FOSTERING SOUND FINANCIAL SECTOR DEVELOPMENT

EXECUTIVE SUMMARY

Message 1. Mexico needs to broaden and deepen its financial system while preserving the financial stability gains of the last decade.

Message 2. Sound financial development requires continuing (i) improving financial infrastructure (including retail payment systems, credit bureaus, and collateral registries), (ii) fostering capital market development, and (iii) strengthening consumer protection and financial literacy.

Message 3. The government should periodically review its strategy of lowering regulatory barriers to foster competition in the financial sector and its procedures for resolving failed institutions. The state's role in financial services should be comprehensively evaluated.

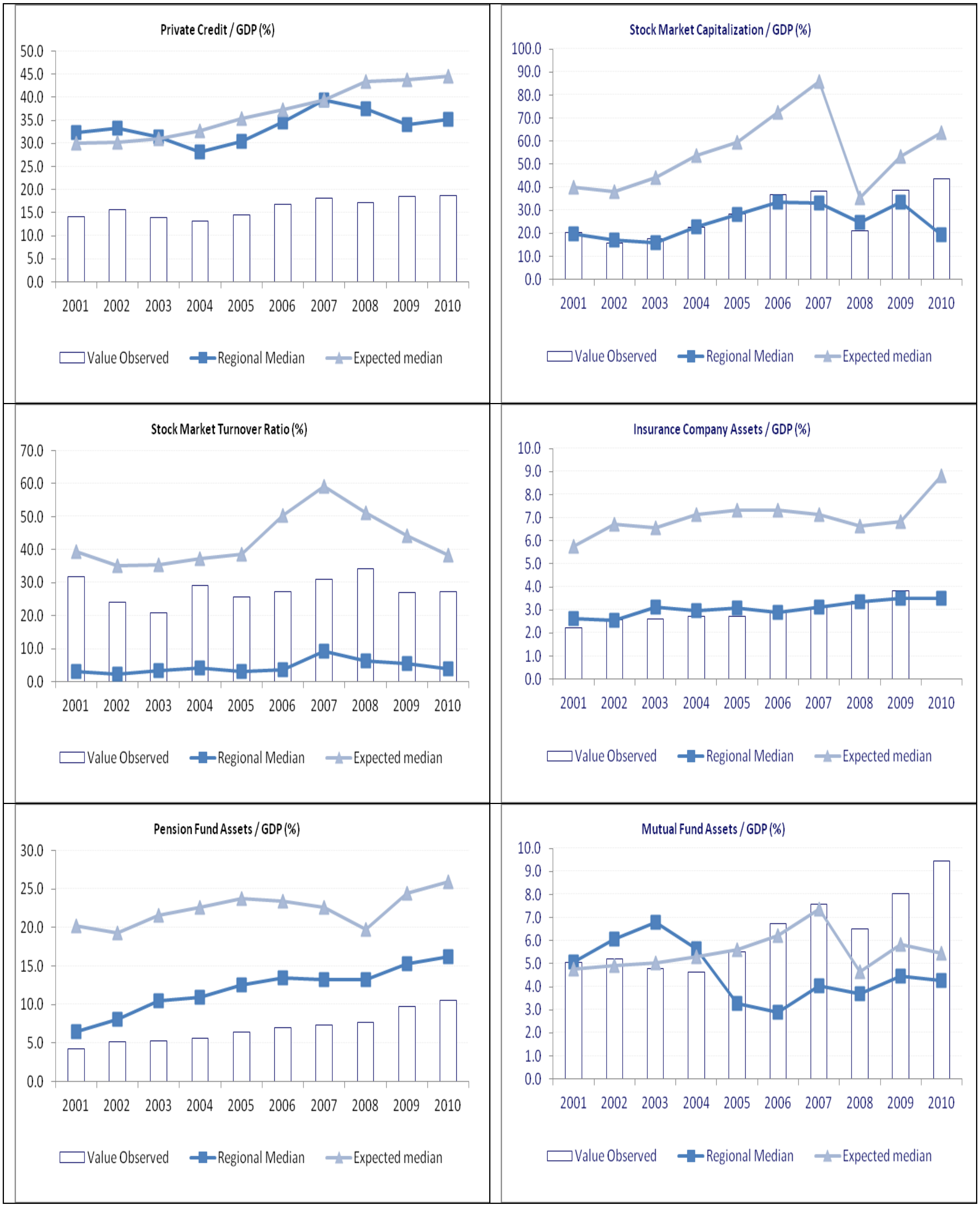
OBJECTIVE

This note outlines a short- to medium-term reform agenda to foster sound financial sector development. Mexico needs to broaden and deepen its financial system without compromising the financial stability gains of the last decade. Much more private investment is needed to transform the economy to boost productivity, and despite improvements in recent years, many households and firms still lack adequate access to financial services. Using the financial payments system to promote financial inclusion is a sound way to broaden access. However, experience in several countries has shown that accelerated (or forced) expansion of credit can harm rather than benefit customers. If financial institutions do not follow sound practices, they can fail, harming borrowers and depositors alike and creating social unrest. Institutional failures may also lead to costly bailouts, with substantial fiscal cost. An oversight system (both micro- and macro-prudential) that encourages prudent-risk taking and facilitates prompt resolution of failed institutions ensures that strategies for financial deepening do not compromise financial stability.

KEY CHALLENGES

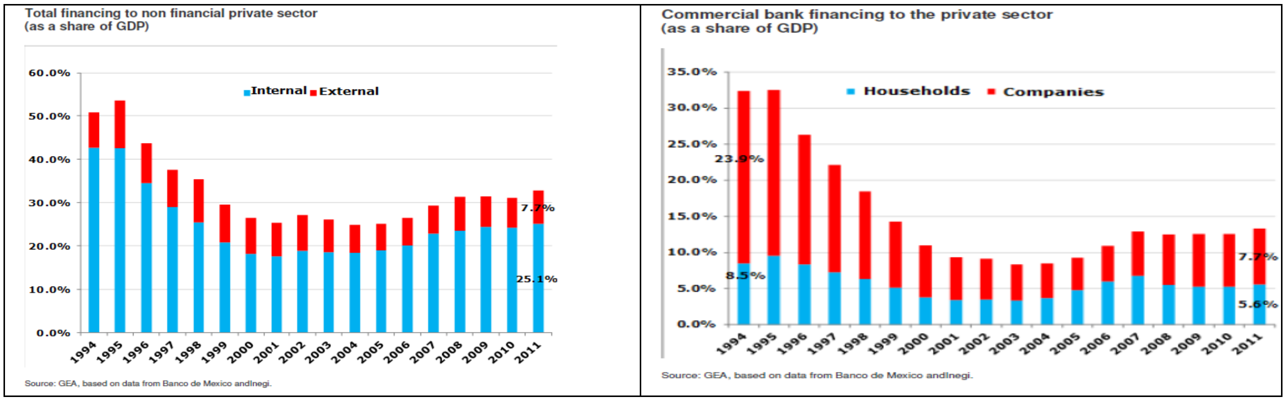
Mexico's financial sector is small for the country's stage of development, impeding the channeling of financial savings into long-term productive investments. Commercial bank credit to the private sector is well below the level in countries with similar characteristics and below the regional average (figure 1). Similarly, the size and depth of capital markets are well behind levels in peer countries. While the market for government debt is deep and liquid, there are few issuers in the nongovernmental bond and corporate equity markets. The system has done a fair job of mobilizing savings in recent years but continues to lag in risk taking and maturity transformation, limiting its contribution to growth. At less than 35 percent of GDP, total financing to the private sector (including domestic and external sources) has yet to recover to its mid-1990s levels (figure 2). Commercial bank lending is increasingly focused on consumer credit, which has higher intermediation margins.[2] Institutional investors, including pension funds and mutual funds, hold most of their assets in fixed-income securities, mostly government bonds.

Figure 1. Financial development in Mexico



Source: Finstat, World Bank.

Figure 2. Total financing to the private sector has yet to recover to its mid-1990s levels



While a variety of financial institutions operate in Mexico, the financial system is dominated by conglomerates that control banks and distribution channels for securities. Barriers to entry have been reduced to deepen credit markets. Unregulated, non-deposit-taking financial institutions (Sofoles and Sofomes) were permitted to operate in the market, and paid-in capital and regulatory requirements were lowered for niche banks, which engage in a more limited range of activities than regular banks. In addition, unregulated credit cooperatives operate (mostly) in rural areas, reaching more than 2 million customers. Public financial institutions provide about a third of total credit to the private sector, largely through two provident housing funds (INFONAVIT and FOVISTE). Despite the important size of public institutions, commercial banks still account for more than half of total credit to the private sector. The seven largest financial groups hold or manage about three-quarters of total financial assets, undermining efforts to increase competition among financial providers and diversify sources of funding. Conflict of interest problems pervade financial transactions.

Despite extensive efforts to expand access, the financial system does not meet the financial services needs of many households and firms. Half the population still does not use financial services despite recent reforms to simplify accounts and regulate correspondent banking services and mobile phone banking services. Findex data indicates that only 27 percent of the population 15 years of age and older have an account in a formal financial institution (compared to a regional average of 39 percent). According to 2010 World Bank Enterprise Surveys, only 32 percent of manufacturing firms have a bank loan or credit line, well below world (56 percent) and regional averages (48 percent). Widespread informality and high collateral requirements (more than double the value of the loan) limit access to credit. Large banks typically require firms seeking loans to hold compensatory balances, which are particularly high for small and medium-size enterprises (SMEs). Only 20–25 percent of SMEs have access to bank credit, mainly through public credit guarantee schemes. Commercial bank lending tends to be short term and costly, with deficiencies in the procedures for collecting on collateral reflected in high bank charges.

POLICY OPTIONS

Expanding the infrastructure for financial payments services to bring households into the financial system

Household use of financial payment services can be expanded by widening the correspondent bank network, encouraging the use of non-cash payment services by revising fee regulations, and increasing competition in the newly launched mobile payments platforms. Correspondent bank networks need to be expanded beyond the more established retail franchises (such as OXXO, Telecomm, 7-Eleven) to reach into individual mom-and-pop shops. Otherwise, cash in/cash out prices may remain high because of limited competition, and correspondent banks will not spread into underserved poor and rural areas. One way to expand access is to allow deposit-taking credit cooperatives to sign up correspondent banks on the same terms as banks. Fee regulations should support the development of new, cheaper channels and product offerings.[3] For example, because banks do not charge customers for making cash deposits and withdrawals at the bank's own automated teller machines (ATMs) or branches, customers often believe that cash is costless. In fact, debit cards and electronic payments are more cost-effective for many transactions. Also, banks may be discouraged from expanding their network of ATMs or branches to remote areas because of higher restocking, safeguarding, and cash collection costs, forcing customers to use higher priced correspondent banks. Finally, recent regulatory changes have paved the way for mobile phone providers to operate mobile payment/banking schemes through banks. Care is required to ensure that the leading mobile operator is not able to transfer its dominance in the telephony market into mobile payments (and back).

Strengthening creditor rights and insolvency procedures

Improving the collateral registration system, especially for real estate, and introducing certificates of collateral could improve firms' access to credit. Setting up the Unified Secured Transactions Registry for security interests over movable assets is an important step toward modernizing the collateral registration system. However, the cost to register real estate assets is high (largely because of high notary fees), and inefficiencies persist, especially in some states. Registry systems are not computerized or connected, and there are discrepancies in cadastral information, making the system slow and unreliable. Application of the Federal Model for the Modernization of Registries could improve the situation. Also, real estate assets could be used more efficiently by introducing a Chilean-style reform. Following this reform, the registry would issue certificates of collateral that fragment the value of the pledged asset to cover only the loan amount (plus an overcollateralization margin). This would allow using the real state asset to secure more than one loan.

Strengthening enforcement proceedings for secured and unsecured credits is essential for reducing economic losses and credit costs. Debtors have a variety of means to delay insolvency enforcement, and local courts lack adequate enforcement capacity.[4] Secured creditors' recovery prospects are hampered by the unlimited priority of worker claims on liquidation procedures, debtor recourse to judicial procedures, and weak police support in executing court resolutions. While trusts can be used to pledge assets and avoid the need for judicial procedures, the cost is prohibitive for small firms. Using more out-of-court enforcement mechanisms and simplifying inefficient judicial procedures would benefit the entire credit protection system.

Small and medium-size firms need easier access to insolvency procedures. Though the insolvency law was reformed in 2000 and 2007, it is rarely used. Thousands of businesses are liquidated every year, with serious loss of economic value, but only about 400 insolvency cases were brought in the law's first 10 years—and more than a third of those were dismissed. The chief reasons are the lack of civil liability of company directors and officers for insolvency, weak incentives for debtor and creditors to use the system, and high financial and transaction costs. While the law contains a complete framework for liquidating a business, important technical flaws remain. For example: criteria for initiating a claim are unnecessarily complex, resolution of the insolvency proceedings does not discharge the debtor of its obligations, and creditors do not participate in the process through a creditors' meeting or creditor committees.

Reorganizing a businesses is extremely difficult. Especially disappointing has been the "conciliation" phase of insolvency proceedings, meant to facilitate an agreement that could preserve the business. Fewer than 100 insolvency plans have been approved under the new insolvency law, and no data are available about the success of those plans. The legal framework sets out numerous obstacles to successful reorganization that leave large groups of creditors unaffected by the insolvency plan, including inflexible procedures, lack of post-petition finance, lack of appropriate treatment for executor contracts, the ability for some creditors (such as the workers) to bring claims outside the insolvency process, and the opaqueness of the rules for approving insolvency plans.

Enhancing credit information systems to facilitate sound credit expansion

Credit histories provided by the Mexican credit information system are often inaccurate, incomplete, and fragmented, despite recent reforms. Efficient credit reporting systems improve access to credit by reducing asymmetric information problems between borrowers and lenders. Deficiencies in Mexico's credit information system prevent it from serving this function (box 1). The fact that there are credit histories for some 70 million people (63 percent of the population) is obvious evidence of fraud and errors, considering the country's low access to credit. A national identification system with unique individual identifiers is needed to reduce fraud and error. Several steps could be taken to expand information coverage and lessen fragmentation. An unresolved legal impediment to plans for exchanging borrower information between credit bureaus needs to be settled. In addition, credit information sources could be expanded to include utilities, government credit programs, unregulated financial institutions, court judgments, fraud alerts, and property registries. Mexico's National Banking and Securities Commission could also consider sharing information from its credit registry.

The legal and oversight framework for credit reporting needs strengthening. The legal and regulatory framework needs to be modernized to encourage innovation and competition and better serve industry needs. By strengthening data quality and facilitating data sharing, asymmetries of information between borrowers and financial institutions will be narrowed and new lending institutions will gain access to records—all of which should encourage competition and provision of new services by bureaus such as scoring models and facilitate access to credit. System upgrading should go beyond legislative changes and address mandate overlaps (in consumer protection issues, for example) and regulatory gaps and ensure that supervision covers more than legal compliance.

Box 1. The Mexican credit reporting system

Two consumer credit reporting bureaus operate in Mexico, Buró de Crédito and Círculo de Crédito.[1] Buró de Crédito collects credit information from most banks and some nonbank financial institutions, retailers, and other creditors on more than 68 million individuals and 3 million firms. For firms, the database includes information on credit only, not on balance sheets, accounts receivable, or other information related to trade credit. Firms provide the information voluntarily. Círculo de Crédito focuses on consumer credit and microcredit and provides information from two retail banks and cable and telephone companies on 40 million individuals. In addition, specialized law firms provide information on court judgments.

The Law on the Regulation of Credit Information Societies (SIC) establishes the legal framework for credit reporting. The law includes mechanisms for protecting privacy rights, such as requiring consent before accessing an individual's or firm's credit reports, and low-cost procedures for consumers challenging erroneous information. It also mandates that all regulated financial institutions report their loan activities to and access information from the credit bureaus as part of their credit application process. Credit bureaus are required to exchange negative information in their databases monthly and to exchange positive information on individual borrowers whenever they issue a report on a borrower (this provision has been challenged in court). Banxico issues rules governing how long credit bureaus may retain negative information in their databases.

Under SIC, private credit reporting bureaus must be authorized to operate by the Secretariat of Finance and Public Credit, and they are supervised by the National Banking and Securities Commission, subject to regulations issued by Banxico. The commission conducts annual and ongoing examinations to verify adherence to the law. Examinations focus on consumer privacy and legal compliance. The commission is limited in its ability to address problems proactively, as it has no mandate to deal directly with the public on potential violations or with nonbank authorizers of credit.

Additional consumer protection laws establish mechanisms for consumers to dispute credit agency data.[2] The National Commission for the Protection of Financial Services Users deals with all disputes involving credit bureaus, all regulated financial institutions, and non-deposit-taking financial institutions, such as Sofomes. The National Consumer Protection Agency handles disputes involving commercial entities, including credit cards issued by nonfinancial institutions (such as department stores) and telecommunication companies.

[1] Buró de Crédito is made up of two firms, TransUnion de México S.A., S.I.C. and Dun & Bradstreet S.A., S.I.C. The first firm is a joint venture of TransUnion and the Mexican commercial banks.

[2] The Law on Consumer Protection for Financial Services (2005), Law on Transparency, and the Federal Law on Consumer Protection.

Developing capital markets to deepen the financial system

To foster capital market development, priority should be given to reforms that strengthen access and competition, while preparing the grounds for more extensive reform. Near-term reforms should focus on facilitating access, opening the market to independent players, and deepening integration with foreign markets. Access could be improved by streamlining the regulatory framework for investment funds and encouraging the growth of independent distribution channels. Narrow licenses for intermediaries (such as specialization in brokerage activities only) could be reconsidered to make it more affordable for independent players to enter the market. The financial regulator could consider creating a hybrid regime within the public offer framework for specialized instruments that waives the prospectus requirement for issues targeted to professional investors.[5] The regulatory framework for pension funds needs to incentivize risk-taking (see discussion below). Another way to raise the quality of services would be to deepen integration with other markets, such as Brazil, the Mercados Integrados Latinoamericanos (comprising Chile, Colombia, and Peru), and the United States.

Over the medium term the strategy should include bringing large issuers into securities markets and improving capital markets oversight. Bringing the energy and banking sectors into the public equity market could greatly increase the supply of securities and market capitalization and boost participation by both foreign investors and domestic retail investors. State-owned companies will need to upgrade their governance and line up political support. The regulator will need to strengthen supervision and enforcement related to potential conflicts of interest by large financial conglomerates; strengthen regulation and supervision of related-party transactions to boost investor comfort; harmonize Mexican standards with those of Brazil, Chile, and other peers;[6] develop a legal framework for derivatives; and strengthen the power and enforcement capacity of the National Commission for the Protection of Financial Services Users (CONDUSEF), so that it can effectively discharge its mandate.

The plans for capital market development should be spelled out in a road map that can serve as a reference point for future administrations and for an effective promotion campaign. The campaign should include a joint public-private effort to promote all segments of the Mexican capital market domestically and abroad. Aggressive financial education efforts with domestic investors and potential issuers should also be promoted, while the Mexican Stock Exchange could provide special services (such as independent research for smaller companies) to attract new issuers. To improve financing before an initial public offering, consideration should be given to incentives (such as tax credits or deductions) that could mitigate the large risks of investing in initial public offerings and debt placements by the second-tier group of companies.

The pension system should be reformed so that capital markets are more effective for insuring against longevity risks, especially by raising replacement rates and reforming the regulatory framework. Contribution rates may need to be raised to achieve reasonable replacement rates.[7] In addition, a regulatory shift is needed from a value-at-risk approach that limits short-term return volatility to an approach focused on long-term investment performance. Other concerns include excessive and socially wasteful competition between funds driven by participants' focus on factors other than replacement rates; the use of derivatives for leverage rather than hedging; limited diversification and rapid accumulation of resources, which could lead to mispricing of domestic assets; and a need for more balanced corporate governance of pension funds. The overregulated annuities market, especially restrictions on pricing and technical parameters, discourages effective competition. Other features of the regulatory framework that could be improved include selection of the reference interest rate, investment regulations, and contract policies.

Improving financial literacy and strengthening consumer protection

The powers and financing of CONDUSEF should be increased to deal with the complexities of financial services. CONDUSEF is responsible for promoting financial education, establishing consumer protection rules, and responding to consumer complaints about financial services firms, while the National Consumer Protection Agency (PROFECO) is responsible for protecting consumers from deficiencies in general goods and services. CONDUSEF is particularly important because of the prevalence of conglomerates, which increases the scope for conflict of interest, and the low level of consumer financial education. However, CONDUSEF lacks the power to demand compensation or arbitrate disputes, and its financing is inadequate to meet its objectives. Some functions handled by PROFECO should be transferred to CONDUSEF. In coordination with other entities, including National Banking and Securities Commission and the Ministry of Education, and based on the results of an ongoing financial capabilities survey, CONDUSEF could mount a comprehensive program of financial literacy, as Brazil and Peru have done.

Revising the national strategy to develop the financial system to support sound access

Lowering prudential requirements to ease entry may help develop the system, but constant monitoring is required to ensure that failing institutions can exit the market in an orderly fashion. Broadening the range of financial operators and services by lowering regulatory barriers to entry implies some risk to sound financial development. Thus, this strategy needs to be continuously monitored and adjusted in line with the system wide risks posed by a collective failure of the growing number of financial institutions. Flexibility needs to be built into the system for creating and liquidating such institutions to avoid disrupting the system or causing social upheaval. A priority is devising a plan for resolving the credit cooperatives that did not met the end-2010 deadline imposed by the Credit Cooperative Law. Options should include supporting mergers of weaker entities with stronger ones and resolving failing cooperatives through purchase and assumption techniques. Resolution procedures need to be improved for bank and corporations (non-regulated financial intermediaries).

The state has a large presence in the Mexican financial system, and it is important to ensure that its interventions foster rather than impede financial development. State development banks and provident housing funds provide about a third of private sector credit. The state also provides partial credit guarantees and subsidizes other financial products, such as agricultural insurance. Over the last decade reforms have greatly reduced the size of development banks, improved their governance and professionalism, and focused their activities on catalyzing financial sector participation. It is important to preserve and continue advancing on such reforms to ensure effectiveness of development bank operations. The provident housing funds, however, still focus on direct lending. As part of important countercyclical measures during the recent financial crisis, credit guarantee programs and development bank balance sheets expanded substantially (increasingly through tier I operations), though their portfolio remained below 2006 levels. A strategy for public sector engagement in the financial sphere should clearly define when direct lending is preferred to tier II operations and when to switch between the two. The strategy should also include plans for partner arrangements between provident housing funds and private credit institutions, and mechanisms for reducing development bank's balance sheet once a crisis has passed in order to maintain profitability and avoid excessive risk taking. Finally, to ensure that resources are being used efficiently, the addition of multiple public interventions in the financial sphere should be evaluated to assess the impact on productivity and growth and to rationalize program portfolios.

Matrix of short- and medium-term policy reform options*

Reform areas	Short-term policy options	Medium-term policy options
Improving financial infrastructure	• Simplify authorization procedures for correspondent banks (AR) • Allow deposit-taking credit cooperatives to sign up correspondent banks on the same terms as banks (LR). • Revise fee regulations to encourage the use of non-cash payment methods (AR). • Allow registries to issue certificates of collateral for more efficient use of eligible assets (AR). • Simplify procedures for executing collateral (LR).	• Introduce a national identification system to improve the quality of credit bureau data (AR). • Review the legal and oversight framework for credit bureaus (LR). • Reform real estate registries along the lines of the registry for movable guarantees (LR). • Reform the legal framework for insolvency and business reorganization to increase its use (particularly by smaller firms). (LR)
Developing capital markets	• Create narrow licenses for intermediaries (LR). • Create a hybrid regime within the public offer framework (LR). • Formulate a strategy for regional capital market integration (AR). • Reform the regulatory framework for pension funds and increase replacement rates (LR).	• Require the listing of banks and partial listing of public companies (LR). • Review the regulatory framework for annuities (HI/AR). • Streamline the regulatory framework for investment funds (HI/ AR).
Strengthening consumer protection and financial literacy		• Strengthen CONDUSEF's powers and resources (LR). • Formulate a strategy to enhance financial literacy (AR).
Revising overall strategy for increasing competition in the financial sector	• Develop a strategy for the resolution of cooperatives (AR). • Review the role of provident housing funds and increase their cooperation with the private sector (AR).	• Review public sector credit programs and formulate a comprehensive strategy for development bank operations (AR). • Approve draft modifications to bank resolution procedures (LR).

*LR/AR= Legal or Administrative Reform. Preliminary Classification.

NOTES

This note was prepared by Eva Gutierrez (Lead Financial Sector Specialist, LCSPF), supported by the substantial package of advisory services that the World Bank has provided in recent years to the Mexican financial authorities. These services include the 2011 Financial Sector Assessment Update (FSAP), the 2011 Report on Compliance with International Standards for Insolvency and Creditor Rights, ongoing work on designing a strategy for the resolution of weak unregulated cooperatives in Oxaca, and the 2010 advisory and convening services on public development institutions.

[2] Housing and household credit account for 36 percent of total credit and 66 percent of the interest generated from commercial bank loans. Business loan portfolios account for 47 percent of total portfolios but generate only 25 percent of interest income.

[3] In July 2010 Banxico published reforms dealing with financial charges and fees (Circular 22/2010). The new rules prohibit credit-granting institutions from charging fees for opening and closing on-demand savings accounts; for cancelling credit cards, debit cards, or prepaid credit cards; for e-viewing balances; for withdrawing cash at automated teller machines belonging to the customer’s own bank; and for accessing banking services at a teller window at a branch bank.

[4] Mexican banks that handle large volumes of collections report an average recovery time of two years for secured creditors; unsecured creditors are rarely taken to court. Mortgage foreclosures can be frustratingly slow, averaging three to five years.

[5] Pension funds have been able to invest in private equity only through special instruments called Certificados de Capital de Desarrollo (CKDs). However, CKDs are a second-best solution that limits the scope of investor due diligence to public information. As a result, not all relevant players have agreed to use CKDs, and pension funds are extremely selective about which fund managers they choose to operate with.

[6] For example, by strengthening supervision and enforcement.

[7] Under reasonable assumptions, the 6.5 percent contribution rate will be unlikely to allow that—particularly for middle-class contributors.