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Mexico

Developing a Sound Governance and Institutional Framework

Reserve management objectives and coordination

745. The main objective for Banco de Mexico (the Bank) in the management of its reserves is the maximization of returns subject to liquidity needs and constraints. With the implementation of a floating exchange regime in 1995, the Bank has been increasing the weight that it places on return enhancement, while also placing high attention on other risks involved in its investment decisions.

746. There is no explicit coordination between monetary policy decisions and external debt management. However, in the past, when the Bank had liabilities with the IMF, reserves were split to allow the synthetic purchase of an SDR-denominated portfolio in order to hedge the currency risk. Additionally, the Bank, as a financial agent for the Federal Government, has a mandate to invest and manage the resources that were pledged as collateral in the Federal Reserve Bank after the 1989 negotiations of the Mexican Brady Bonds; in performing these duties, the Bank must observe restrictions imposed under the "Collateral Pledge Agreement."

Transparency and accountability

747. The Bank publishes its Reserves on a weekly basis in its Summarized Balance, and its Assets and Liabilities on a monthly basis in the Data Template on International Reserves (foreign currencies).

748. However, with respect to a more detailed disclosure, the Bank considers the effort required to explain the technical issues related with reserve management to the public to be very costly. Instead, that effort should be placed in addressing more important topics of national interest.

749. External audits are performed once a year and the results are delivered only to the Congress and the President.[42]

750. Internally, the audit department monitors operations on a daily basis to verify if the bank norms are being met. However, the middle office is responsible for monitoring whether investments comply with the guidelines set by the Board of Governors on a daily basis as there are degrees of freedom that allow some deviations from the benchmarks. These deviations are limited using a Value-at-Risk approach.

751. The Bank keeps formal documentation of every topic approved by the Board of Governors. The General Direction of Central Banking Operations also gives authorizations in writing.

[42] Chapter VII, Article 51, subindex III of Banco de Mexico's Law (BDML) states: "In April of each year, a report on the implementation of monetary policy during the second semester of the previous year and, in general, on the activities of the Bank throughout said year, within the context of the domestic and international economic situation."

Finally, both the General Director and the Director of Operations are constantly informed of every investment strategy put in place, and of the performance generated against the benchmarks on a daily basis.

752. Recruiting employees with high business ethics and high professional skills is the way to ensure sound management of internal operations. Due to the confidential nature of the work within the Direction of Operations, a particular effort is taken in selecting personnel. Training the staff by sponsoring them to graduate studies, as well as sending them to highly recognized Central Bank Seminars, are ways of confronting the difficulty of retaining high-quality staff. In the end, however, the most efficient tools to avoid this situation have been a challenging work environment and an increased level of responsibility.

Institutional framework

753. The Constitution of Mexico gives total autonomy to the central bank and defines the control of inflation as its main objective.

754. According to Banco de Mexico's Law (BDML), reserves are wholly owned by the Bank in order to facilitate the accomplishment of the objective mentioned above.

755. The BDML also gives power to the Bank's Board of Governors to define policies and standards in order to perform its duties, including the management of reserves. The types of operations, the definition of reserves, and the authorized assets in which to invest are defined in BDML Articles 7, 19, and 20, respectively (see Box 1).

756. Even though the "Exchange Rate Commission" (composed of members from the Ministry of Finance and Banco de Mexico) is the highest decision authority on exchange rate policy and the management of foreign reserves, in practice, it is the Bank's Governing Board that authorizes the main investment guidelines. The Governing Board is informed semiannually of the investment performance; nevertheless, reports are available daily at their request.

757. An Investment Working Group formed by senior operating staff is responsible for the oversight of ongoing operations. Weekly meetings are held to evaluate and decide on the investment strategy to be followed by headquarters-based staff.

758. External fund managers act independently based on the same guidelines placed by the Board for internal operations. There are no predetermined proportions on the amount of reserves that can be placed with external managers; although currently approximately 5 percent of total reserves are delegated to five different institutions. These institutions provide a list of all the operations executed on a daily basis, and deliver a performance report on a monthly basis.

759. In addition to the Investment Working Group, a Risk Management Unit, which is independent from the Operations Department, supervises to ensure that risks and limits in the management of reserves are met on a daily basis by both the external managers and the Operations Department. Within the Operations Department, foreign exchange dealing operations are executed independently from the investment reserves management activities.

760. A Counterpart Working Group that assembles every six months, led by the General Director of Operations and formed by the Operations Department and the Risk Management Unit, is responsible for evaluating and approving the addition or deletion of counterparts from a predefined authorized list.

Establishing a Capacity to Assess and Manage Risk

Risk management

761. The main risks that the Bank faces are liquidity, credit, currency, and interest rate risks. To deal with all of them the Bank has a specific approach. The Board of Governors defines the strategic asset allocation embodied in two benchmark portfolios: one for the investment portfolio and the other for the foreign exchange diversification of reserves. Once the benchmarks have been defined, the Board sets the guidelines that will apply to the active management of the international reserves.

762. The investment benchmark has been modified several times; currently it is composed of

Box 1. Banco de Mexico's Law

BDML ARTICLE 7 states, among other things, that Banco de Mexico shall be entitled to perform activities such as:

I. Deal with securities;

II. Make deposits in either domestic or foreign credit institutions or security depository institutions;

III. Purchase those securities provided for in Article 20, Section II, issued by international financial institutions or legal entities with foreign domiciles;

IV. Carry out transactions involving foreign currency, gold, and silver, including repurchase agreements.

BDML ARTICLE 19 states: The reserve provided for in the previous article shall be composed of:

I. The foreign currency and gold, property of the Central Bank, that are free of all lien and whose availability is not subject to any restriction;

II. The amounts resulting from the difference between Mexico's participation in the International Monetary Fund and the balance of unpaid contributions to said institution that are payable by the Bank, when this balance is less than the aforementioned participation; and

III. The foreign currency procured through financing obtained for exchange regulatory purposes from the legal entities referred to in *Article 3, Section VI*. To determine the amount of the reserve, the foreign currency not yet received from the sale of domestic currency will not be taken into consideration; and the Bank's liabilities in foreign currency and gold, except for those liabilities with maturities over six months and those corresponding to the financing referred to in Section III of this article, will be deducted.

BDML ARTICLE 20 states that reserve investments must be made in securities, deposits, or other obligations issued by highly rated foreign institutions.

Pursuant to this Law, the term foreign currency includes foreign bank notes and metallic coins, bank deposits, negotiable instruments, securities, and all types of credit documents payable abroad and denominated in foreign currency, as well as international means of payment in general. The foreign currency qualified to be part of the reserve is only the following:

I. Foreign bank notes and metallic coins;

II. Deposits, negotiable instruments, securities, and other liabilities payable outside national territory that are considered to be first rate in international markets, denominated in foreign currency, and payable by international financial institutions, foreign entities, and governments other than the Mexican Government, provided they are highly liquid or redeemable within a term no longer than six months;

III. Credits payable by central banks, redeemable within a term no longer than six months, and which are current; and

IV. The special drawing rights issued by the International Monetary Fund.

U.S. Treasury instruments (65 percent), U.S. agencies debt (32.5 percent), and AAA credit card ABS (2.5 percent), and is of a 1.25 year duration. Securities lending is permitted and is executed through three securities lending agents (that happen to be three of the Bank's custodians) and the income generated is considered part of the return that is compared against the performance of the benchmark.

763. The foreign exchange benchmark is normally modified on a yearly basis, and currently it is composed of 88 percent dollars and the remaining 12 percent in other G-7 currencies and Swiss francs, but historically the average has been 90 percent dollars vs. 10 percent non-dollars. The use of derivatives is authorized as part of the foreign exchange active management.

764. For both benchmarks Value-at-Risk (VaR) methodology is used to estimate on a daily basis the portfolios' exposure to market risk. VaR is estimated for a one-month horizon period with a 95 percent confidence interval. The maximum amount of risk allowed is equivalent to 0.25 percent of the difference portfolio VaR. Additionally if

the maximum cumulative underperformance in any calendar year, or any part of a calendar year, reaches 50 basis points (or more) below the return of the fixed income benchmark (or 100 million dollars (or more) worse than the foreign exchange benchmark) the portfolio will be managed passively thereafter so as to replicate the benchmark for the remainder of the calendar year. For both benchmarks, the middle office marks to market the positions daily in order to verify that investments comply with the guidelines set by the Board of Governors.

765. In relation to liquidity, credit, currency, and interest rate risk:

- Liquidity risk: The Board has chosen G-7 currencies and Swiss francs for foreign exchange operations and as those that constitute the Central Bank Forex Benchmark. For investment decisions the Board has chosen assets with deep secondary markets and high credit quality (such as U.S. treasury instruments, agencies, and industrialized country debt). Additionally the Bank splits its reserves into several tranches. Out of the 88 percent of the international reserves that are held in U.S. dollars, 6 percent are in a liquidity portfolio with a very short duration.[43]

- Credit risk: The investment guidelines do not allow the purchase of sovereign securities lower than Aa2 as rated by S&P in their long-term debt, placements with foreign banks must be in A2, P2 institutions as rated by S&P and Moody's, respectively, in their short-term debt, and the total exposure to bank risk cannot exceed 50 percent of the international reserves. Finally, the investment in AAA credit card asset-backed securities is allowed. Ratings are reviewed semiannually as well as limits for individual bank exposure. These limits are based on their relative credit rating against the rest of authorized bank institutions and also based on their market competitiveness.

- Currency risk: Due to the nature of the Bank's Balance expressed in Mexican pesos, foreign exchange movements in the peso-dollar market have a direct impact on the Bank's results. In the internal management of international reserves, however, currency risks arise from deviations against the foreign exchange benchmark.

- Interest rate risk: The exposure to interest rate risk arises from deviations against the investment benchmark, even though in this particular portfolio the use of derivatives is not allowed. The Value-at-Risk methodology described above is used to monitor and control risk. Additionally, the investment staff is not authorized to buy more than 10 percent of any individual security and the maximum maturity investment is 10 years.

Operations in efficient markets

766. The Bank agrees that undertaking transactions in deep and well-established markets ensures that reserve-related transactions can be easily absorbed at market-determined prices without undue distortions or adverse impacts on the level and availability of foreign exchange reserves. That is why the currencies and assets used by the Bank comply with this requirement. Nevertheless, the Bank recognizes that there could be extreme situations such as LTCM or September 11 events that can cause liquidity to disappear at any time, making it impossible to avoid these distortions for the management of international reserves.

[43]The liquidity portfolio considers investments with maximum maturities of three months (although investments in instruments such as U.S. treasuries and U.S. agencies can be made liquid on a same-day basis).