

Mexico's New Banking Measures Aim to Increase Credit, Transparency

By Edward C. Skelton

ABSTRACT: The overhaul of Mexico's banking laws, enacted as part of President Enrique Peña Nieto's wide-ranging economic and business structural changes, is designed to increase credit to small and medium-sized businesses while enhancing regulatory oversight and transparency.

Promises of wide-ranging structural reforms aimed at boosting long-run growth and economic development accompanied Mexican President Enrique Peña Nieto's arrival in office in December 2012.

Changes have followed, including legislative approval of plans to modernize important sectors of the economy, most notably a constitutional amendment ending state monopolies over oil and gas as well as electricity.¹ Other moves affect telecommunications and broadcasting, anti-monopoly rules and penalties, education, fiscal policy, and congressional and local elections. The overall economic package is forecast to add 1 to 2 percentage points to growth in the medium- to long-term.

A less heralded development, involving the banking system, could provide the biggest immediate economic boost. By making it easier for households and smaller enterprises to access credit, Peña Nieto's financial system overhaul seeks to bolster growth in the short run

and foment broader economic development in the long run. The new law—"Ley para Regular las Agrupaciones Financieras"—has the potential to increase the productivity of small and medium-sized businesses and help workers borrow against their future income, improving social mobility and income distribution.²

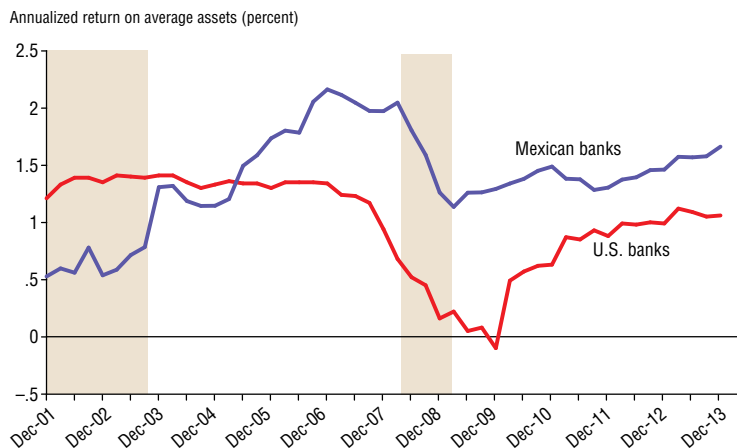
Increasing Competition

Mexico's banking industry is highly concentrated—its five largest banks hold 72 percent of system assets. Moreover, the country's banks have a reputation for high fees and interest rates, conservative credit policies and indifferent service.

The nation's central bank, Banco de México, in an effort to reduce commercial bank charges and commissions, publishes on its website the institutions' fees and interest rates and requires them to divulge the true cost of borrowing.³

Banks are very profitable, with consistent and strong earnings for more than 15 years (*Chart 1*). Banks managed to post a return of 1.1 percent of assets

Chart 1 Mexican Banks Post Strong, Consistent Profits



NOTE: Shaded areas denote Mexican recessions, as defined by the Instituto Nacional de Estadística y Geografía (INEGI).
SOURCES: Comisión Nacional Bancaria y de Valores; INEGI; Reports of Condition and Income.

in 2009 when real (inflation-adjusted) per capita gross domestic product (GDP) declined about 9 percent. By comparison, U.S. banks' losses totaled 0.1 percent of assets that year.

For its part, the Mexican Bankers Association rejected the argument that industry profitability is excessive, saying earnings are proportional to risk. Those returns have spawned recent market entrants, who have set up shop with the backing of government officials seeking to increase the number of commercial banks.⁴

Recent regulatory changes aim to increase bank competitiveness partly by explicitly prohibiting bundled sales of financial products. For example, it was common practice for banks to require consumers receiving an auto loan to purchase insurance from the same financial group or to require borrowers to also maintain a deposit account.

To further promote competition, customers will be able to more easily transfer accounts and loans to other institutions, allowing greater mobility of deposits and consumer loans. Prior to the change, borrowers could generally only refinance a loan with the existing holder of the credit. The new law allows subrogation, meaning that when the proceeds from a new loan are used to satisfy a prior lien, the new lender replaces the prior lienholder. Subrogation makes it much easier for borrowers to refinance mortgage loans with another lender.

Assessing Competitiveness

Mexico's newly autonomous and empowered antitrust commission (known by the Spanish acronym Cofece) turned its attention this year to the country's concentrated banking industry, with agency head Alejandra Palacios characterizing the sector a top priority.

In March, Cofece began preparing a study of the financial sector and drafted a series of recommendations to boost competition. The commission is expected to present the study to Congress in the third quarter. Cofece also has the power to open formal investigations of specific banks, which could lead to price regulation, forced asset sales and other actions. Under the new competition law

(one of the structural changes), court challenges cannot delay commission actions (except forced asset sales).

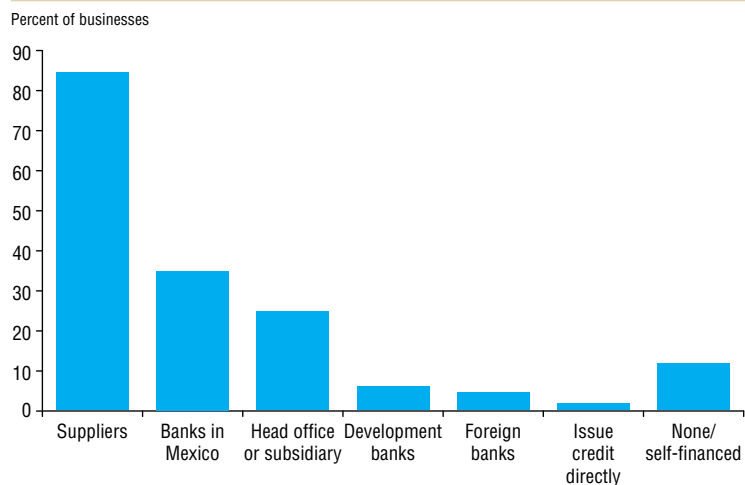
Smaller Business Credit Access

Arguably the banking system's greatest weakness involves small and medium-sized businesses' difficulty obtaining credit. Only 32 percent of all established "formal" businesses in Mexico have arranged financing via either a loan or line of credit, according to the World Bank's Enterprise Survey.⁵ By comparison, a rate of 80 percent is prevalent in Chile and 66 percent in Brazil. For small and medium-sized businesses, the situation is worse—18 percent of formal businesses with fewer than 20 employees have access to regular financial channels in Mexico, compared with 73 percent in Chile and 43 percent in Brazil.

Instead, both large and small Mexican businesses rely on their suppliers for financing (*Chart 2*). A recent academic study found that when compared with similar firms without credit access, small and medium-sized businesses with the ability to obtain any type of formal financing were better able to grow and increase employment.⁶ And, to the extent that access to credit helps firms grow, the economy as a whole realizes productivity gains, by absorbing workers from less productive enterprises, expanding the

▶ Arguably the banking system's greatest weakness involves small and medium-sized businesses' difficulty obtaining credit.

Chart 2 Mexican Businesses Rely on Suppliers for Financing



NOTE: Data add to more than 100 percent because some businesses have more than one source of credit.
SOURCE: Banco de México, *Evolución Trimestral del Financiamiento a las Empresas*, First Quarter 2014.

capital stock and achieving efficiency gains within individual firms.

Bolstering Regulatory Oversight

Mexico’s financial overhaul should help regulators and improve consumer rights. Condusef, a consumer watchdog government agency, will be better able to increase transparency and punish potentially abusive practices. Significantly, Condusef will also be able to directly counsel and advise consumers on financial products and services. The new law also creates an independent arbitrator, housed within Condusef, to resolve customer complaints about financial institutions.

The initiative also establishes new oversight. The Bureau of Financial Entities (Buró de Entidades Financieras) will issue information on the practices of each financial institution, maintain a list of sanctions imposed and improve consumers’ access to information.

The new measures also increase the authority of the Banking and Securities Commission (known by its Spanish acronym, CNBV). The regulator will publish the amount of fines and other punishment, including pending actions. In the past, authorities could not divulge bank sanctions until all appeals were exhausted, delaying disclosure sometimes by years.

Regulators are to periodically assess lending to ensure efficient credit flows and evaluate how well banks support the most productive sectors of the economy. The CNBV will have the authority to direct institutions to lend to specific sectors or industries, focusing on small and medium-sized businesses. It is unclear how this will work in practice. A regulator requesting a bank to increase its lending is unusual and gives rise to concerns that banks may face undue pressure or that credit could be misallocated.

Capital rules outlined in international banking reforms, known as Basel III, are included in the law as are new liquidity stress tests and contingency planning requirements.⁷ Another legal change was tightening the liquidation process for insolvent banks and clarifying how banks are declared insolvent. Before the change, legal uncertainty

surrounded the conditions under which insolvency could be declared and the mechanics behind bank liquidation, including payment to eligible depositors. Besides laying out a resolution process, the law establishes a process to determine if a failing institution is systemically important to the entire financial system. Institutions won’t be designated systemically important until failure, and secondary legislation will be necessary to establish special resolution facilities for such banking operations.

Strengthening the Legal Regime

Banks should directly benefit from a strengthening of loan guarantees and the recovery of collateral as well as a streamlined bankruptcy process. Previously during bankruptcy, debtors used now-closed loopholes to prolong debt resolution. The law makes it easier during a liquidity crunch to obtain bridge lending—temporary financing until more permanent arrangements are in place.

The reform also allows banks to recover cash pledged as security on a credit without filing a formal lawsuit and receiving a judicial order. To implement these changes, the law creates a system

of specialized courts and judges and also makes it easier to secure loans. The new system will shorten the period necessary to repossess collateral and enforce loan guarantees. In turn, the changes are expected to promote credit growth.

Development Bank Emergence

In addition to commercial banks, Mexico has six state-owned development banks (*see box*). Traditionally, the development banks have been risk averse. Under the new rules, they will have greater operational flexibility via an expanded mandate requiring them to promote economic development in their areas of specialization, explicitly financing small and medium-sized enterprises, infrastructure and innovation. Development banks will also be allowed to take on more risk, as long as core capital (typically equity and reserves) is not significantly affected.

Previously, the banks confronted restrictions on short- and medium-term loan issuance. There also were rules prohibiting more than one loan to the same borrower. The new rules allow loan guarantees for borrowers without finance ministry permission. Development banks may also lend based on

Mexico’s Development Bank Specialization

Mexico’s six development banks each specialize in a different area of the economy. Individual institutions seek to provide access to savings accounts, checking accounts and financing for individuals and businesses as well as provide technical assistance and training. The development banks and their areas of focus are shown below.

Development Bank	Specialization
Nacional Financiera (Nafin)	Small and medium-sized businesses
Banco Nacional de Obras y Servicios Públicos (Banobras)	Public infrastructure, especially municipal projects
Banco Nacional de Comercio Exterior (Bancomext)	Foreign trade for exporters and importers
Sociedad Hipotecaria Federal (SHF)	Housing, including housing development
Banco Nacional de Ahorro y Servicios Financieros (Bansefi)	Lower-income households and the unbanked
Banco Nacional del Ejercito, Fuerza Aérea y Armada (Banjercito)	The armed forces

pledged collateral, rather than only on a borrower's primary repayment capacity. By granting more credit, the development banks could play an important economic development role.

Mexico's commercial banks have expressed concern, citing the market distortions attributable to state backing of development banks. The commercial lenders argue that greater development bank activity would be helpful and complementary only if concentrated in indirect financing such as credit guarantees. Regulators, meanwhile, opined that the changes will allow development banks to better serve areas where the commercial banks do not operate.

Remaining Hurdles

Although the financial overhaul should help spread financial services and encourage economic development within Mexico, it does not address all the structural weaknesses impeding the development of the financial system. A high level of informality is the biggest issue.

Workers and businesses in the informal sector operate outside the regulatory umbrella and generally are unable to document their income or payment history. As a result, access to credit mostly occurs informally, such as from family or friends. Close to 60 percent of the country's workers are employed outside the formal sector, and informal economic activity totals approximately 30 percent of GDP, according to estimates by Mexico's National Institute of Statistics, Geography and Informatics.⁸

Recovering collateral is yet another impediment to credit access. On average, it takes commercial banks three years to repossess a house after its mortgage has become delinquent. In some cases, the process can run 10 years.

The new measures don't fully address the difficult collateral recovery process and require legislative approval of secondary laws that are expected to be introduced later this year. Plans include creation of specialized courts and judges.

While development banks will have more leeway to incur some losses, it remains to be seen if regulators and

the Mexican Congress will tolerate shortfalls, which have traditionally been viewed as coming directly out of taxpayer pockets.

Last, authorities estimate 200 regulatory revisions will be required to implement the financial measures. Consequently, there is some risk that the spirit of the law may be lost in the process. And, although regulatory authorities will assess the banks' lending practices to ensure they are fulfilling their role as financial intermediaries, there are currently no objective standards to measure compliance.

Looking Ahead

While transformation of Mexico's energy, telecommunications and fiscal laws have gained public attention, changes to the financial system could have the most direct effect on small and medium-sized businesses. Domestic lending to the private sector is expected to grow to as much as 40 percent of GDP by 2018, from about 25 percent in 2012 (*Chart 3*).

Mexico's Finance Ministry forecasts the new measures will boost annual growth by 0.5 percentage points between 2015 and 2018, mostly through increasing consumption and investment. To the extent that financ-

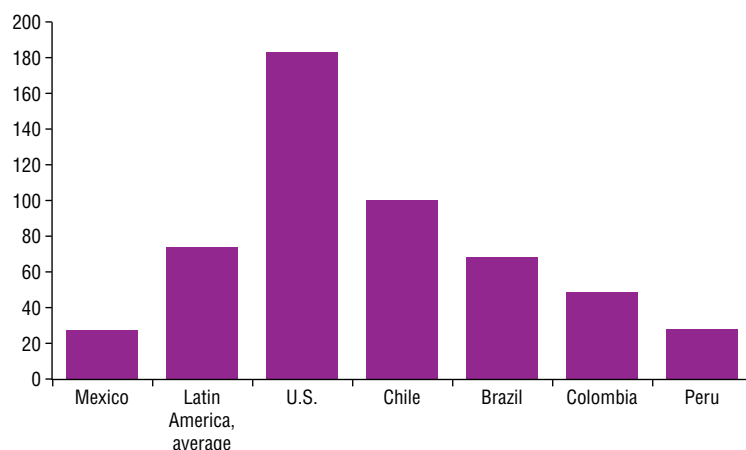
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► *Mexico's Finance Ministry forecasts the new measures will boost annual growth by 0.5 percentage points between 2015 and 2018, mostly through increasing consumption and investment.*

Chart
3

Private Sector's Access to Credit Low in Mexico

Private sector credit as share of GDP (percent)



SOURCE: World Bank, survey data as of 2012.

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ing is more available to households and smaller businesses, informality could decline, improving efficiency and broadening economic development. Still, overall benefits will be determined by whether the new rules work as designed.

The financial sector is anticipated to function as a more effective development tool. The goal is to establish a virtuous cycle allowing more Mexicans to acquire the necessary resources to make their business plans a reality and establish productive enterprises in the formal market, creating quality jobs and sustainable future growth.

Skelton is a business economist in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Notes

¹ For more information about the energy reform, see "Reforma Energética: Mexico Takes First Steps to Overhaul Oil Industry," by Michael D. Plante and Jesus Cañas, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter 2014.

² The published law can be found at www.diputados.gob.mx/LeyesBiblio/pdf/LRAF.pdf.

³ Banks must reveal the true cost of financing through the Costo Anual Total (CAT), which is equivalent to the annual percentage rate used in the U.S. More information is available (in Spanish) at www.bancodemexico.gob.mx/waCalculadoraTarjetaCredito/MasInformacion.jsp.

⁴ For more information, see "Mexico Develops Niche Approach to Expansion of Banking Services," by Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter 2013.

⁵ The survey of 1,480 Mexican firms was conducted between August 2009 and June 2010.

⁶ See "Access to Credit and the Dynamics of Informality in Mexico," by Oscar Sanchez, Inter-American Conference on Social Security, Working Paper no. 0114.

⁷ For more information about Mexico's adoption of Basel III capital standards, see "Mexican Banks Get Ahead of New Global Capital Standards," by Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter 2012.

⁸ Among other benefits, the fiscal reform passed in October 2013 was designed to reduce the size of the informal economy. For more information about informality in Mexico, see "Informality in Mexico," by Nicola Brandt, Organization for Economic Cooperation and Development, OECD Economics Department Working Paper no. 896, October 2011. Informality varies by geographic region, and regional differences in formality help explain disparities in economic growth and development. See "The Determinants of Informality in Mexico's States," by Sean M. Dougherty and Octavio Escobar, Organization for Economic Cooperation and Development, OECD Economics Department Working Paper no. 1043, April 2013.

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