Financial Systems

The Central Bank Report on the Financial System

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On November, 12, the Central Bank of Mexico released its Report on the Financial System as of October 2014 (“the Report”), in which it highlights the rise in global financial vulnerabilities. Among those vulnerabilities are the flagging world economic activity, the increased leverage of non-financial sectors, and the burgeoning shadow banking sector. The foremost risk originating externally is that of a sudden reversal of capital flows associated with the normalisation of monetary policy in the advanced economies. Although Mexico has stood apart from other emerging economies in terms of its solid macroeconomic fundamentals, a well-capitalised financial system, and the prospect of medium and long term growth engineered by the structural reforms, it is vital to safeguard this macroeconomic robustness, to maintain an orderly macro-financial environment and to bullet-proof the financial system’s ability to withstand harmful shocks.

The international scene is marked by a growing contrast in economic performance among countries and regions

The United States and the United Kingdom are showing significant signs of economic recovery, for which these countries are expected to be the first to shift their monetary policy stance. In the United States the upturn in economic activity has rested mainly on growth in consumption and non-resident investment, which has helped to bring down unemployment. In contrast, eurozone economic activity continues to look faint-hearted, due to the unforeseen contraction in the German and French economies, while growth in Japan has been more discreet than expected.

In the emerging economies there has also been a slowdown as a result of a lack of dynamism in the Chinese economy, weak consumption and investment in Brazil, and geo-political tensions which stem from the Ukraine crisis that have dampened foreign investment, industrial production and confidence in the Russian economy. As a result, the risks associated with the external environment should come from interest rate adjustments abroad, exchange rate volatility and fluctuating commodities prices such as food and energy items.

On the domestic front, from 2Q14 there have been signs of increasing activity, but with its ups and downs

The driver has been exports into the United States, which has been backed up by livelier domestic spending, although this is still at a relatively low pace. Even though there are signs of recovery, the challenge of maintaining high growth rates still remains. The major domestic risk is of the economic recovery running out of steam,[1] especially from the effects of lower growth in fiscal and financial variables: there could be a greater impact from international rate hikes and Mexico could see its ability to stand out from other emerging economies thwarted, while lower growth could affect the fiscal balance and the mix of higher rates and a lower level of activity could exacerbate the impairment of the loan portfolio.

[1] After the publication of the Report, both the central bank and the SHCP (Secretariat of Finance and Public Credit) revised their GDP growth forecasts. The central bank now expects the 2014 GDP growth rate to be in the 2.0-2.5% range (previously 2.0-2.8%) while for 2015 this could be 3-4%, whereas the SHCP cut its estimate of 2.7% for 2014 down to somewhere in the 2.1-2.6% range, with 3.2-4.2% for 2015.

The central bank expects the strength of economic activity in the US economy to be a factor underpinning Mexico's economic growth in the short term, while the structural reforms should ensure higher economic growth rates in the medium and long terms.

Among the most conspicuous risk factors in the macro-financial environment are a prolongation of international monetary stimuli and the expansion of shadow banking activity

In the first case, increasing distortion in the allocation of resources arises. Unsustainable interest rates and low risk premiums could lead to serious fallout, mainly in the emerging economies, owing to the risk of the reversal of capital flows. In the second case, financial intermediation through investment vehicles and transactions that are not subject to traditional banking regulation has burgeoned, for which any failure or a lack of liquidity among these entities could spread problems to financial and non-financial companies with which they are interconnected.

The central bank notably observed that macro-prudential regulation could turn out to be limited, as it is only applicable to regulated intermediaries. Given the proliferation seen in intermediaries who are not subject to traditional banking regulation, an indefinite continuation of monetary stimuli could heighten vulnerabilities and the risk of the overspill across financial systems, which would detract from the effectiveness of traditional macroeconomic policies.

Private-sector funding has been driven by placements by companies abroad. The credit risk indicators betray a slight impairment

Overall, non-financial private-sector borrowing to June 2014 rose by a real annual rate of 8.5%, sustained by debt raised from abroad (which grew at a real annual rate of 22.3% between June 2013 and June 2014), whereas bank credit grew by 4.7% over the same period.

This dynamic primarily derives from the surge in bond placements abroad by Mexican blue-chip companies, which have taken advantage of favourable conditions for issuance in world markets. As a result, the Mexican banks have channelled more resources into funding SMEs, which has helped to enhance credit portfolio diversification and reduce concentration risk. NPLs for the corporate loans portfolio showed a mild improvement, though this category is still running at relatively high levels given certain late-payment problems presented by companies in the construction and transportation sectors.

With respect to the consumer banking credit portfolio, the most notable aspect was its loss of momentum, accompanied by higher risk for personal loans and credit cards, where bigger increases in NPLs have emerged. The credit card segment continues to taper off, as it started to do in 2013. This is observable both in terms of the balance and number of cards allocated. The decrease in new cards granted, in particular to persons with no credit history, is indicative of tougher origination standards. Conversely, the decline in payroll loans has reversed, probably due to improved origination criteria, which is manifested in lower initial expected loss reserves.

Housing loans have performed more dynamically than consumer loans. Growth in middle-income and residential housing segments has picked up, interest rates are still coming down and in general no major impairment has been noted in this portfolio. The central bank stresses the potential of a future increase of mortgage refinance loans, given the greater ease of mortgage subrogation. This fact could even change the mechanics of the

market, since mortgage loan subrogation exposes originators to pre-payment risk, and they could be more incentivised to arrange loans at variable rates, instead of the fixed rates currently used.

In terms of market risk, a certain degree of tension has been noted in the FX and bond markets

Since September 2014, signs of a swifter than expected recovery in the United States reawakened investor expectations that the Federal Reserve's change of monetary stance will be faster than initially thought. On top of this, in October 2014 fears of a slowdown in the European economy triggered volatility in the financial markets. This has all brought the exchange rate depreciation and a slight yet steady upturn in long-term interest rates.

With the exception of brokerage firms, whose exposure grew, for other financial intermediaries exposure to interest-rate risk has held at the same levels than those observed in 2013.

Due to increased borrowing by Mexican companies in international markets, some of them could become exposed to exchange-rate risk, but the central bank admits that analysing such risk is not an easy task, as the information on risk hedging is not standardised. Exchange rate risk analysis from company to company reveals that some of them could show serious losses given a substantial weakening of the exchange rate. On the other hand issues have been placed with long maturities and at fixed rates, so companies do not appear to have taken on major refinancing and interest rate risks.

The liquidity level in currency and government security markets is holding at adequate levels, despite the greater volatility in financial markets

The Mexican FX market features a free-float system, which is highly liquid and operates continuously, 24 hours a day. These factors have helped maintain trading volumes, even in spells of high volatility, which helps to avoid interruptions to price-making processes.[2]

On the other hand, trading volumes of government bonds have remained buoyant and, even though from 2Q13 there has been a drop in the average amount per transaction, this could reflect changes in the trading patterns of market participants. Despite the smaller stocks of bonds in the hands of banks and brokerage firms relative to the total amount in circulation, the Mexican sovereign debt market has stayed highly liquid.

In the past year, the risk of direct contagion,[3] as measured by the number of banks which would be affected by a spill-over process, has held relatively constant

Direct exposure to financial intermediaries from abroad has moreover been reduced, which has helped to bring down the risk of any spill-over effect from this source. Nonetheless, the total sum of potential losses has risen on

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[2] Given the volatility in financial markets, which has become more pronounced since the Report was published, on December 8, 2014 the central bank announced exchange rate auctions where some USD200mn will be offered on a daily basis.

[3] In its 2006 Report, the central bank defines the risk of direct contagion as that where non-performance by a bank leads to the failure of another one. The methodology used by the central bank makes it possible to identify this risk in terms of the sum of total losses, as it considers that a default event occurs when a bank runs into losses which bring its Capital Ratio down to below 4%. It also allows identification in terms of the number of banks, when the default event for one bank triggers non-performance by another, and this in turn dominoes to the other institutions (second round, spill-over effects). In its 2014 Report the central bank pinpoints the greatest risk of a spill-over effect as coming from an increase in the sum total of losses, whereas the risk in terms of number of banks from such spill-over effects has remained constant.

account of the inter-connected nature of networks, and there has also been an increase in the outstanding amount of assets in the system which would be affected, given that certain banks along chains have lifted their level of participation in the system in terms of total assets.

The Report additionally separates out four potential sources of spill-over risk from interconnection among financial institutions into 1) unsecured loans and holdings of securities, 2) derivative trading, 3) exchange rate risk, and 4) repo transactions. Recent trends in such sources of exposure suggest that the level of interconnection among institutions has risen, although the average sum total of exposure has fallen.

The financial position of households as of June 2014 was 28.9% of GDP, whereas non-financial private company borrowings accounted for 20.6% of GDP

The financial position of households[4] improved by 2.7pp with respect to June 2013. This strength was sustained by the increase in the value of securities held in pension fund portfolios, which was associated with lower interest rates over the period. This effect on overall savings outstripped the rise recorded in borrowings. Debt servicing by households as a percentage of available income was unchanged on the level of 2.9% seen in June 2013.

The funding of non-financial private companies grew by an annual figure of 11.7% in real terms. As mentioned above, this was mainly based on bond issuance in international markets. The higher level of funding raised abroad by companies (mostly the major ones) has increased leverage.

In the future the borrowing requirements of these companies in the domestic market could become sizeable as the monetary policies of the advanced countries are reversed, so they could be driven to seek more bank credit locally. This could give rise to a higher cost of borrowing for larger companies and a crowding-out effect of credit for SMEs.

The Mexican financial system has posted both higher assets and improved returns that generally remain above those reported by stock exchange listed companies

There has been a notable rise in the number of banks and a drop in the share of foreign institutions, especially among the *afores* (pension fund management companies) and brokerage firms. Financial system assets posted an annual growth of 6.1% in real terms at the close of 1H14. The fastest-growing financial intermediaries were the popular savings and credit institutions (PSCIs, or EACPs in Spanish), the regulated *sofomes* (multi-purpose financial companies), the *siefores* (pension fund investment companies), the development institutions (including the development banks) and the commercial banks. On the other hand, the assets of brokerage firms, unregulated *sofomes* and the bonded warehouses registered a fall in real terms against the previous year.

Compared to 1H13, as of June 2014 reported an increase in returns for *afores*, fund management companies, development institutions, surety companies and popular savings and credit institutions. Relative to the rate of return registered in June 2014 by Mexican stock exchange listed companies of 8.6%, only four of the 11 types of intermediaries for which information is available posted returns below this level, namely the PSCIs (7.9%), the credit unions (6.4%), the development institutions (5.8%) and the bonded warehouses (2.2%).

[4] The financial position of households is defined as the difference between assets held by them which are included in the M2 aggregate and borrowing arranged within the financial system (balance of consumer loans + balance of housing loans) as a proportion of GDP.

Commercial banks continue to represent the biggest share of the financial system, with assets accounting for 48.6% as of June 2014

The balance of commercial bank assets showed real annual growth of 7.4% with respect to June 2013. The most lively components were security investments and derivatives trading, whereas the loans portfolio rose at a more sedate pace than assets overall due to the impact of the economic slowdown on the demand for credit. Among the relevant events within the banking system there are the acquisition of two subsidiary banks of foreign institutions by Mexican investors, the authorisation of four specialized banks (of which two are already operating) and the withdrawal of the licence of a niche bank.

Income from loan business in the commercial banking sector was hit by the economic downturn noted since 2H13 and also by lower interest rates, which was reflected in a smaller growth rate for net interest margin, which, as of September 2014, was below the average of the past five years. On the expenditure side, administrative costs came down and there was a significant rise in the recognition of reserves, due to a change in the methodology used to rate the commercial portfolio which became fully effective between December 2013 and June 2014.

One of the vulnerable areas in the banking sector identified by the central bank relates to niche banking. The indicators for profitability and non-performing loans in this sector reveal that they have still not managed to become established. In addition to this, their business model entails certain inherent risks such as low asset diversification, problems in achieving a stable deposit base, and difficulties in compliance with prudential regulation.

The solvency of the banking sector is demonstrated by adequate capital and leverage ratios, and progress continues to be made in implementing liquidity regulation pursuant to Basel III

Although the capital ratio has come down slightly, it has held at adequate levels (moving from 16% in August 2013 to 15.8% in August 2014). Certain medium-sized banks, however, have lost the cushion they were operating with a year ago and so the central bank recommends lifting their capital levels if they intend to boost their assets at the same rate as in previous years. On the other hand, the leverage ratio has remained over 9%.

With respect to the new liquidity rules, both the central bank and the CNBV (National Banking and Securities Commission) are working on the regulatory framework for their implementation, and this is expected to become effective in the opening months of 2015. In general, implementation is not predicted to have a significant effect on the banking system, as most institutions already fully satisfy the Liquidity Coverage Ratio (LCR). There are, however, some banks that have an LCR below 60%, but since they have only recently been founded, the regulation is expected to grant them more time to comply with the requirement. Among the steps which institutions have taken to bolster their liquidity position, the Report points to increasing stable funding through retail deposits.

The portfolio of development banking and development funds is growing apace but this has included an increase in the non-performing portfolio

At the end of the 1H14, the direct loan portfolio of the development banking sector, FIRA and Financiera Nacional (FN) was MXN670.4bn, growing at an annual real rate of 11.6%. Moreover, by means of guarantees further net funding of MXN340bn was granted. In the past three years high growth rates have been observed in the development portfolio, mainly for infrastructure. It is also interesting to note that first tier direct loans have

continued to show buoyancy: the balance for this category already represents two thirds of overall direct credit provided by development institutions.

The portfolio of direct loans provided to the private sector showed a balance as of June 2014 of MXN477.6bn. Between June 2013 and June 2014 real growth for this portfolio was 9.6%. Within this there was notable growth of 12.2% in real terms of credit for the business sector, as well as for the housing and consumer segments, with real rates of 9.3% and 23.3% respectively. The balance of credit arranged for the public sector amounted to MXN185.3bn, with real annual growth of 16.8% against June 2013.[5]

The balance of the non-performing portfolio as of June 2014 showed an increase of an annual 5.4% in real terms. This was prompted by the growing mortgage portfolio within this category and the past-due portfolios of Nafin and Bancomext, which were primarily linked to the housing construction sector. By institution, this past-due portfolio split out into 79% for the SHF, 6.5% for Nafin, 6.3% for FIRA, and the rest was divided among FN, Bancomext and Banobras.

Although the non-bank financial intermediation sector as defined by Other Financial Intermediaries (OFIs) is smaller than commercial banking, its growth rate during the past three years has been significant

Whereas commercial banking has grown at an annual average of 4% over the past three years, the OFIs have done so at a rate of 11.4 %. In Mexico the OFIs account for approximately 20% of financial system assets and 22% of GDP.[6]

Within this sector, the *Fibras* (similar to REITs) stand out as being the intermediaries which have had the most growth, although for the moment no excessive risk-taking has been noted and exposure could be contained, given that prudential regulation has been issued. This regulation includes the requirement to keep a cap on borrowing (50% of the book value of assets) and to observe a minimum debt service coverage limit. An additional potential risk among these intermediaries is the mounting interest in issuing mortgage-backed securities or securities backed by housing developers loans, which would imply a potential increase in systemic risk from the Fibras and should be watched carefully. Something that also stands out is the importance of having a suitable incentives system in place that means Fibra managers or originators keep a portion of the issues, so as to share risks and gains with holders and in turn to head off excessive risk-taking.

Other institutions within the OFIs which should be closely monitored are the *certificados de capital de desarrollo* (structured equity securities, or CKDs), due to the fact that these have invested in portfolios of loan portfolios and therefore have a deeper interconnection with the system. Another segment mentioned as meriting attention are the mutual funds, since, as several offer their clients the option of same-day redemption for their investment, they could come up against the risk of a run in situations of stress where investors demand their funds to avoid

[5] The remaining MXN5.9bn to make up the total of MXN670.4bn in direct loans was for credit granted as a federal government agency.

[6] The categories which could be classed as OFIs according to FSB methodology are: brokerage firms, *sofomes* (both regulated or unregulated), hedge and investment funds, institutions or companies which provide any form of credit (such as auto-finance companies or department stores), institutions specialising in issuing asset-backed securities (such as Exchange-Traded Funds), structured equity securities (CKDs), and the infrastructure and real estate investment trusts (*Fibras*).

losses. Nonetheless, the central bank acknowledges that the regulatory measures of the mutual funds offset such risks.[7]

The FX, equity and interest-rate markets display episodes of volatility. With respect to market infrastructure, headway is still being made in adopting international best practices

Despite this volatility, both the Mexican peso and the Mexican Stock Exchange Index (IPC) have performed better than other countries. This has been as a result of the ample liquidity in the currency market, the orderly conduct of macroeconomic policy and the adoption of structural reforms, which are factors that have contributed towards boosting the rating of Mexican sovereign debt. On the other hand, the fall in interest rates is a consequence of these same factors, as well as of a climate of lower inflation and of the cut in the central bank's reference rate.

Other elements which have helped to overcome volatile periods have been the high level of international reserves, which have continued to grow and reached a historical high, and the fact that the International Monetary Fund (IMF) is in the process of assessing whether to renew the Flexible Credit Line.[8] Regarding the recent Mexican peso's depreciation against the U.S. dollar, the Financial System Stability Council[9] said that the prudential measures to which the banking sector is subject with respect to its foreign currency positions have meant that the volatility in FX markets does not represent any direct risk to its solvency or liquidity.

The main points with respect to the derivatives market are the changes in regulation and how it operates, both domestically and internationally. Looking abroad, in October 2013 the regulation associated with the Dodd-Frank Act came into force, which makes mandatory for interest rate derivatives dealt with a US counterpart to be traded via swap execution facilities (SEFs). The adoption of this regulation sparked a drop in the trading volume in Mexico of swaps that are benchmarked against the Equilibrium Interbank Interest Rate (TIIE). This fall was temporary though, and the volume is now ahead of pre-October 2013 levels, as most market participants have migrated their trading to SEFs.

The Report also points out that in Mexico the new rules applicable to market participants that trade with derivatives contracts listed in stock exchanges (Tripartite Rules), published and effective by May 2014, allow clearing houses to settle trades carried out on derivatives exchanges and on electronic platforms. Mexico's central counterparty clearing house for derivatives (Asigna) is also expected to be recognised as such by the European Securities and Markets Authority. This will allow European financial institutions that use Asigna to reduce their capital and margin requirements for trading.

With respect to the infrastructure in financial markets, the Report highlights the progress made by the various market participants in complying with the Principles for financial market infrastructure (the Principles) which were published by the CPMI (Committee on Payments and Market Infrastructures) and IOSCO (International Organisation of Securities Commissions) in April 2012. It also mentions the implementation of clearing house

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[7] These measures include: daily asset valuations, limits on portfolio concentration and diversification, a liquidity reserve requirement, and restrictions on withdrawals of funds per client if they face withdrawal orders *en masse*. Additionally, as part of the financial reform it has been established that the CNBV will issue rules to regulate the suspension of share buy-backs by investment funds and, where disorderly market conditions prevail, the CNBV may authorise investment fund managers to change buy-back dates without any need to amend their prospectuses.

[8] This line was renewed on 26 November 2014 for two years and is for an amount of almost USD70bn.

[9] Press Statement of 16 December 2014

regulations regarding card payments, which were issued by the central bank, as well as general provisions issued by the central bank and CNBV, to govern the terms and conditions on which services are provided in relation to payment networks, including interchange rates and fees charged among the participants which were referred to in the Payments System Act.

The results of the stress tests show that the banks and brokerage firms would generally retain reasonable solvency levels

Nevertheless, in extreme yet plausible scenarios certain institutions could suffer significant losses capable of putting their solvency at risk. In the credit stress testing the system would keep its capital levels above the regulatory minimum, although in the case of certain institutions these would show a lower level, even below 4.5%.

The main potential risks would come from the reaction of the financial markets to a disorderly return to normal of monetary policy in the United States, but the stress testing carried out by the central bank in various scenarios for increases of rates in the United States suggest that the system has sufficient capacity to absorb losses, as even in the worst case scenarios the system's capital level would not show substantial variations.

In the market stress testing, the biggest impact was from the changes along Mexico's interest-rate curve. In the credit stress tests the initial effects would be seen in higher interest rates and a subsequent rise in bank revenues. Yet with the passing of time the higher rates and the behaviour of other variables would bring about an increased probability of default as well as a higher NPL ratio, and would therefore lead to greater reserves. Although on average in most of the scenarios the system would not present problems of solvency, there would be some banks with capital levels that would drop below the regulatory bar. National interest rates are the variable where extreme values of them are associated with the least healthy capitalisation levels.

In the risk breakdown, the threats have taken on new significance which are associated with imbalances from excessive prolongation of the monetary stimulus in advanced economies, the lack of steam in economic recovery worldwide and geo-political events

The most substantial risk from outside is still of a sudden reversal of capital flows, which could materialise with swifter than expected economic recovery in the United States and greater inflationary pressures there, as well as from flagging economic activity in China or an escalation of geo-political conflicts.

The risk factors originating externally have been joined by, on the one hand, an exacerbation of the imbalances engendered by the dragging out of monetary stimuli programmes abroad, which adds fuel to market volatility, and on the other hand, a dampening of global economic activity and geo-political risks, which could affect investor confidence. Less robust economic growth worldwide could also deepen the downward correction in the oil price, which would add to the risks faced by countries that are exporters.

From within the main risk would be a waning domestic economy, which would make the financial system more exposed to both internal and external shocks. The central bank does, however, recognise that the latest economic indicators offer signs that economic recovery is underway and it is confident that stronger demand from abroad, the counter-cyclical fiscal policy, the extra monetary spur from the central bank itself, and the realization of benefits of the structural reforms, will all help to shore up the recovery.

Besides this, consideration is given to the risks deriving from low interest rates, as the risk exists in Mexico of companies or intermediaries over-leveraging or that low margins in banking activity might lead the banks to strive for greater returns, which inhibits their ability to deal with future shocks.

Lastly, the domestic risks include the impairment of consumer loans. Although growth of this portfolio has fallen, it could be revived. Here, the central bank expects recovery built on firmer foundations and considers it desirable for banks to analyze their customers' capacity to service debt, in order to reduce the risk of over-indebtedness and a higher increase in default rates. In the mortgage market, the potential new-found flexibility from mortgage subrogation calls for careful monitoring of trends in housing prices and credit growth, as well as the origination standards and arrangement terms underlying this.

Conclusion:

Although the central bank recognises the solvency of the Mexican financial system, it indicates that global financial vulnerabilities have increased. On top of the risks from abroad, particularly those associated with monetary policy definition in the United States and the future performance of the Mexican economy, there is now global economic weakness and a burgeoning shadow banking sector. In this situation, the quest for profitability and smaller risk premiums have made the financial system more sensitive to shocks of a different nature.

Mexico has stood out for its policies consistent with a market economy and its prudent handling of fiscal, monetary and financial policies, all of which has kept the risks to macroeconomic stability and the country's financial system in check. Within this economic context, inflation and the current account deficit have been held at low levels, whereas the public sector's deficit and borrowing are at sustainable levels.

We concur with the central bank regarding the importance of keeping those advantages for which the national economy has characterised up to now, given the prospect of future hikes in international interest rates and the emergence of certain weak-points that have shown up after the publication of the Report. Indeed, in the past few weeks, besides the downward revision of GDP growth forecasts, there has been an upturn in volatility in the FX market and a major drop in oil prices. As a result, the central bank took preventive measures to provide the FX market with liquidity and the SHCP announced it has hedges and resources available from the budget revenues stabilization fund to protect the federal government's oil revenues for 2015. However, if the adverse events persist for a significant length of time, they could constitute an additional risk to Mexico's external accounts and public finances. This underlines the importance of carrying out future fiscal reforms which might reduce the reliance of public finances on oil.

With respect to the greater exchange rate exposure which some Mexican companies might face, we think that it would be desirable for the financial authorities to pay closer attention to the disclosure of information on the derivative instruments held by the companies which issue bonds and shares, so as to monitor their capacity to cover the exposure in this area. One useful monitoring tool could be the Compliance Indicator for Derivatives Disclosure which was set up by the National Banking and Securities Commission (CNBV) in 2011, but it has not been updated since 2Q12.

On the other hand, we think that a higher level of loan arrangement activity both in commercial banking and development banking should be backed up by the recovery of domestic demand, to ensure that portfolio growth is healthy and sustainable across its various segments. As the central bank indicates, steps should continue to be taken to underpin the strength of the financial system and its capacity to recover from volatility episodes. Such steps should include measures to increase information and transparency on the position of non-financial companies which issue bonds, to confirm that the risks are properly hedged and to intensify efforts to provide

more information on the financial activities which are conducted through institutions or markets that are not subject to traditional regulation, for the purpose of obtaining a clearer idea of the scale of these and of the risks which they could entail for financial stability.

We agree that the changes which facilitate mortgage subrogation could lead to lending institutions providing a larger percentage of variable rate loans. This would exacerbate risks to the system as the interest rate risk would be passed on to borrowers, who are less able to manage the risk than the financial institutions. For this reason it would be a good idea to develop markets to hedge against prepayment risk, so that there could be a banking system where mortgages are arranged at fixed rates, while at the same time conserving the advantages of subrogation for consumers.

After the Report was published, the Foreign Exchange Commission, comprising members from the SHCP and the central bank, announced a programme of intervention in the FX market in which up to USD200mn can be auctioned daily to keep the currency market liquid. It is worth noting here that the market was showing normal liquidity conditions when the measure was announced.

As the Report by the central bank says, a considerable upturn has been noted in first tier development banking. We feel that this is not a positive phenomenon, as first tier activity tends to give rise to distortions and occasionally crowds out the private sector.

Looking ahead, we think it would also be advisable for the Report to cover Infonavit's situation, since this is an institution that, given its size and significance for the Mexican financial system, could be classified as being of systemic importance.

The Report highlights the regulation on *Fibras*, which places limits on the leverage levels that these are allowed to have. We think that this regulation was unnecessary because: i) *Fibras* are vehicles that are acquired by institutional investors, ii) they have an adequate disclosure system, and iii) they do not constitute a systemic risk.

Finally, in our view the regulations which provide incentives for a greater number of derivatives trades to be channelled to the central counterparty are positive, since the risks to the financial system will be reduced. This nonetheless makes more necessary to have adequate regulation and supervision of the counterparty, as now a higher concentration of risks will be focused on this institution.

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