CASE STUDY

Financial Sector Assessment Program (FSAP) 2016

MEXICO

1. PROJECT HIGHLIGHTS

Key Cross-Country Benefit	Key National Benefit
Reducing risk of transmission of financial instability across borders that would weaken the global financial architecture.	***National financial sector regulation strengthened and crisis management framework enhanced.***

2. QUICK FACTS

Categories	Project Details
Project Name	Financial Sector Assessment Program (FSAP) in Mexico
Project Description	In today's interconnected world, instabilities and distortion in countries financial sectors can quickly be transmitted to other countries and trigger international financial instabilities. To comprehensively and timely assess the situation in countries with important financial sectors, the FSAP is conducted on a regular basis – every five years in the case of Mexico. The 2016 FSAP focussed on the public sector and long-term resilience in finance.
Global Public Good (GPG) Theme	Stable international financial architecture
Sub-Theme	Prevention and management of global financial crises

Disclaimer: We based the case study on the information cited and publicly available as of May 2023. The findings – especially concerning the GPG perspective – have been concluded to our best knowledge. The views expressed are the authors' assessments and do not necessarily reflect the project stakeholders' views. Any errors that remain are our responsibility.

Sector	Financial sector
Country of Implementation	Mexico
Region	Latin America and the Caribbean
Income Category	Upper-middle-income economies
Implementation Period	2016
Project Volume	N.a.
Financial Source	World Bank's Economic and Sector Work Studies
Instruments	Technical assistance and policy support
MDB Involved	World Bank
Implementing Partner	World Bank, International Monetary Bank
Link to Detailed Project Information[1]	https://documents1.worldbank.org/curated/en/621671508177153708/pdf/Mexico-2016-FSAP-Update-FSA-03232017.pdf#:~:text=The%20Financial%20Sector%20Assessment%20was%20prepared%20in%20the,and%20the%20Monetary%20and%20Capital%20Markets%20Department%2C%20IMF

3. WHY THIS IS A GOOD PRACTICE

This project is a good practice example for implementing the following features that promote GPG provision:

- **Scalability:** The FSAP process can be easily scaled up as the budget for the exercise derives solely from the resources of the partner international financial institutions (IFIs): the World Bank and IMF. While the first FSAP in 2006 looked at five areas, the 2022 looked at 16, indicating an expansion of scale. [2]
- **Sustainability:** By building on previous FSAPs, the 2016 mission helped to strengthen the country's financial stability. As an economy with a systemically important financial sector, this contributed to maintaining the stability of the global financial architecture in the wake of the global financial crisis. The sustainability of the FSAP depends on the commitment of a country to implement the proposed

[1] Unless otherwise stated, the information used in this case study can be found in this source.

[2] International Monetary Fund, 'Mandatory Financial Stability Assessments under the FSAP', IMF, September 2022

recommendations to improve the financial stability. In the case of Mexico, which has conducted significant reforms following FSAP screenings, those are highly sustainable, as they indeed translate into actual policy.

- **Transformability:** The FSAP process is transformative as each mission involved collaboration and engagement between the World Bank and IMF and the various national authorities including both the central bank and finance ministry as well as the various supervisory bodies. This leads to recommendations for reforms, whose progress can be tracked by each successive FSAP mission. Through the ongoing monitoring and recommendations, it aims at incremental improvements in the financial sector which can eventually transform it towards a more resilient and stable pillar in a country's institutional framework.

4. PROJECT INFORMATION

4.1 CHALLENGES OF GPG PROVISION IN THE COUNTRY CONTEXT

Stable financial architecture is a global public good, because of the tendency for financial turbulence to spill over across borders. However, the domestic effects of financial instability are often not as pronounced as the international ones which is why countries might have an incentive to deprioritise financial stability in comparison to other macroeconomic pillars, for example rapid growth. Without concerted international action, this feature leads to an underprovision in support for the level of financial stability that is necessary for prosperity, growth and political stability worldwide. **If the international financial architecture deteriorates and financial crises spread over between countries, this has severe global consequences as the financial sector is highly interconnected and it is difficult to prevent the consequences once they have started rolling.**

For this reason, it is important to establish appropriate early-warning systems that can monitor the financial sector and recommend measures before a crisis occurs**. For this reason, the IMF established the Financial Sector Assessment Program (FSAP) as a comprehensive and in-depth assessment of a country's financial sector**. Based on the findings in these assessments, recommendations and adjustments to increase the financial stability are implemented.[3] In 2010, in the wake of the GFC, the FSAP became a mandatory part of the IMF's surveillance measures for at that time 25 countries which have a systemically important financial sector (SIFS). Today, 47 countries are identified as SIFS. [4] [5] 32 of them go through a FSAP every five years and 15 of them every ten years. The list includes major development economies as well as developing economies such as Mexico. The World Bank takes over the systematic review of developing countries that are relevant from a

[3] International Monetary Fund (2023): https://www.imf.org/en/Publications/fssa

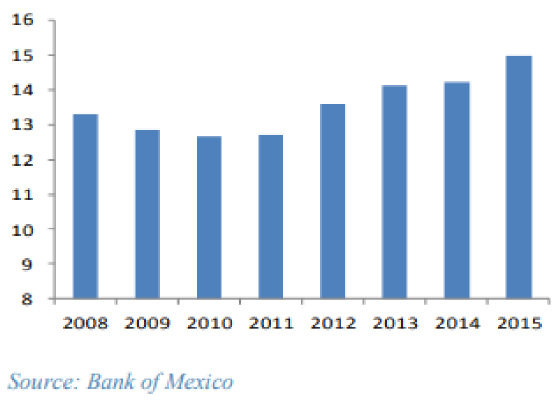
[4] International Monetary Fund (n.d.): https://www.imf.org/en/Publications/fssa/mandatory-financial-stability-assessments-under-the-fsap

[5] The countries are Australia, Austria, Belgium, Brazil, Canada, Chile, Hong Kong SAR, Denmark, Finland, France, Germany, Greece, India, Indonesia, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, Norway, Portugal, Russia, Saudi Arabia, Singapore, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States, Argentina, Chile, Colombia, Czech Republic, Hungary, Malaysia, New Zealand, Peru, Philippines, Poland, Romania, Slovakia, South Africa, Thailand, United Arab Emirates.

global perspective. The Bank has therefore supported Mexico with a series of FSAPs undertaken jointly with the IMF. This case study focuses on the one carried out in 2016.

Mexico has experienced stable economic growth and inflation as well as sound domestic macroeconomic indicators (e.g., household debt) during the last decades. Its financial sector is classified as systemically important. This classification is based on its size of the financial sector and the connectedness with other financial sectors across the world. Being assessed as systemically important means that instabilities are likely to effect other countries. **Potential risks to the financial stability stem from Mexico's high international interconnectedness** – in particular towards the US. This makes it vulnerable to tightening global financial conditions. Some challenges further include the high concentration in the banking sector or a high incidence of informal financial activities: About half of the Mexican population does not use formal financial services.[6] To monitor the financial system and to assess its development, Mexico is part of the FSAP on an ongoing basis since 2001. Both the assessments in 2006 and 2011 certify Mexico a fairly sound financial system with some needs for remedial action. Through the continued support of, for example, the World Bank, Mexico was able to weather the global financial crisis without large disruptions.

FIGURE 1: MEXICO'S HOUSEHOLD DEBT



Source: [World Bank (2017)]() based on data by Bank of Mexico

4.2 INTERVENTION

4.2.1 Project Design and Agents of Change

Between April and June 2016, the rotational FSAP in Mexico took place. This included an assessment by a so-called mission team consisting of members of the World Bank together with the International Monetary Fund. It examined eight areas of the financial system in Mexico, assessed the country's status quo in these areas and derived recommendations to improve the performance. The themes and sub-categories that were part of the analysis are presented in Figure 2.

The FSAP develops recommendations to improve the financial stability in a country. Those recommendations are not binding but are of advisory nature. **However, in the scope of future FSAP assessments and the important signalling character that these assessments yield, it makes sense for a country to follow the recommendations and implement corresponding reforms.**

[6] International Bank for Reconstruction and Development /The World Bank (2018): https://documents1.worldbank.org/curated/en/663471541444778751/pdf/Mexico-Country-Program-Evaluation-An-Evaluation-of-the-World-Bank-Group-s-Support-to-Mexico-2008-17.pdf

FIGURE 2: PROJECT COMPONENTS

Financial System Structure and Challenges

- Banking Sector
- Pensions
- Insurance
- Mutual Funds
- Other Financial Intermediaries

Financial Markets

Financial Markets Infrastructure

- Payment Systems
- Insolvency and Secured Creditor Rights
- Credit Reporting Systems

Micro-Prodential Regulation, Supervision and Oversight

- Banking
- Securities

Macro-Prudential Policy Framework

Systematic Liquidity: Framework and Risks

Crisis Management and Financial Safety Nets

- Bank Recovery and Resolution
- Deposit Insurance

Financial Sector Development Strategies

- State-Owned Financial Institutions
- Increasing Financial Access
- Developing Long-Term Finance

Source: Oxford Economics based on World Bank (2017)

4.2.2 Expected Results

The 2016 FSAP mission issued several recommendations for future action to help strengthen financial stability going forward. The areas of recommendations and the recommended time frame of implementation are shown in Table 1:

TABLE 1: RECOMMENDATION AREAS

Area of Intervention	Time Frame
Institutional Arrangements and Governance	Medium-Term
Financial Stability Policy Framework	Short-Term

Financial Sector Oversight	Short-Term, Medium-Term
Deposits Insurance, Crisis Management, and Resolution	Medium-Term
Development Banks	Short-Term
Pensions	Short-Term
Small and Medium-size Enterprise Finance	Medium-Term

Source: Oxford Economics based on International Monetary Fund (2016)

The recommendations in the 2016 FSAP span from institutional arrangements and governance over the field of financial stability policy framework to long term finance, among others. As stated above, the recommendations themselves are not binding. **Accordingly, the expected results heavily depend on the country ownership of these recommendations and on the political commitment to translate the recommendations to actual policy reforms.** For example, following the recommendations of a previous FSAP, a Financial System Stability Council (CESF) was implemented to conduct macro-prudential oversight. This institution is a sustainable improvement and contribution to the stability of the Mexican financial sector which provides strong positive externalities to other countries. As the subsequent FSAP after 2016—the 2022 FSAP—has already been conducted, one can analyse the sustainability of the 2016 FSAP with respect to improvements for financial stability.

For the key recommendations in the 2016 FSAP, some of them have not been implemented yet, some of them have been partially implemented and some of them have been implemented. With regard to the international dimension of measures – i.e., recommendations that contribute to stabilising the international financial architecture – the conclusion is mixed. **While for example the recommendation to strengthen the status of the CESF for assessing financial stability risks has been partially implemented, adopting a framework to monitor and correct legislative gaps in the financial supervision has not yet been implemented**.[7]

5. PROJECT IMPACT

5.1 NATIONAL BENEFITS

For Mexico, the FSAP in general yields multiple benefits: First, through the external assessment, it has access to information and technical assistance that helps to improve and strengthen the financial sector. **Being a middle-income country in the transition towards more prosperity and development, institution building and functioning state institutions are highly important**. Accordingly, the FSAP helps to credibly and constantly monitor the own financial system and adjust it, if necessary. Second, the examination within the framework of this highly esteemed programme creates good signals for foreign investments. If the financial system of Mexico is considered as sound and stable by independent institutions, foreign investors are more likely to invest in the country. This, in turn, yields economic profit and fosters growth for Mexico.

Furthermore, those assessments—being conducted partly by the World Bank—serve as basis and create new scope for additional development policy financing by the Bank. For example, previous FSAPs have underpinned

[7] International Monetary Fund (2022): https://www.imf.org/en/Publications/CR/Issues/2022/11/04/Mexico-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-525439

a DPL specifically targeted at finance and growth in Mexico in 2006.[8] **Undertaking regular evaluation programmes increases Mexico's credibility to pursue improvements in the financial sector and hence the attractiveness as cooperation partner for the World Bank.**

5.2 CROSS-COUNTRY BENEFITS

By comprehensively assessing the status quo in the Mexican financial sector, the 2016 FSAP—like previous and subsequent ones—contributed to an overall strengthening of the global financial architecture. It was very sensitive towards potential weaknesses or flaws in the performance of this important sector and was able to serve as an early-warning system before a severe crisis emerges. **The reforms identified by the FSAP process had increased Mexico's financial resilience, which in turn had strengthened its contribution towards the GPG of a stable financial architecture**. Overall, macroeconomic policies were found to be strong, and the financial system broadly resilient to adverse shocks.

Based on its schedule of an assessment every five year and gradual implementations of (parts of) the proposed reforms by the country, the FSAP contributes to a successive adjustment of the Mexican financial sector to new challenges. This is not only beneficial for Mexico itself, but also for other countries: Not only is Mexico an important destination for foreign direct investments from other countries, which are dependent on sound macroeconomic conditions. It is also a key player for the financial stability both in the region and along multiple other developing countries. This is made clear by its classification as systemically important financial sector. **Instabilities in the Mexican financial sector would have significant negative externalities to other countries.** Accordingly, the FSAP in Mexico significantly contributes to preventing the emergence of a global financing crisis and strengthening the financial architecture.

Risks to financial stability can come from many sources, including climate change. The work for the 2016 FSAP preceded the culmination of the international climate change negotiations that led to the Paris Agreement at the Conference of the Parties that was signed that year. However, slowing climate change, which is integral to the GPG of Climate & Environment, was a frequently cited issue in Mexico's 2022 FSAP.[9]

The report following the 2022 FSAP said that financial sector should play a bigger role in reaching Mexico's climate goals. It urged the authorities to establish a climate finance strategy and introduce a green taxonomy. Development financial institutions could be given more ambitious climate finance targets to deepen green markets, it said. Uncertainty over the magnitude and timing of these risks pointed to the need for further refinement of risk analysis to inform policy, it added.

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[8] World Bank (2006): https://documents1.worldbank.org/curated/en/210471468046785469/pdf/PID010Appraisal0Stage.pdf

[9] International Monetary Fund (2022): https://www.imf.org/en/Publications/CR/Issues/2022/11/04/Mexico-Financial-Sector-Assessment-Program-Financial-System-Stability-Assessment-525439

6. LESSONS FOR FUTURE GPG PROVISION

6.1 SUCCESS FACTORS

A report by the World Bank Group's Independent Evaluation Group (IEG) into the Bank's overall options between 2008 and 2017, rated the "financial cluster", which included the 2012 and 2016 FSAP reports, as "highly satisfactory". The World Bank's series of FSAPs contributed significantly to the stability agenda and sound financial regulation. It said: **"**The FSAPS were highly praised by the authorities. the government's efforts to strengthen financial sector prudential oversight yielded positive results."[10] It concluded that, in the financial sector, the **World Bank's series of FSAPs contributed significantly to the stability agenda and sound financial regulation**. Improvements in prudential oversight, bankruptcy regulation, and other areas were reflected in the country's 2014 financial reform regulation.

In general, the FSAP combines various features that make it a good practice and suitable instrument for a comprehensive financial sector assessment and a contribution to strengthening the international financial architecture as GPG. First, the implementing agencies—the World Bank and the IMF—have a high level of integrity and experience. As a result, **their assessments enjoy a high degree of credibility—one crucial stabilising factor for the international financial system**. Second, the recurring cycle of FSAP makes sure that the continuous process of a country can be monitored and that even incremental changes are being noticed. Combined with that, the classification of countries with systemically important financial sectors and monitoring intervals that are adapted to the important account for the fact that different countries produce different externalities to the international financial system and that it is important to focus on those countries that produce the most externalities.

"The FSAPs were highly praised by the authorities. The government's efforts to strengthen financial sector prudential oversight yielded positive results." — International Bank for Reconstruction and Development /The World Bank (2018)

6.2 HOW TO REPLICATE THE GOOD PRACTICE

In addition to that, the following lessons can be learnt from the project and can be used to replicate the good practice project:

- One of the main benefits of the FSAPs is that they produce recommendations of a micro- and macro-prudential nature and on developmental needs in developing and emerging market economies, tailored to country-specific circumstances.
- As financial stability assessments under the FSAP are a mandatory part of surveillance for members with SIFS and are currently expected to take place every five or 10 years, they are able to provide

[10] International Bank for Reconstruction and Development /The World Bank (2018): https://documents1.worldbank.org/curated/en/663471541444778751/pdf/Mexico-Country-Program-Evaluation-An-Evaluation-of-the-World-Bank-Group-s-Support-to-Mexico-2008-17.pdf

signals to international regulators about their relative systemic relevance in transmitting shocks across borders.

- The FSAP process can be easily replicated in other economies if international regulators believe that the maintenance of global financial stability would be improved by examining other national systems. This has already happened: the mandatory FSAP began in 2010 with 25 countries but in 2012 was expanded to 29 jurisdictions, and again in 2021 to 47.
- As many programmes by the World Bank heavily depend on country ownership and the country's credibility to implement the designed reforms, it makes sense to have tools that holistically monitor the country's performance up to a certain point. In the case of the FSAP in Mexico, the World Bank can look back at at least 20 years of financial sector assessment and five in-depth analyses that provide a comprehensive and reliable description of the current status quo and the suitability for subsequent programmes.