches)	6,523,381
Number of banks	
Number of banks operating in Mexico	46
Number of internationally active banks	5
Number of banks required to implement Basel standards (according to domestic rules)	46
Number of Global Systemically Important Banks (G-SIBs)	NA
Number of Domestic Systemically Important Banks (D-SIBs)	NA
Capital standards under the Basel framework	
Number of banks on IRB approach for credit risk	2
Number of banks on IMA for market risk	0
Number of banks on AMA approaches for operational risk	0
Number of banks on IMM for counterparty credit risk	0
Capital adequacy (internationally active banks) (MXN millions; percent)	
Total capital	494,117
Total Tier 1 capital	411,736
Total CET1 capital	391,947
Total risk-weighted assets	3,259,771
RWAs for credit risk (percent of total RWAs)	63.83%
RWAs for market risk (percent of total RWAs)	24.60%
RWAs for operational risk (percent of total RWAs)	11.57%
Total off-balance sheet bank assets <sup>15</sup>	21,896,408
Capital adequacy ratio (weighted average)	15.2%
Tier 1 Ratio (weighted average)	12.6%
CET1 Ratio (weighted average)	12.0%

Source: Bank of Mexico.

Note: Weights for capital adequacy ratio, Tier 1 ratio and CET1 ratio based on total assets of each bank. Internationally active banks are those considered in the RCAP sample: Banamex, BBVA Bancomer, Santander, HSBC and Banorte.

<sup>15</sup> Includes derivatives at fair value and the credit equivalent amount of non-market related off-balance sheet exposures.

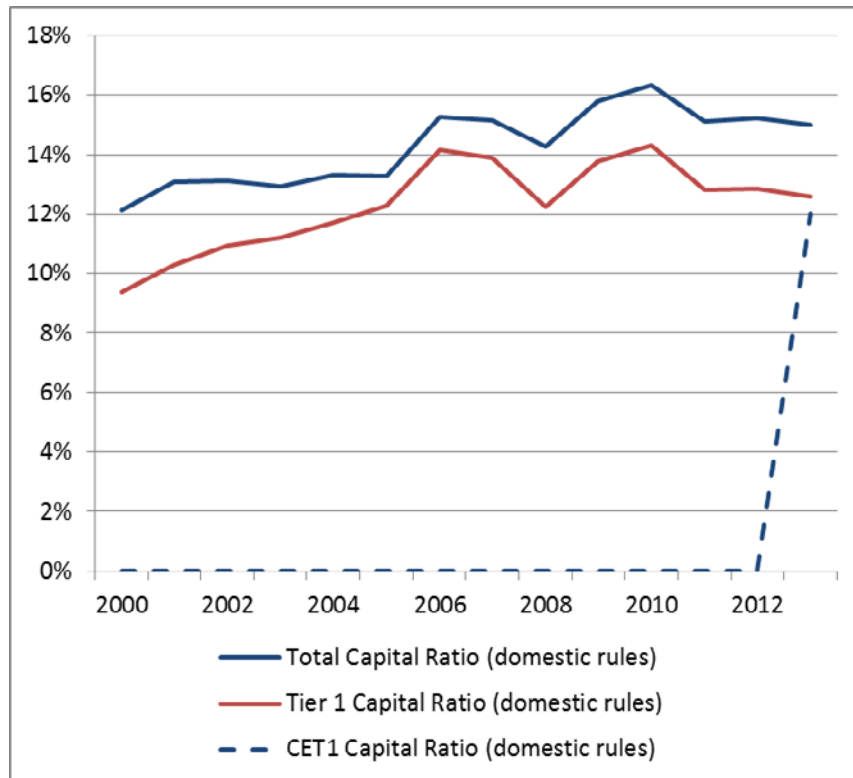
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## Evolution of the capital ratios of Mexican internationally active banks

Weighted average, in percent

Figure 1

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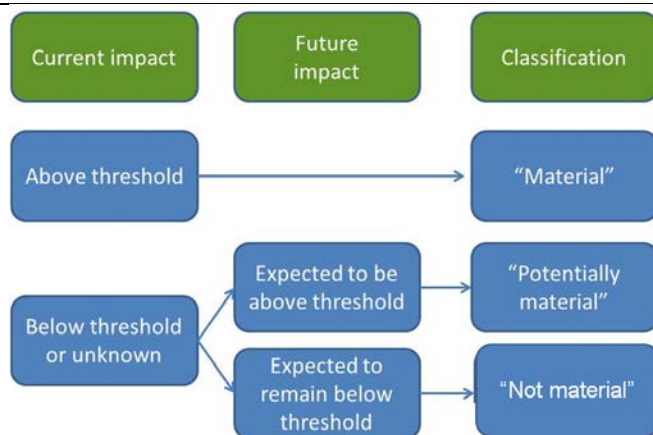


Source: CNBV.

## Annex 9: Materiality assessment

The assessment of materiality distinguished between quantifiable and non-quantifiable gaps. For the Mexican RCAP, an attempt was made to quantify the impact of all quantifiable gaps for each bank in the sample affected by the gap. Several gaps were assessed based on bank data and data available to the Mexican authorities. Following the amendments published in December 2014 by the Mexican authorities no quantified material gaps remain. Where no data were available to quantify gaps, the review team relied on expert judgment. Following this approach, an attempt was made to determine whether gaps are “not material”, “material” or “potentially material”.

Classification of quantifiable gaps Figure 2



Number of gaps/differences by component

Table 8

Component	Non-material	Material	Potentially material
Scope of application	1	0	0
Transitional arrangements	0	0	0
Definition of capital	1	0	0
Capital buffers	2	0	1
Pillar 1	-	-	-
Minimum capital requirements (general)	0	0	0
CR: Standardised Approach	1	0	0
CR: IRB	2	0	0
CR: Securitisation	3	0	0
Counterparty credit risk	0	0	0
MR: Standardised Approach	7	0	0
MR: Internal Models	0	0	0
OR: SA/BIA	0	0	0
OR: AMA	0	0	0
Pillar 2	0	0	0
Pillar 3	0	0	2

Note: materiality is defined based on quantitative benchmark thresholds (for the quantifiable gaps) and expert judgment (for the non-quantifiable gaps). See Section 2 with the detailed assessment findings for further information.

## Annex 10: Areas where Mexican regulations are stricter than the Basel minimum standards

In several places, the Mexican authorities have adopted a stricter approach than the minimum standards prescribed by Basel or have simplified or generalised an approach in a way that does not necessarily result in stricter requirements under all circumstances but never results in less rigorous requirements than the Basel standards. The following list provides an overview of these areas. The information in this annex has been provided by the Mexican authorities and has not been cross-checked or assessed by the RCAP Assessment Team. It should be noted that these areas have not been taken into account as mitigants for the overall assessment of compliance.

### Definition of capital and transitional arrangements

#### 1. Basel III paragraphs 67–68

Basel requires goodwill and other intangibles to be deducted from Common Equity Tier 1 (CET1) capital. In addition, the CNBV requires that all items deferred for more than one year that represent disbursements or expenses recognised in the shareholders' equity and deferred in time be deducted from CET1.

#### 2. Basel III paragraphs 69–70

The CNBV requires deferred tax liabilities not to be netted from deferred tax assets corresponding to the tax on profits arising out of tax losses.

#### 3. Basel III paragraph 78

Mexican banks cannot hold directly or indirectly instruments representing their capital stock, except under special approved circumstances, including granting credits for the acquisition of such instruments. In such cases, however, all own shares acquired by the institution under this exception are deducted from CET1, regardless of whether they form part of Additional Tier 1 or Tier 2 capital.

#### 4. Basel III paragraph 79

The requirement of Basel establishes that reciprocal cross holdings in the capital of banking, financial and insurance entities must be completely deducted. The CNBV requires all reciprocal holdings to be deducted from CET1 including non-financial entities.

### Credit risk: standardised approach

#### 1. Basel II paragraphs 69–71

The standard requirement of Basel is 75% for retail exposures, but the CNBV requires a 100% risk weight.

## 2. Basel II paragraphs 72–73

For claims secured by residential property, the Mexican banks are subject to a 50% RW if the down payment is at least 30% or the down payment plus the covered amount is at least 30% of the home value (ie LTV  $\leq$  70%). A 75% RW applies if the down payment is 20–30%, or if the down payment plus the covered amount is 20–30% of the home value (ie LTV 70–80%). All other residential mortgages not meeting these conditions are risk-weighted at 100%. In this sense, the Mexican treatment for residential mortgage exposure is more conservative than Basel.

## 3. Basel II paragraphs 75–78

All past due loans are risk-weighted at 115%, regardless of their specific provisions, which are at least 20% of the outstanding balance of the loan.

## Credit risk: Internal Ratings-Based Approach

### 1. Basel II paragraphs 506–510

In addition to the Basel requirements, there is a specific threshold for the probability of default (PD) for collateral valuation purposes.

## Operational risk

### 1. Basel II paragraphs 660–663

Basel requires banks that adopt the standardised approach for operational risk to comply with certain qualifying criteria. In Mexico, all banks – irrespective of the approach applied – are subject to these qualifying criteria, including maintaining operational risk historical loss data bases.

## Market risk

### 1. Basel II paragraphs 683(i)–689(iv)

The CNBV has established a broader scope for exposures subject to market risk requirements. Under Mexican regulation, every exposure is subject to market and credit risk capital requirements; therefore, a wider universe of assets and liabilities than that envisaged under Basel rules is subject to market risk requirements.

### 2. Basel II paragraphs 718(i)–718(viii)

Higher risk weights are applied. In addition, a more granular differentiation of risk weights, depending on the underlying interest rate, is used. Instruments whose interest rate is subject to a surcharge receive an additional risk charge. Stricter zones for grouping time bands are also applied.

3. Basel II paragraphs 718(xix)–718(xxii)

Banks are required to apply a 22.23% general market risk charge, instead of the 8% set out in Basel rules.

4. Basel paragraphs 718(xl)–718(xlii)

A higher capital charge of 12% is applied to foreign currency exposures. No *de minimis* exception is allowed, requiring banks to capitalise every exposure on foreign currency.

## Annex 11: List of approaches not permitted under the Mexican regulatory framework

The following list provides an overview of approaches that the Mexican authorities have not made available to its banks through its regulatory framework. Where the Basel standards explicitly request certain approaches to be implemented under specific circumstances, the missing approaches have been taken into account in the assessment. However, where the Basel standards do not require jurisdictions to implement these approaches, they have been implicitly treated as “not applicable” for the assessment.

### Credit risk: Internal Ratings-Based approach

Mexico does not permit the use of IRB models for equity positions.

### Securitisation

CNBV does not allow the use of IRB to determine the risk-weighted asset amounts of securitisation exposures – only the Standardised Approach may be used.

### Operational risk

Mexico does not allow banks to apply the partial use of the Advanced Measurement Approach (AMA).

### Market risk

Mexico has implemented neither the Internal Models Approach (IMA) to market risk, nor the requirements for correlation trading.

### Counterparty credit risk

CNBV has not adopted the rules for IMM and the advanced CVA charge.

### Other

Mexico does not permit its banks to make a distinction between the trading book and the banking book for prudential calculation purposes.



## Annex 12: List of issues for post assessment follow-up

The Assessment Team identified the following issues listed below for follow-up and for future RCAP assessments of Mexico:

### Capital countercyclical buffer

Mexico had not incorporated either of the countercyclical capital buffer requirements — the national countercyclical buffer or the bank-specific countercyclical buffer — into its regulations at the time of this RCAP assessment. Nevertheless, its banking act gives the power to the CNBV to impose a countercyclical capital buffer requirement based on the provisions that the CNBV issues in the Official Gazette of the Federation. Basel III indicates an implementation date of 1 January 2019 for the countercyclical buffer regime, and as such the Assessment Team recommends this issue be highlighted for post-assessment follow-up.

### Credit risk Standardised Approach

CNBV allows the application of lower risk weights to bank exposures to their sovereign or central banks that are denominated in domestic currency as well as foreign currencies. From a materiality point of view, the Assessment Team found that the impact of the deviation is not material either on an individual or a collective basis. Its potential materiality is restricted by the limits set to banks' holdings of foreign currency exposures and the close FX monitoring by CNVB and BdM. The team, however, suggests that the materiality of this issue is followed up under the RCAP.

### Credit risk IRB

Mexican regulations do not provide for all the asset class definitions as in the Basel standards. The Assessment Team considers this unlikely to be material at present as factors associated with specific IRB credit models should reflect these differences. However, as IRB credit model usage expands, there may be a lack of consistency in asset class definition or operational requirements for the risk parameters included in the Basel standards. The team therefore suggests keeping this issue under review in a future RCAP assessment.

### Credit risk: securitisation framework

The definition of re-securitisation exposures broadly complies with the Basel framework, but lacks the detailed supporting description from the 2009 Basel enhancements that were intended to clarify the application of the definition. Further, there is no specific reference in Mexican regulation that swaps and reserve accounts are securitisation exposures. While CNBV considers that swaps and reserve accounts of a securitisation structure are such exposures, the risk of incorrect capital treatment is possible due to the lack of explicit wording. The team therefore suggests keeping this issue under review in a future RCAP assessment.

## Market risk: Standardised Measurement Method

A few deviations pertaining to the computation of foreign exchange exposures in a single currency, a specific risk capital charge for non-domestic currency denominated sovereign debt, and a specific risk capital charge for underlying credit derivatives have been identified. Collectively these items are considered immaterial at the moment and in the next several years, but they should be re-assessed in any future RCAPs.

## Pillar 2

Although Mexico's domestic regulations on risk management and capital management have covered the broad expectations under Pillar 2, discussions with the CNBV and representatives from its banks indicate that to date there has not been a full and thorough implementation of Pillar 2. The Assessment Team recommends a post-assessment follow-up to identify whether and to what extent Mexico is actively implementing a Pillar 2 regime.

## Annex 13: Areas for further guidance from the Basel Committee

The Assessment Team identified the following areas where further guidance is required from the Basel Committee. Additional detail is provided in Section 1.4 of the report.

### Scope of application

For internationally active banks the Basel III capital framework is intended to apply on a fully consolidated basis, including any holding company that is the parent entity within a banking group. In accordance with footnote 5 of the Basel II rules text, application to the standalone bank is permissible if it achieves the same objective, provided the full book value of any investments in subsidiaries and significant minority-owned stakes is deducted from the bank's capital.

The wording of the section in the Basel II framework on scope of consolidation (and footnote 5 in particular) would benefit from additional clarification, as the Assessment Team has identified some potential ambiguity in its interpretation.

### Pillar 2

As a general comment, the Assessment Team considers that the Basel Committee's Pillar 2 rules text may offer more opportunities for interpretation and/or ambiguity than other parts of the framework. This may make the regulatory consistency assessment more challenging and as such the Assessment Team considers that there may be merit in clarifying aspects of the Pillar 2 framework.

### Retail treatment of residential mortgage loans

Under the Basel IRB approach, residential mortgage loans are eligible for retail treatment when the credit is extended to an individual that is an owner-occupier of the property (with reasonable flexibility regarding buildings containing only a few rental units). The requirement that the investor be an owner-occupier is not necessary to achieve retail treatment under the standardised approach to credit risk. This inconsistency has led some jurisdictions (including Mexico) to align the definitions and use the standardised definition of retail for standardised and IRB exposures. The prudential motive for the different definitions of retail is not clear, and as such the Assessment Team recommends that the IRB retail definition be reviewed.

### Pillar 3

The Basel framework allows application of the risk-based capital requirements to the standalone bank (see above). At the same time, on a literal reading, Pillar 3 disclosure requirements apply to the top consolidated level only. The Committee may wish to clarify the application of Pillar 3 disclosure requirements in case the framework is applied on a standalone bank basis.

## Annex 14: The Mexican authorities' summary of their implementation of the Pillar 2 supervisory review process

According to the General Provisions Applicable to Credit Institutions, banks must comply with the minimum guidelines of the Framework for Comprehensive Risk Management and establish frameworks that allow them to conduct their business activities within risk parameters that are appropriate to their net capital, liquid assets and operating capacity, whether in normal, adverse or extreme market conditions.

Based on these provisions, the CNBV conducts an annual financial projection-based scenario stress exercise. In this exercise, the CNBV defines the features and parameters that the banks must apply when assessing their solvency position based on their business plans. The aim of the stress scenarios exercise is to assess the vulnerabilities of each institution by means of sensitivity analyses and to verify that each institution has sufficient capital to continue providing credit.

In the past, based on the stress scenario exercise and the CNBV's preventive supervision process,<sup>16</sup> the CNBV has required banks to increase capital to address concentration risk, market risk, liquidity risk, and other risks or situations not covered by the minimum capital requirements under Pillar 1.

Pursuant to the financial reforms of 10 January 2014, the CNBV has strengthened its powers so that it can now require credit institutions to maintain capital above the regulatory minima based on their own specific scenarios. In determining such scenarios, credit institutions must comply with the provisions and guidelines established by the CNBV. On 31 December 2014, the CNBV issued further provisions to strengthen the processes, guidelines and criteria that credit institutions will require in order to conduct a rigorous capital adequacy assessment process.

In summary, the CNBV has the authority, which it has on occasion exercised, to require banks to hold capital in excess of the regulatory minima on an institution-specific basis when the CNBV observes that a bank is no longer in compliance with the minimum requirements given its current and probable future risk profiles.

<sup>16</sup> The preventive supervision process comprises a thorough review of the credit institution's financial information, strategy, financial projections, risk analysis, among others, and the use of the faculties given to the supervisory areas in agreement with the central bank.