

CAPITAL MARKET DEVELOPMENT

(TC-98-05-12)

EXECUTIVE SUMMARY

EXECUTING AGENCY: S.D. INDEVAL S.A. de C.V.

BENEFICIARY: Cámara Mexicana de Compensación y Liquidación ("CMCL"). Investors in the Mexican stock market, directly through their individual stock holdings and indirectly through pension and mutual funds, will benefit from a higher level of confidence and efficiency resulting from the creation of a clearinghouse that employs international standards of operation.

OBJECTIVES: The principal objective of the MIF Technical Cooperation is to support the creation of a Mexican securities clearinghouse that is adequately capitalized and regulated and has an efficient and low cost operating structure.

DESCRIPTION: The Project will finance the execution of eight activities required for the establishment and operation of the CMCL: (i) drafting the regulatory framework required for securities clearing house operations and proposed improvements to existing legislation; (ii) developing of CMCL's financial plan, including its fee structure; (iii) developing of CMCL's internal auditing standards and procedures; (iv) developing of the CMCL financial safeguard system and risk management operating regulations; (v) developing of CMCL's bylaws, corporate governance and general rules of operation and procedure; (vi) training for CMCL and Comisión Nacional Bancaria y de Valores (CNBV) staff responsible for risk management; (vii) providing a dissemination campaign to market participants, including the circulation of a comparative study with international institutions equivalent to CMCL; and (viii) identifying critical areas for the development of the Mexican capital markets that could qualify for further support from the IDB

PROJECT COST AND FINANCING:	Modality:	Grant
	Beneficiary:	US\$1,500,000
	MIF:	US\$1,500,000
	Total:	US\$3,000,000

Executive Summary

Page 2 of 2

IMPLEMENTATION	Period of execution	12 months
SCHEDULE:	Period of disbursements	14 months

ENVIRONMENTAL CLASSIFICATION:	The Environmental Management Committee considered this project at its meeting of June 26, 1998.
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CONTRACTUAL CONDITIONS:	None
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I. COUNTRY AND PROJECT ELIGIBILITY

- 1.1 This technical cooperation has been designed to strengthen the capital markets in Mexico through supporting the creation of the country's securities clearance and settlement system. The project is thus consistent with the general objectives of the Bank and the MIF to strengthen and expand private investment and capital markets as the basis for economic and social development. Mexico was declared eligible to receive all modalities of MIF funding at the Donors Committee meeting of January 21, 1994.

II. BACKGROUND

- 2.1 Investor confidence in securities markets is absolutely essential for these markets continued operation and growth. Thus, guaranteed clearance and settlement is crucial to assure buyers and sellers that their trades will take place as agreed. In Mexico today, even though clearance and settlement of securities trading is done under a DVP environment at INDEVAL, it still is primarily the responsibility of each broker/dealer, to effect the final delivery for settlement. This system exposes the Mexican financial markets to an unnecessary level of risk and is not in accordance with international best practices as expounded by industry groups such as the Group of Thirty (G30).
- 2.2 Moreover, financial instruments are increasingly listed and traded across borders. An emerging market sometimes finds itself competing with a well-developed capital market to offer a similar financial instrument and the emerging market frequently finds itself at a relative disadvantage with respect to the investor's confidence. This is presently the situation with the Bolsa Mexicana when it competes to offer Mexican stocks that are also traded as American Depositary Receipts (ADRs) in the New York Stock Exchange. Credit committees of financial institutions may limit the amount of trading activity that can be done in the emerging market because of an unwillingness to keep significant margin collateral or net capital deposits at clearing houses in emerging markets. One of the objectives of this project is to increase confidence in the Mexican capital markets so domestic and foreign institutions increase their trading activity at the Bolsa Mexicana.
- 2.3 To accomplish this, INDEVAL is proposing the creation of a securities clearing house called the Cámara Mexicana de Compensación y Liquidación (CMCL). The Mexican Government and the private sector support the creation of CMCL. CMCL will initially provide clearance and settlement services for securities transactions in the Bolsa Mexicana and eventually to over-the-counter markets ("OTC"). The CMCL will act as the counterparty to each member and guarantee the successful clearance and settlement of all securities trades on the Bolsa Mexicana and eventually in the OTC markets. For the CMCL to become an effective

entity in the Mexican market, it must operate within a solid legal framework, its operating systems must be safe and efficient and its financial safeguards must be adequate for the risks to which it is exposed.

III. PROJECT OBJECTIVES AND COMPONENTS

- 3.1 The principal objective of the MIF Technical Cooperation (TC) is to support INDEVAL in its creation of a Mexican securities clearing house (CMCL). The MIF TC will consist of eight activities required for the establishment and operation of the CMCL:
- 3.2 (i) Regulatory Framework. The project will fund the preparation of a draft regulatory framework required for clearing house operations. The regulations - possibly to be issued under the Ley de la Comisión Nacional Bancaria y de Valores- are continually evolving and will be prepared in close coordination with the regulatory body for banks and securities, the Comisión Nacional de Banca y Valores (CNBV). INDEVAL and the CNBV have already formed working groups (including Banco de Mexico) which will meet on a regular basis to discuss the progress of the project and ensure a constant dialogue regarding the substance of the regulatory framework. It is not anticipated that the approval of any legislation will be necessary for the operation of the CMCL. Nonetheless, the project will finance a review of existing legislation (ie. bankruptcy law, civil and commercial codes) with regard to the operation of a clearing house.
- 3.3 (ii) Financial Plan. INDEVAL will fund the development of CMCL's fee structure that covers CMCL cost and is acceptable to market participants, as well as a sensitivity analysis and market testing for such fees.
- 3.4 (iii) Auditing Standards. The project will fund the development of internal auditing standards and procedures (which meet international standards) to be applied to CMCL and its clearing members which are also consistent with principles and procedures established by the Instituto Mexicano de Contadores Publicos (IMCP).
- 3.5 (iv) Financial Safeguard System. The project will fund the development of the CMCL financial safeguard system (FSS). The FSS is the cornerstone of CMCL's clearance and settlement operations and is comprised of the amount and nature of member's contributions to guarantee clearance and settlement operations. Members will be required to provide an initial capital contribution and place in reserve callable capital contributions. The design of the FSS will also include establishing risk management procedures and financial supervision designed to measure and model CMCL's exposure to clearing members under current and future market conditions, daily mark-to-market to prevent the accumulation of losses, and a system to administer collateral.

- 3.6 (v) Organizational Structure and Regulations. The project will fund the development of CMCL's bylaws, corporate governance and general rules of operation and procedure.
- 3.7 (vi) Risk Management Training. The project will fund risk management training for CMCL, INDEVAL and the CNBV staff responsible for risk management.
- 3.8 (vii) Dissemination. The project will fund a dissemination campaign to international market participants to inform them of the creation of the CMCL and detail the improvements resulting from the reform. As part of the dissemination campaign the TC would finance the preparation and circulation of a comparative study with international institutions that are equivalent to CMCL;
- 3.9 (viii) Further Developments: The capital markets are very dynamic, and continuous developments to stay competitive in global markets are required. The project will fund an analysis to identify critical areas for the development of the Mexican capital markets, that would include an assessment of which areas could qualify for further support from the IDB. In addition, this category will finance project administration and an evaluation at the end of the project. All three activities will require about 5% of total project costs.

IV. EXECUTING AGENCY AND MECHANISMS

- 4.1 The executing agency in this project will be INDEVAL, a for profit organization regulated by the Ley del Mercado de Valores and the Comision Nacional Bancaria y de Valores (CNBV). Its shareholders are banks, broker-dealers, insurance companies and other financial institutions. INDEVAL is organized in five separate departments: Risk Management, Operations, Custodial Services, Settlement and Legal. The various activities funded under this TC will be executed under the coordination and supervision of the appropriate department manager, as follows:

Component	Coordinator
Regulatory Framework	Legal Department/CNBV
Financial Plan	Risk Management Department
Internal Auditing Standards and Procedures	Risk Management Department/CNBV
Financial Safeguard System	Risk Management Department
Organizational Structure and Regulations	General Manager
Risk Management Training	Risk Management Department
Dissemination.	General Manager
Further Developments	General Manager

- 4.2 INDEVAL has already done extensive background work for this project and has established various technical working groups in the areas of legal/regulatory, accounting and operational matters that have coordinated internally and with the CNBV. The activities funded under this project will proceed simultaneously. Upon completion of CMCL's internal regulations, and approval of the regulatory framework, it will be incorporated and become operational.

V. COST AND FINANCING

- 5.1 As indicated in the table below, the MIF and INDEVAL will each fund US\$1.5 million for the various technical activities described above. In accordance with MIF guidelines, MIF resources will not finance equipment purchases, and no more than 50% of INDEVAL's counterpart funding will be used for the purchase of equipment and software.

Consolidated Budget

Activity	MIF	INDEVAL	Total
I. Legal and Regulatory	\$380,000	\$200,000	\$580,000
II. Financial Plan	\$0	\$250,000	\$250,000
III. Auditing Standards and Procedures	\$190,000	\$285,000	\$475,000
IV. Financial Safeguard System	\$300,000	\$400,000	\$700,000
V. Organizational Structure and Operating Regulations	\$300,000	\$200,000	\$500,000
VI. Risk Management Training	\$150,000	\$125,000	\$275,000
VII. Dissemination	\$30,000	\$40,000	\$70,000
VIII. Further Developments and Project Evaluation	\$150,000	\$0	\$150,000
TOTAL	\$1,500,000	\$1,500,000	\$3,000,000

VI. PROJECT JUSTIFICATION AND RISKS

- 6.1 The creation of CMCL, with a financial safeguard system which provides transaction guarantees backed up by margin collateral, will be highly valued by investors and should encourage domestic and foreign institutions to increase their securities trading activity at the Bolsa Mexicana. The MIF and IDB, through this technical cooperation, have the opportunity to act as a catalyst in increasing the public's confidence in Mexico's securities market.
- 6.2 The above project poses a number of risks that the MIF management will need to consider:
- 6.3 a) Regulatory Reform. The regulatory reforms required for the establishment and operation of the CMCL must ultimately be approved by the CNBV. This risk is mitigated by the close coordination

between INDEVAL and the CNBV in the development of the regulatory and legislative framework.

- 6.4 b) Capitalization of the FSS. The private sector has been supportive of the project, however, the actual capitalization of the FSS depends upon its willingness and ability to meet requirements that are still unknown and will be developed under this project. INDEVAL members, who also are the most likely members of the CMCL, are well informed of all aspects of the project and will continue to be so throughout project execution.

VII. PROJECT PERFORMANCE CRITERIA

- 7.1 The supervising consultant will provide quarterly written progress reports to INDEVAL, the IDB and MIF. The progress reports should discuss completion of benchmarks and deliverables that measure the progress and timeliness of the project. The project is compartmentalized so that several technical aspects of the project can proceed simultaneously. The program is expected to be begin in the third quarter of 1998 and to be completed in mid-1999.
- 7.2 Among the major benchmarks or deliverables to be included in the quarterly progress reports are the following: (a) articles of CMCL incorporation, bylaws and internal rules and regulation; (b) financial plan with pro-forma income and cash flow statements and CMCL's initial balance sheet; (c) operating, accounting and auditing manuals; (d) risk management manual for margins, collateral and liquidity funds; evidence that risk management software has been installed and tested; (e) examples of risk management training materials; (f) completion of plan for public dissemination campaign; and, (g) the final progress report will include an analysis of comparable institutions and an assessment of those areas that could qualify for further support from the IDB.

VIII. EXCEPTION TO POLICIES AND PROCEDURES (None)

IX. CONTRACTING PROCEDURES

- 9.1 As a private, for-profit organization, standard Bank procurement procedures do not apply to INDEVAL. Nonetheless, the Bank and INDEVAL will agree upon contracting procedures appropriate for private sector entities that ensure transparency and efficiency.

SIMPLIFIED LOGICAL FRAMEWORK

Overall Objectives: To strengthen investor confidence in the capital markets of Mexico through supporting the creation of a Mexican securities clearinghouse that is adequately capitalized and regulated and has an efficient and low cost operating structure.

Specific objectives and activities	Indicators	Means of Verification	Assumptions
Component I: Regulatory Framework(a) New regulations - to be issued under the Ley Bancaria y de Valores - in close coordination with the regulatory body for banks and securities, the Comisión Nacional de Bancas y de Valores ("CNBV"). (b) Review of existing legislation (ie. bankruptcy law, civil and commercial laws) with regard to the operation of clearing house.	New regulations considered by the CNBV for incorporation in the Ley Bancaria y de Valores. Drafted reviews of existing legislation.	Regulations and proposed amendments submitted to the CNBV for approval.	The CNBV continues to work with INDEVAL in establishing clearing house regulations and continues as a regulatory priority.
Component II: Financial Plan. (a) Development of CMCL's fee structure which covers CMCL cost and is acceptable to market participants, including sensitivity analysis and market testing of such fees.	CMCL operations are low cost and financially self sustaining.	Quarterly Financial statements of CMCL and quarterly progress reports of consultants.	CMCL will be capitalized by its clearing members and will have the authority to charge fees on clearing transactions and other services.
Component III: Auditing Standards. (a) Development of the auditing standards to be applied for CMCL and clearing members. (b) Development of mechanisms to monitor and enforce the standards.	An internal auditing system which meets international standards and is consistent with norms and procedures established by the Instituto Mexicano de Contadores Publicos (IMCP)	Quarterly consultants report indicating that the auditing standards have been adopted by CMCL.	CMCL and their members are willing to adopt IMCP auditing standards.

Specific objectives and activities	Indicators	Means of Verification	Assumptions
<p>Component IV: Financial Safeguard System. (a) Development of the CMCL financial safeguard system ("FSS");</p> <p>Determine the size and nature of margins, capital contributions and liquid collateral needed to establish a FSS.</p>	A well capitalized clearinghouse that assures financial stability and is able to adequately measure risks.	Consultant's quarterly reports confirm that clearing members have contributed to capital, margins and liquidity funds of the FSS; a risk management system, including software, have been implemented and tested.	Clearing members are willing to contribute to CMCL liquidity funds.
<p>Component V: Organizational Structure. Development of CMCL's bylaws, corporate governance and general rules of operation and procedures.</p>	A clearinghouse with a strong organizational and management structure.	Quarterly consultants reports confirm the drafting of the by-laws of CMCL and the general rules of operation and procedure.	CMCL and its clearing members accept the by-laws and operational procedures.
<p>Component VI: Risk Management Training. (a) Risk management training CMCL, INDEVAL and the CNBV staff responsible for risk management. Includes management procedures and information systems (software).</p>	Market participants and regulators are trained in state-of-the-art risk management systems.	Consultant's quarterly reports document the number of participants who have gone through the training process.	Willingness of the participants to learn new technologies and methods in a team environment.
<p>Component VII: Dissemination: (a) A dissemination campaign to domestic and international market participants to inform them of the creation of the CMCL and detail the improvements resulting from the project. Preparation of a comparative study of international institutions that are equivalent to CMCL.</p>	CMCL adheres to international standard of market practice and the international markets are informed of new developments. Establish confidence of investment communities in CMCL.	Dissemination material issued to the public and the market players.	Willingness of clearing houses outside of Mexico to disclose non-confidential information so that the comparative study can be done.
<p>Component VIII: Further Development: An analysis to identify critical areas for the development of the Mexican capital markets; (b) Assessment of which of those areas would qualify for further support from IDB.</p>	An analysis of Mexican capital markets and international market practices and an assessment of the need for future IDB assistance.	A report pointing to potential IDB projects with CMCL or INDEVAL.	CMCL and INDEVAL's continued commitment to achieve the highest operational standards.

PROPOSED RESOLUTION

MEXICO: NON REIMBURSABLE TECHNICAL COOPERATION FOR CAPITAL MARKETS DEVELOPMENT

The Donors Committee of Multilateral Investment Fund

RESOLVES:

1. That the President of the Inter-American Development Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Multilateral Investment Fund, to enter into such agreements as may be necessary with the S.D. INDEVAL S.A. de C.V. (Institución para el Depósito de Valores) and to take such additional measures as may be pertinent for the execution of the program memorandum referred to in document MIF/AT-_____ with respect to a technical cooperation program to support the development of the Mexican capital markets.
2. That up to the amount of US\$1,500,000, or its equivalent in other convertible currencies, is authorized for the purpose of this resolution, chargeable to the resources of the Technical Cooperation Facility of the Multilateral Investment Fund.
3. That the above-mentioned sum is to be provided on a nonreimbursable basis.