Mexico’s Financial Reform: A Step in the Right Direction

*Domestic bank credit to the private sector as a percentage of GDP is currently at around 16% – much lower than in other similar emerging economies. We believe that the financial reform is a step in the right direction to boost credit in Mexico.*

Mexico’s financial reform was signed into law last year. Its approval was overshadowed by the debate over the energy reform. However, we believe that the financial sector reform is also significant to increase potential growth in Mexico.

In this report, we explore the reform under four dimensions: increase banking sector competition; improve the legal framework of the sector, foster financial inclusion and strengthen the protection of consumers. We argue that development banks are given an important role in increasing their loan participation and thus generating more competition. Legal enforcement is improved by accelerating asset-repossession processes and legal proceedings, as well as allowing banks to charge guarantees on non-performing loans. Finally, there are positive developments on financial inclusion, although these must be accompanied by financial education. Further financial penetration in Mexico could lead to a significant expansion of economic activity in the years to come.

1. **Competition**

Mexico began a liberalization process of the Financial sector during the 1990s. At the beginning of that decade, macroeconomic imbalances, the lack of an adequate regulatory system and a weak rule of law contributed to one of largest financial crises in the country’s history – the so-called Tequila crisis.

A stronger financial regulatory framework was adopted immediately following the Tequila crisis, and foreign ownership was allowed. A series of M&As took place shortly after, concentrating the Banking sector; and, by 2004, foreign bank participation accounted for 82% of total assets.[1]

In order to improve the level of competition in the sector, the reform empowers the newly created Federal Competition Commission (Cofece, by its Spanish acronym) to sanction anticompetitive practices in the determination of interest rates. Cofece will now be an active regulator monitoring the level of competition in the banking sector.

The financial reform required Cofece to evaluate the banking system and issue recommendations accordingly. Cofece published its report on the competitive conditions of the financial system and made the following recommendations:

   a) Reduce entry barriers  
   b) Guarantee access to financial services under reasonable and non-discriminatory conditions  
   c) Strengthen the criteria of price regulation when anti-competitive conditions exist  
   d) Dissuade anti-competitive behavior  
   e) Provide more protection to financial-services users and foster greater transparency

[1] For more information on the development of foreign banks in Mexico, see Haber and Musacchio (2004).
f) Facilitate the mobility of consumers to other financial institutions

g) Generate a more efficient management of pension accounts

h) Promote and increase financial education

The mandate of development banks has changed from one of capital accumulation to one of increased lending, which will likely help SME’s

During the last decade, commercial banks have redirected their loan portfolio from the government to businesses. In 2001, loans to the government represented 48.1% of the total and by 2014 they stood at 15.1%. During the same period, business loans have grown by 178% in real terms; however, most of these loans are directed towards large firms.

Currently, 72.1% of total commercial loans are business loans and of these, 75.3% are directed to large firms while only 24.7% are directed to small and medium enterprises (SMEs). According to the World Bank’s Enterprise Survey, 29.5% of established formal SMEs in Mexico have obtained financing through loans or credit lines, compared with 78% in Chile and 57% in Brazil. In fact, according to the Mexican Central Bank’s survey on market credit (1Q15), 79.0% of the surveyed firms obtain their funding from suppliers and only 36.2% from commercial banks. Furthermore, more than 70% of employment in the country is generated by SMEs, and one of their main growth limitations has been lack of credit access. The government through the financial reform aims to foster credit to SMEs through development banks. In the last survey on market credit, loans from development banks to SMEs represented only 5.4% of the total.

![Firms’ Sources of Finance](source)

![Composition of Bank Credit](source)

The reform modifies the mandate of development banks from the preservation and accumulation of capital to that of credit expansion toward strategic areas of economic development for the country. However, the latter must include guaranteeing the efficient, prudent and transparent use of resources. The new law aims to relax the legal framework of development banks, eliminating obstacles that limit their activities and integrating mechanisms that allow them to obtain further financing. Furthermore, development banks are empowered to offer financial services that foster innovation, environmental sustainability and the promotion of financial inclusion of rural SMEs.

[2] For more details, please see the National Development Plan 2013-2018 for the discussion of the necessity of increasing lending to SMEs.
Development banks are allowed to take on more risk and to have a deficit, authorized by the Ministry of Finance, in their programs and budget. Accordingly, these banks may agree with the Ministry the periods in which they will refund their generated profits from sovereign collateral. Development banks will be able to invest, acquire obligations to buy or sell shares or make future contributions to the capital stock of firms, in excess of 15% of the capital paid by the issuer and for a period greater than three years, when these firms perform activities related to the purpose of the banks and with the previous authorization of the Ministry of Finance.

The new regulations grant greater powers to the Council of Directors to approve, without prior additional authorization from the federal government, the organic structure, wage policies and other extraordinary benefits due to the performance of the development banks and other actions; it proposes incentives attached to the development banks’ performance and fosters continuity through bonuses and higher salaries.

**Portability of operations and prohibition of attached sales will foster competition and lower costs.**

The reform allows for the portability of banking operations and prohibits attached sales favoring competition. Credit portability, along with the mobility of guarantees without incurring in new costs, will reduce entry barriers, decreasing transactions costs for consumers. On the other hand, attached sales are forbidden, meaning that sales of a financial product conditioned on the acquisition of others will not be allowed.

On the other hand, Article 17 of the reform establishes measures that aim to reduce commissions that banks charge users of other financial institutions when using each other’s infrastructure. Banks can enter contracts among themselves in order to reduce such commissions.

2. **Legal Enforcement**

Mexico ranks low in the rule-of-law index compared with other emerging economies. Banks have frequently complained about lengthy legal processes and the difficulty of repossessing collateral of unpaid loans. Much of these costs experienced by banks are normally passed to consumers as higher lending rates (Claeys and Vander Vennet, 2008), and empirical evidence suggests a positive relationship between the efficiency of the judicial system and a lower cost of credit (Laeven and Majnoni, 2003).
The reform contemplates several measures intended to improve the speed of legal processes in commercial lawsuits. Examples include the elimination of the judge’s discretion with regard to notification periods, which must be reported one day after the evaluation of the resolution; the period for the admittance of proofs is reduced from 8 to 5 days in order to accelerate the legal process; and others.

Also, the reform proposes the creation of a special bank-settlement regime allowing for the efficient disposal of assets, thus limiting the loss of their value. At the same time, the deposit-insurance institution (IPAB) is expected to act as the liquidator after a judge passes sentence. IPAB will have the necessary level of independence to act upon the asset-disposal process, adjudication of creditors and the abrogation of acts of fraud committed by creditors. The cooperation between IPAB and the judge through a better-regulated process will help resolve any legal vagueness and reduce inefficiencies in the processes.

Finally, the reform facilitates banks charging guarantees on non-performing loans. For example, property may be retained if there is fear that the debtor could dispose of, alienate or squander it. It also allows banks to recover cash pledged as security on a loan without a formal lawsuit.

3. Financial inclusion

One of the main challenges of the current administration is to enhance financial inclusion. Most Mexicans do not have access to financial services. Data from the World Bank indicates that Mexico has low levels of financial infrastructure; the number of ATMs per 100,000 inhabitants in Mexico is lower than for its Latin American peers. Moreover, the percentage of total population with a financial account is very low. According to the National Financial Inclusion Survey for 2012, 44% of Mexicans do not have access to the financial system and 64.5% of adults do not save using financial instruments.\[3\]

Domestic bank credit to the private sector in Mexico is low, even when compared with other emerging economies. In terms of GDP, it stands at around 16% of GDP, much lower than the penetration ratios reported by its Latin American peers.

*\[3\] The National Financial Inclusion Survey 2012 can be downloaded through the following link: http://www.inegi.org.mx/est/contenidos/proyectos/encuestas/hogares/especiales/enif/enif2012/default.aspx*
The reform aims to make financial services available to communities that do not currently have access to them. In order to do so, the reform allows popular saving entities, community savings institutions, and cooperative savings-and-loan institutions to hire third parties to provide services to rural areas, reducing excessive transaction costs.

4. Protection of consumers

The reform strengthens the National Commission to Protect the Rights of Financial Services Users (CONDUSEF, its acronym in Spanish).

CONDUSEF is given more powers to issue recommendations to financial institutions and to publish them for the general public, as well as to report activities that deviate from safe financial practices. It will also have the ability to cooperate with other financial authorities to exchange information.

A bureau of financial entities is created, which will be subordinate to CONDUSEF. This bureau will provide information on the behavior and performance of financial institutions, sanctions that have been imposed on them and all the necessary information required to inform users about their performance in the provision of financial services. At the same time, financial entities will have to provide information on their loans awarded to at least one credit-score agency.

The reform proposes to advance the legal and arbitration capacities of CONDUSEF and the mechanisms for the defense of financial-services users. A new arbitration system is created for financial matters in order to implement a new dispute-resolution process. CONDUSEF will now have the ability to represent users in collective actions against financial institutions.

The National Banking Regulator (CNBV, its acronym in Spanish) will now disclose all bank sanctions including fines, penalties and pending actions. It will assess the lending structure to see how well the banking system is supporting the most productive sectors of the economy. It has the authority to direct lending to specific sectors and firms (e.g., SMEs), although actions such as these could raise concerns in the banking sector.

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