Policies and Innovations for Improving Financial Access in Mexico

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Policies and Innovations for Improving Financial Access in Mexico[1]

Abstract

This study argues that although financial access in Mexico is still low, in the last decade several innovations to improve this situation have been implemented. In particular, Mexico has promoted pro-market policies to deal with the following obstacles: poor competition in the financial sector, inadequate legal and judicial frameworks, unregulated non-banking financial services providers, relatively inefficient use of public resources. It is argued that these obstacles relate to at least six of the ten "principles for financial access with stability" put forward by the Center for Global Development. The paper analyzes in detail four recent financial innovations: (i) the mortgage-backed securities market, (ii) a network of popular savings and loan associations, (iii) an electronic market for reverse factoring, and (iv) store, niche and correspondent banking. It is highlighted that financial inclusion policies in Mexico rely heavily on government sponsored schemes as indicated by three of the four cases analyzed here. Further, in none of these cases have private entities so far obtained independence from the tutelage and resources of public institutions. Finally, the paper addresses the limitations of these innovations, provides some policy recommendations, and gives some guidance in terms of exporting these experiences to other countries.

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I. Introduction

There is an old and popular adage that characterizes Mexico as a country of “two-classes:” one rich, modern, and prosperous, and the other poor and anachronistic. This characterization applies to the financial sector, where the two coexist. On the one hand, a competent banking system provides credit to a relatively small number of large firms and high income individuals, who in turn have access to both national and international financial markets. On the other hand, numerous micro, small, and medium sized enterprises and millions of low income individuals cannot access most basic financial services.

Historically, to enhance financial deepening and access Mexico has designed different policies. During the Import Substitution Industrialization (ISI) period development banks and subsidized prices were commonly used to provide funding for people to acquire houses, other durable goods, raw materials, and equipment. Unfortunately, most of these programs failed in terms of fostering growth and reducing poverty. Most importantly, they were unsustainable because of their financial fragility and the expansion of public deficits. In short, market failures were substituted by government failures, which were induced by rent seeking behavior and lack of proper governance rules in development agencies. For this reason, in the last two decades Mexico has promoted other routes to boost financial development, such as the implementation of pro-market policies [De la Torre, Gozzi and Schmukler, 2007].

Achieving this goal requires overcoming several challenges. First, there is still room for increasing competition in the financial sector. Second, even though the legal and judicial frameworks are critical for market transactions, relatively few advances have taken place in contract enforcement. Third, under some circumstances new nonbanking institutions may endanger the safety and soundness of financial services; however, we will argue this can be solved by improving the prudential regulation of these entities. Finally, given government’s role in creating new financial markets and providing incentives for markets to encourage financial access, it is imperative that public policies achieve the proper balance between soundness and market practices, and that public resources are used efficiently.

These obstacles relate to at least six of the ten "principles for financial access with stability" put forward by the Center for Global Development [CGD Task Force, 2009]. (Please see Box 1 below for a brief list of the Principles, which were put forth by CGD's Task Force; Annex 1 presents a more detailed description.)

BOX 1

CGD Principles for Expanding Financial Access

Principle 1: Promoting entry of and competition among financial firms

Principle 2: Building legal and information institutions and hard infrastructure

Principle 3: Stimulating informed demand

Principle 4: Ensuring the safety and soundness of financial service providers

Principle 5: Protecting low-income and small customers against abuses by FSPs

Principle 6: Ensuring usury laws, if used, are effective

Principle 7: Enhancing cross-regulatory agency cooperation

Principle 8: Balancing government's role with market financial-service provision

Principle 9: Using subsidies and taxes effectively and efficiently

Principle 10: Ensuring data collection, monitoring, and evaluation

Source: CGD Task Force on Access to Financial Services, Center for Global Development, October 2009

The principles that relate the most to the obstacles for financial inclusion in Mexico are the following: principle 1, principle 2, principle 5, principle 8, and principle 9. As we show in the paper, some of the recent reforms undertaken in Mexico to improve financial access are in line with these principles, while other issues remain challenges. To better illustrate these remarks, we think it is worth analyzing four recent financial innovations: (i) the mortgage-backed securities market, (ii) a network of popular

savings and loan associations, (iii) an electronic market for reverse factoring, and (iv) store, niche and correspondent banking.

In the remaining part of this introduction we present an overview to highlight the fact that financial access in Mexico is still low and, hence, there is considerable room to implement constructive policies. In particular, we argue that in cross-country comparisons Mexico's indicators of financial deepening and access perform poorly, even in comparisons with economies at similar levels of development. Moreover, we present data that shows particularly skewed distributions in the use of financial services and in the ratio of financial transactions to total expenditures, which reinforces this bleak scenario. Consequently, we conclude that low-income individuals have clearly been neglected in the provision of financial services. In section two we explain the obstacles mentioned above in more detail. Then, in the following four sections, we analyze four key innovations undertaken in Mexico in the last decade. Finally, the last section ends with general conclusions and several policy recommendations to improve these four specific innovations.

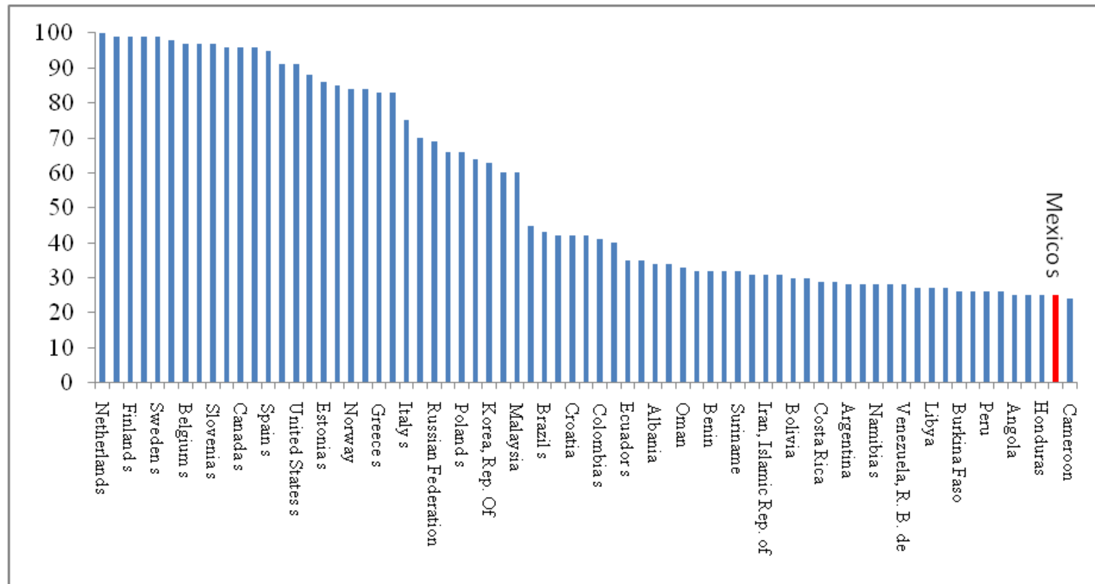
I.1. An overview of financial deepening and access in Mexico

At present, the Mexican financial sector is characterized by social exclusion and a remarkably low level of depth. In a recent study (Beck et al., 2008) where financial access is measured as the percentage of the adult population with access to an account with a financial intermediary, Mexico had an index of 25% and was ranked 101st out of 157 countries; that is, at the bottom part of the worldwide distribution. In addition, when compared with countries of similar or higher income levels (upper middle-income countries or higher, according to the World Bank's classification), Mexico stands out as the country with the world's lowest level of financial access, with the exception of Romania (see Figure 1). Even more, Mexico's position is well below those of many countries with lower levels of per capita income.

Figure 1

Cross-country comparison of financial access

(% of adult population with an account in a FI)



Source: Beck et al (2008) Table A.1

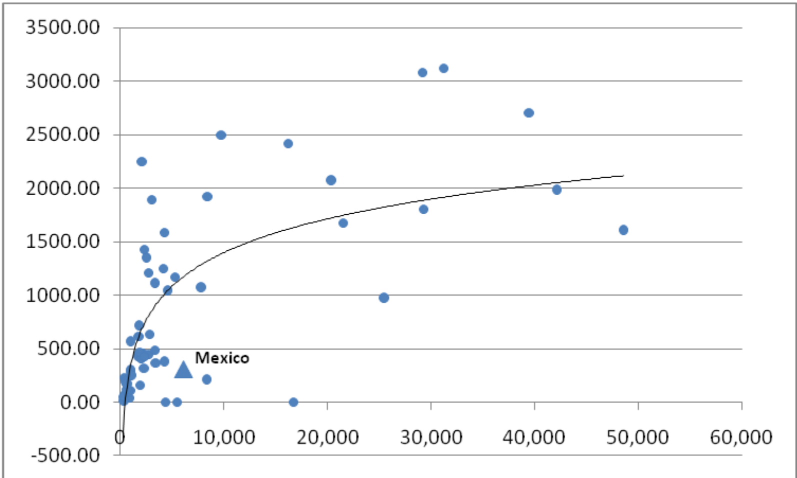
According to Beck et al. (2008), the number of deposit accounts per 1,000 people also portrays the lack of access to financial services. This indicator is around 300 in Mexico. To illustrate how low this value is, Figure 2 depicts data on GDP per capita in 2003 and the number of deposit accounts per 1,000 people in 54 countries for which information is available. The continuous line is a fitted curve estimated using the log of GDP per capita as an explanatory variable. Clearly, Mexico's indicator is located well below what one would expect given its level of income.

The banking sector in Mexico is also severely limited in terms of providing access to credit. Unfortunately, there are no comparable data available on the number of loans per capita for Mexico that could allow us to perform a cross-country comparison. But cross-country data on bank credit to the private sector suggests low financial deepening. Figure 3 shows the 1999-2003 average of this variable as a percentage of GDP against the log of per capita GDP in 2003 for 86 countries. Again, the continuous line is a fitted curve, and Mexico's indicator is well below the value that corresponds to its

level of development. Although bank credit to the private sector in Mexico has increased at a fast pace in recent years, and is now around 22% of GDP, it still lags below its expected level.

Figure 2

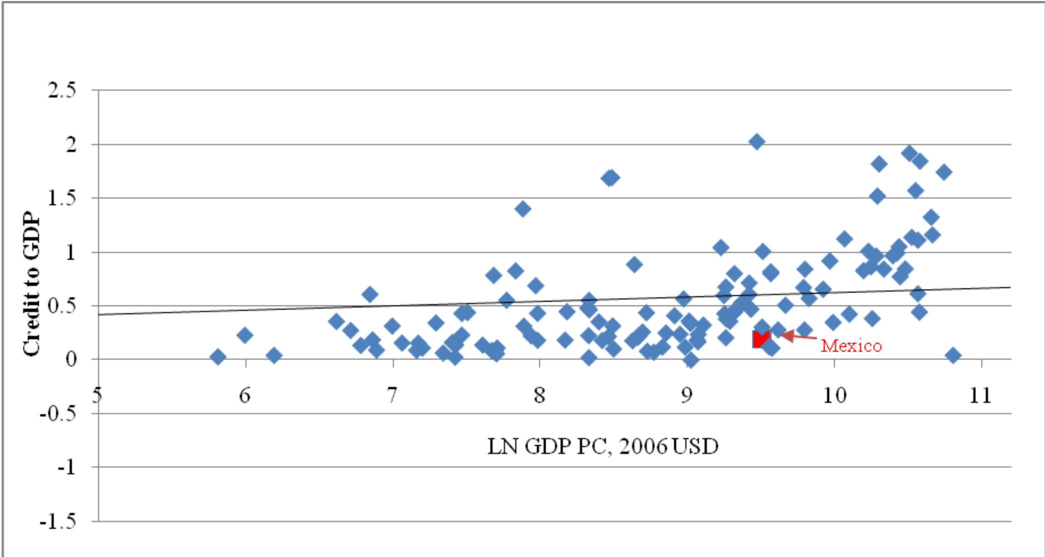
Deposits (number per 1000 people) versus GDP per-capita



Source: Beck, et al (2008), Table A.2

Figure 3

Banking credit to the private sector as a function of GDP per-capita

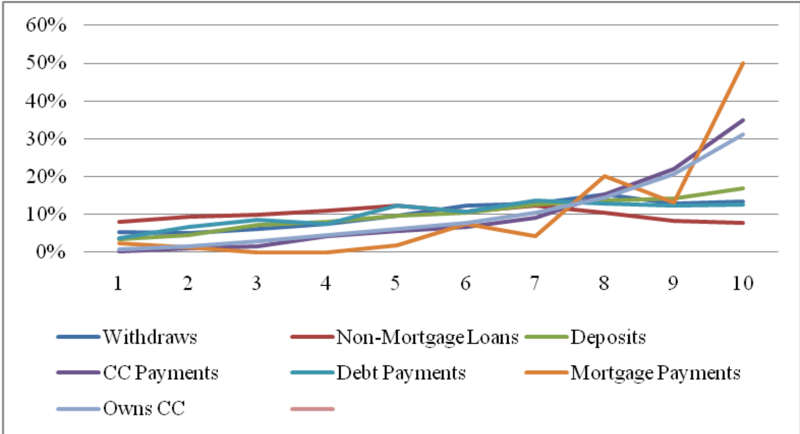


Source: Beck, et al. (2008), Table A.3

Limited financial inclusion is also evident in the distribution of people utilizing some financial product (withdrawals, mortgage payments, credit card transactions, deposits, etc.). Figure 4 shows that the first five deciles have extremely low use percentages, suggesting that financial access is highly unequal. Likewise, Figure 5 presents the amount of financial transactions as a proportion of total expenditure. This data reinforces the conclusion stated above, except that this time it holds for the first 7-8 deciles.

Figure 4

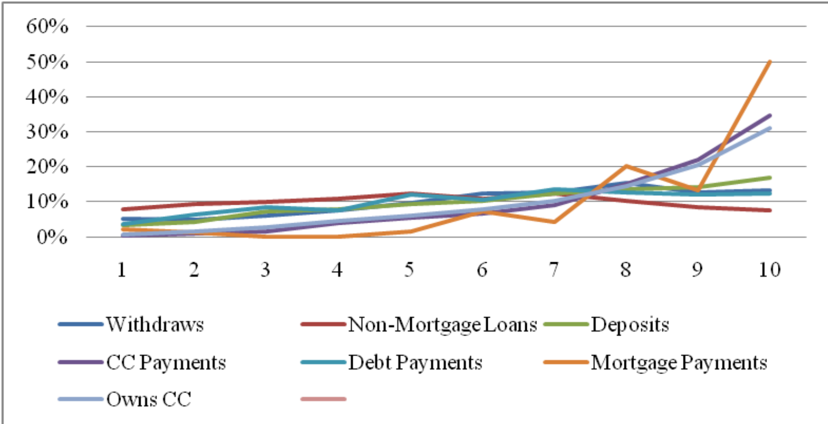
Percentage of people using some financial service by income level



Source: Own calculations based on ENIGH, 2008 (INEGI)

Figure 5

Amount of financial transactions to total expenditures by income level



Source: Own calculations based on ENIGH, 2008 (INEGI)

II. Obstacles to financial access in Mexico

II.1. Judiciary and legal enforcement

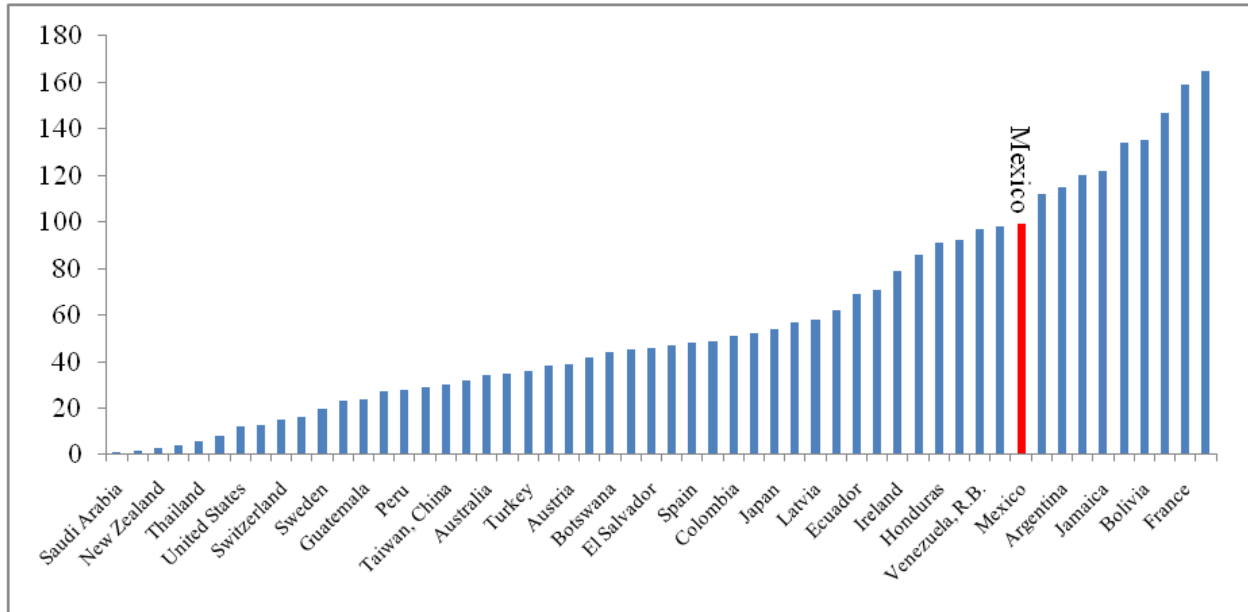
For any market to operate it is important to build hard infrastructure that allows for the efficient flow of information and ability to smoothly conduct transactions of physical goods and services. However, these resources need to be accompanied with the proper judiciary and legal infrastructure, as principle 2 suggests. The quality of the institutions that provide this type of infrastructure is even more critical in financial markets, because intermediaries use other peoples' financial resources to produce a service. In addition, this sector's transactions are plagued with problems of asymmetric information that require sophisticated contracts to generate incentive compatibility among involved actors [Laeven and Majnoni, 2003].

Mexico has been identified as having a very poor level of property rights protection, especially when it comes to finance [La Porta et al, 1999]. It is also well known that the Mexican legal and judicial system is complex [López Ayllon and Fix, 2006]. To be more specific, it is important to emphasize the deficiencies observed in the process of registering property. This is a complicated and expensive process, given that registering is carried out at the state level and requires a public notary. As a result, it does not work properly: Hernández-Ochoa (2006) estimated that in 2003 unregistered urban properties reached a value of $245,000 million dollars; that is, 40 per cent of the total value of property in Mexico. In addition, state registries of property do not coordinate among themselves, and this has deterred the possibility of forming a national public registry.[2] Therefore, transferring ownership of commercial property in Mexico is indeed an expensive and inefficient process, so that Mexico ranks among the most notorious countries in the world. (Figure 6).

[2] In September 2010 a new registry for credit guarantees (*Registro Único de Garantías Mobiliarias*, RUG) started operations. This new development is positive, but immediate results are not expected because: a) at the state level adjustments to legal frameworks are needed; b) not all states have signed agreements to incorporate their data into the new registry; and c) it is possible that new standards are issued or existing ones are modified to accommodate RUG's operation. Other positive news is that Mexico City's (Distrito Federal) public registry of property and commerce has been undergoing a modernization process to migrate the data into electronic databases, improve the framework for protecting it, and making it easier to use. As part of this process, the Federal District's Public Registry of Property and Commerce enacted a new law.

Figure 6

Efficiency in Registering Commercial Property



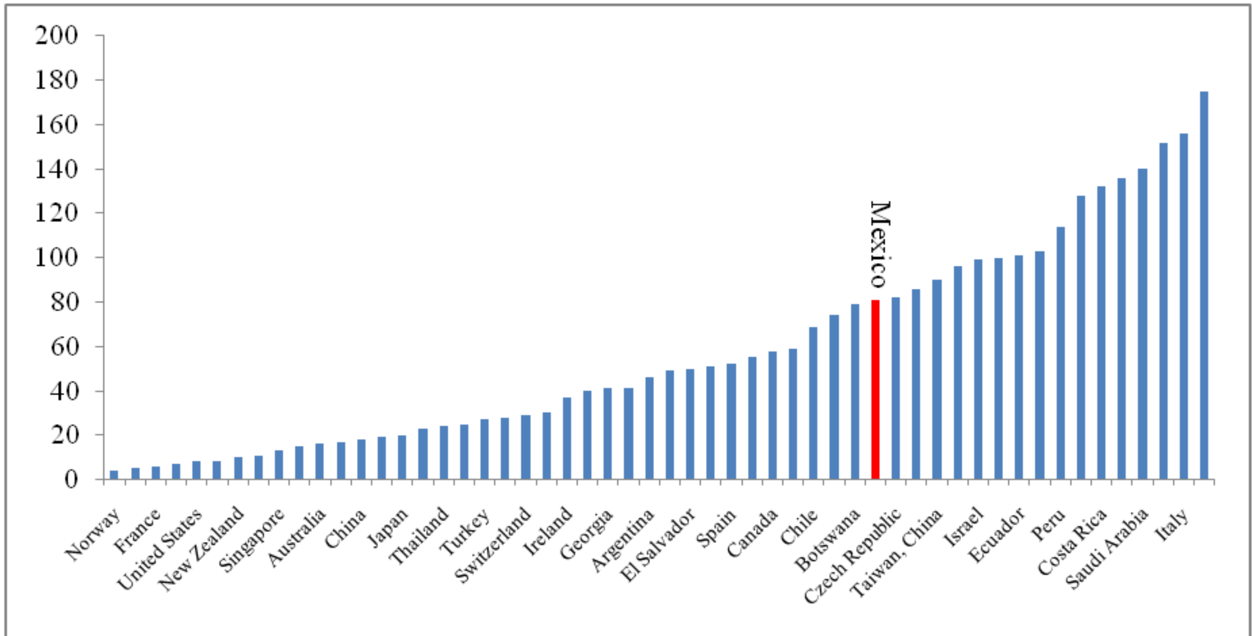
Source: Doing Business, World Bank, 2010

It is important to highlight that both public notaries' fees and the entire transferring process are expensive, amounting to between 7 and 8 percent of the net value of the property (half of this is normally assigned to taxes and fees, the rest is the notary's honorarium). This is compared to 3 to 4 percent in most OECD countries (in the UK, it is even less). Further, the registering process is time consuming. As a result, because both of these factors may deter people from registering property, the collateral involved in the extension of credit is generally not as valuable.

Mexico's procedure for contract enforcement also has deficiencies when compared with those of other countries (Figure 7). The procedure has two steps: the resolution of disputes (loan defaults, for example) by courts that issue a sentence, and the execution or act of enforcing a contract. Caballero (2006) points out that the key bottleneck is in the sentencing and execution that takes place in mercantile trials (such as credit recovery), because it subject to a complex procedure full of loopholes. Table 1 supports this conclusion: the time it takes to carry out a sentence is far longer than the time it takes to obtain a judicial result.

Figure 7

Contract Enforcement in a cross-country comparison



Source: Doing Business (2010)

Table 1

Time extensions of judicial mercantile procedures in Mexico at the state level

	No. of Days (total)	Days between start of trial and sentence	Days between sentence and execution
Average	767	256	522
Maximum	896	613	813
Minimum	593	36	224
Doing Business average	400	190	210

Source: Caballero (2006)

II.2. Concentration and competition in the banking sector

Undoubtedly, the Mexican banking sector is concentrated despite the fact that there are 41 banks currently operating in the country. Hence, principle 1, promoting the entry of and competition among financial firms, needs to be addressed. Table 2 presents the Herfindal-Hirschman Index (HHI) for different attributes of the entire banking system.[3] Additionally, the US Department of Justice's criteria— that an HHI value in the 1000-1800 range indicates moderate concentration, and a value in the 1800-2400 range indicates high concentration—can be considered as a reference. According to this criteria, assets and personal loans are highly concentrated, whereas most other attributes are only moderately concentrated.

Table 2

Banking concentration in Mexico

IHH: Commercial Banks (all)

Rubro	*2007*	*2008*	*2009*
Assets	3,400.33	3,391.42	3,419.15
Commercial Credit	1,478.04	1,387.48	1,395.58
Business Credit	1,348.25	1,293.56	1,325.03
Government Credit	2,152.73	2,372.28	2,521.99
Consumption Credit	1,977.90	1,971.69	1,730.98
Credit Cards	2,351.97	2,234.87	2,310.03
Personal Loans	3,102.73	3,088.21	2,928.72
Car Loans	NA	NA	2,110.47
Mortgages	2,561.02	2,552.13	2,391.94
Short Term Deposits.	1,692.12	1,678.40	1,672.61
Medium & Long Term Deposits	1,375.81	1,285.11	1,285.64
Securities Investments	1,581.34	1,629.24	1,752.62
Interest earnings	1,426.26	1,392.25	1,368.91
Adjusted financial margin	1,554.22	1,476.36	1,416.14
Fees and Commisions	1,904.34	1,811.27	1,744.39

Source: Author's calculation with data from CNBV.

[3] We acknowledge that the use of the HHI to assess the degree of competition is debatable.

Among analysts there is a widespread feeling that there is not enough competition in the Mexican banking sector. This conjecture is supported in recent studies by Negrín, Bátiz, Ocampo and Struck (2008), Chiquiar and Ramos (2009), and Solís (2008). The former study analyzes the credit market from 2000 to 2005 by type of loan: specifically, consumer, mortgage and commercial loans are considered. As expected, it finds that the intensity of competition across types of loans is not homogenous. The only segment of the credit market which seems to behave in a competitive fashion is the market for mortgage loans. Avalos and Hernández-Trillo (2008) have suggested that this could be the result of participation from non-bank competitors (the so-called SOFOLES and SOFOMES).

In an attempt to abate conditions that facilitate and encourage non-competitive behavior, authorities increased the number of concessions in the banking sector. Further, they restricted some commissions and service fees, mostly on credit cards, under the belief that these features distort pricing and need to be regulated because they are opaque and prevent consumers from choosing the most efficient financial service providers (principle 5). However, weak competition remains a critical bottleneck to the expansion of financial services. Credit products are very peculiar because an increase in the number of suppliers does not necessarily produce a reduction in interest rates. On the other hand, banks offer trust and a reputation that exudes confidence and, thus, brand recognition of incumbent banks limits access to cheap sources of funding for entrants. It is also worrisome that the so-called "niche and store banks," created to reach the low income population concentrate in only a few segments (Table 3). In short, it is necessary to increase competition in the banking sector that is directed at the low income population.

Table 3

HHI Niche-and Store-Banks (Low Income Popp.)

	2007	*2008*	*2009*
Assets	8,451.14	6,978.02	5,142.78
Commercial Credit	10,000.00	9,230.65	8,202.95
Firms	10,000.00	9,313.68	8,219.81
Consumption	6,917.01	5,205.01	3,537.67
Credit Cards	4,262.96	3,690.49	4,082.87
Personal Credits	9,766.23	8,941.60	5,038.31
Vehicles	NA	NA	8,046.99
Mortgages	10,000.00	10,000.00	10,000.00
ST Deposits	9,921.85	9,377.04	3,160.10
LT Deposits	4,424.85	2,374.69	3,158.66
Financial Assets Trading	9,993.87	2,656.76	9,345.36
Interest Income	7,340.04	6,514.48	5,253.22
Financial Margin	6,797.54	6,682.74	6,926.84
Fees and Commissions	8,036.81	3,160.10	2,396.74

Source: Own Calculations based on CNBV

II.3. Regulatory infrastructure for widening financial access

The case of Mexico offers an excellent illustration that rules for the soundness of financial intermediaries are necessary for a sustainable financial system, as principle 4 proposes. The expansion of credit without proper prudential regulation and supervision that took place after the privatization of banks in the early 90s was not only unsustainable, but it also took almost 10 years after the Tequila crisis of 1994-1995 for credit to the private sector as a proportion of GDP to recover and begin to increase again. In contrast with the judicial infrastructure, where no clear improvement has taken place over the last fifteen years, the regulatory infrastructure has been transformed several times over the same time period. In particular, important achievements were made in the regulation and prudential supervision of banks (principle 4), and in the provision of information and protection for financial services users (principle 5).

In the light of these reforms, Mexican banks already meet most of the appropriate standards proposed by the Financial Stability Board (FSB) to strengthen the international financial system [IMF Staff 2010 and FSB 2010]. As a matter of fact, during the global financial crisis of 2008-2009 they maintained adequate capital levels. However, since this crisis has brought to the forefront the importance of monitoring systemic risk, the need to pass a new bankruptcy law for financial institutions has been emphasized, and in fact currently there is legislation waiting to be presented to Congress.

A policy of financial access for low-income individuals can be successful when the regulatory framework also exhibits the following features: (i) FSPs have mandates to offer adequate information to their customers about their products and services (principle 5); (ii) there is a system of credit bureaus that provide positive and negative information on firms and individuals' performance in paying old loans and utility bills (principle 2); (iii) the need to strengthen the technical and financial standards of popular savings banks and micro-financial institutions is recognized (principle 2); (iv) there is flexibility in the regulatory burden imposed on FSPs that accounts for their size and the types of financial products offered (principle 4).

These issues have been addressed in Mexico during the last years with different degrees of depth. However, the regulatory framework is not fully adequate to promote financial inclusion, because it is necessary to become a bank in order to offer certain financial services, such as issuing a money order or taking deposits. This bottleneck has had clear repercussions on the nature of the banking infrastructure in Mexico, as observed in the data from the cases studies, which indicate that banks' services are unevenly distributed across regions and population segments.

II.4. Direct policies using public resources

Most development banks and government funds were modernized at the beginning of the 21st century in terms of their administration, technological platforms, corporate governance, and financial supervision [World Bank Staff 2010, SHCP 2010 and IMF Staff 2006]. Specifically, in 2000, effective new rules for rating public banks' portfolios and their supervision were implemented and responsibility for enforcing them given to the Securities and Banking National Commission (CNBV). With the aim of

achieving a proper balance between social objectives and market friendly practices, as principle 8 suggests, these banks are attempting to emphasize a role as market coordinators and focus on the provision of financial services to firms and households traditionally excluded by the private sector. However, as of today these objectives have not been completely met and many contradictions remain.

In conclusion, three of the four cases analyzed in this paper indicate that financial inclusion policies in Mexico rely heavily on government sponsored schemes. Further, in none of these cases have private entities so far obtained independence from the tutelage and resources of public institutions, either because the financial innovations are still in an early stage of development or because financial bureaucrats in the government agencies and financial service providers (FSPs) of the private sector are locked in a cozy relationship that impedes public initiatives from advancing to a stage of full autonomy. In this sense, they are also a prime example of principle 8's relevance— balancing government's role with market financial-service provision.

III. Development of mortgage-backed securities

III.1. Antecedents

As in many other emerging economies, housing needs are far from being covered in Mexico [CIDOC and SHF 2010]. While the number of families is estimated to be around 26.7 million, only 17.8 million have adequate housing. Further, an estimated 530,000 new homes are added each year to the deficit of 8.9 million due to the country's demography. The housing sector has several bottlenecks that constrain the supply of new houses, one of the most important being the lack of financing. Data in Table 4 clearly show that a large portion of the housing shortfall, 3.4 million houses, corresponds to the number of individuals with very low-income (0 - 3 times the minimum salary, VSM) that do not work in the private sector or the federal government. Thus, these individuals are not affiliated with Mexico´s largest housing provident funds (INFONAVIT and FOVISSSTE).

From the 70's through the 90's there were already in Mexico several public financial institutions with a mandate to channel credit to low-income housing. Loans were granted at highly subsidized rates and allocated according to discretionary criteria because these institutions were politically biased and,

thus, favored organized groups with a pro-government stance. By contrast, financial policies implemented in the last decade have been more pro-market oriented in several dimensions. [IMF Staff, 2007]: These dimensions include the following: (i) there is an emphasis on the regulation and supervision of FSPs in the private sector (principle 4); (ii) the most important housing provident funds and government mortgage banks are being modernized [Chiquier and Lea 2009] and encouraged to operate transparently and efficiently (principle 9); and (iii) some of these public institutions have played an active role in fostering the market for housing credit with innovative strategies that attempt to solve market failures (principle 8). In particular, the securitized mortgage market in Mexico was developed with the aim of addressing two key bottlenecks: (a) legal uncertainty and transaction costs that made it very difficult for lenders to recover their collateral in cases of default (principle 2), and (b) lack of competition in the banking sector that hampered the creation of innovative mortgage products with the capability of widening financial access (principle 1).

Table 4

Distribution of the housing deficit in terms of income and geographical location

	From 0 to 3 VSM	From 3 to 6 VSM	Over 6 VSM	Total
Affiliated	3.4 millions	2.2 millions	0.9 millions	6.5 millions
Non-Affiliated	0.3 millions	0.9 millions	1.2 millions	2.4 millions

Source: SHF with data from ENIGH 2008 and ENOE 2008.

III.2. The reaction: SHF

Sociedad Hipotecaria Federal (SHF) was established on 2001 with the main objective of shoring up the Mexican mortgage market for moderate and low-income housing. With its support, the so-called SOFOLES (*Sociedades Financieras de Objeto Limitado*, created in 1994) became the main mortgage originators of the private sector at the beginning of the new millennium. SHF played a very important role in standardizing the sector's origination requirements and loan formats. Its contribution to create the market for mortgage-backed securities (MBS) was crucial: it facilitated the packaging of loans through standardization policies, provided credit enhancement by introducing a system of public

guarantees, and promoted market liquidity through back-to-back loans to SOFOLES, which were funded by means of bond issues and market-making activities.

Modifications in the legal and institutional infrastructure

For an FSP to become interested in issuing MBSs it is essential to create legal mechanisms that ease the transfer of real estate titles and expedite procedures to recover collateral. Traditionally in Mexico, property titles and liens have been registered at a bureaucratic registry office at the state/municipal level (*Registro Público de la Propiedad*) with the intervention of a public notary, who charges fees as high as 8 to 9 percent of the property's value. Likewise, in the MBS market, the holder of a mortgage loan should have senior status when claiming collateral rights, which is not the practice in Mexico [Zanforlin and Espinosa, 2008]. Moreover the time required for enforcing mortgage collateral in Mexico fluctuates between 9 and 30 months (the average is 20 months). This contrasts sharply with 14 European countries (not including Italy) where the procedure lasts in most cases less than one year, and with the United States where it lasts 8.4 months on average [Chiquier and Lea, 2009, Table 5.1]. Last but not least, it is important to have financial entities that operate as special purpose vehicles (SPVs) to facilitate the transfer of the debt service to the bond holder.

Accordingly, laws covering securities and credit guarantees that were passed in 2000 made it possible to use a trust (*fideicomiso*) as an SPV. Through this figure the trustee obtains priority rights on the loan's collateral, as opposed to what happens with a traditional mortgage. With the new legal framework, the trustee can sell the collateral in a public auction without undertaking a mortgage foreclosure procedure or asking permission from the borrower. This permits the trustee to foreclose credit collateral through out-of-court procedures, in case the borrower defaults, as well as make payments to investors of securitized bonds. Likewise, the law exempts the trust from registering the transfer of mortgage liens while the debt keeps being serviced.

Fostering competition in the mortgage financial sector

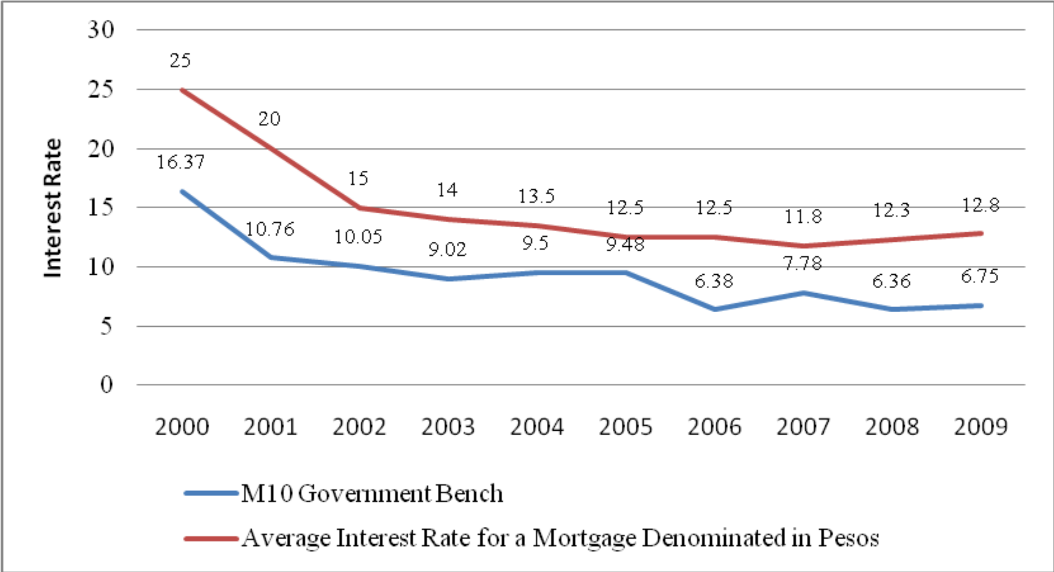
SOFOLES became very active in originating mortgage credit to socio-economic groups that had never received much attention from commercial banks. Real estate developers of low-income housing were also favored through bridge-loans coming from securitized certificates issued by SOFOLES. These

institutions became true contenders in the provision of mortgage credit and made possible a sharp reduction in interest rates (see Figure 8). This strategy was reinforced with the creation of a new legal entity in 2006, *Sociedades Financieras de Objeto Múltiple* (SOFOMES). The idea was to strengthen the financial position of non-bank intermediaries, giving them more flexibility and the possibility of operating in different financial activities (lending, factoring, leasing) and segments (consumption, housing, commercial).

SOFOLES (used here as a generic term for SOFOLES-SOFOMES) are not the only institutions backing securities with mortgage credit in the Mexican market. Additionally, there are also multiple types of securities available in the market for residential mortgages. These securities include the following: BOHRIS issued by non-bank financial intermediaries, including SOFOLES, as well as banks certified by the SHF; CEDEVIS, which are issued by the INFONAVIT, a housing provident fund created by the federal government in 1972 to administer a savings fund for housing for private sector workers; and TFOVIS, which are issued by FOVISSTE, a similar fund for federal government workers.

Figure 8

Average Mortgage loan denominated in Mexican Pesos



Source: SHF

The first issuance of residential MBS in Mexico occurred in December 2003. In the following four years the total value of securitized certificates increased steadily (see Table 5). But the international financial crisis and the lack of liquidity in the domestic market lead to a reduction in the amount of money raised in real terms during the 2008-2009 period. INVONAVIT issued CEDEVIS for the first time in 2004, yet by 2007 its percentage of the securities market was already 27%. FOVISSSTE's TFOVIS are even more recent, since they were first issued in June 2009.

Table 5

Annual new issues of residential MBS by type of certificate

(Millions of pesos)

Year	BORHI+HiTo	Other Emissions	CEDEVIS	TFOVI	Total
2003	596	–	–	–	596
2004	2749	–	1959	–	4708
2005	2859	–	3274	–	6133
2006	12497	–	5998	–	18495
2007	22430	3847	10213	–	36490
2008	16015	4830	14443	–	35288
2009	7425	–	6110	3500	17034
	64570	**8677**	**41997**	**3500**	**118745**

* Data for 2009 only includes information as of August 25, 2009. The total for 2009 was 36,553 (in millions of pesos)

Source: SHF and CIDOC (2010), Section 6.1.1.

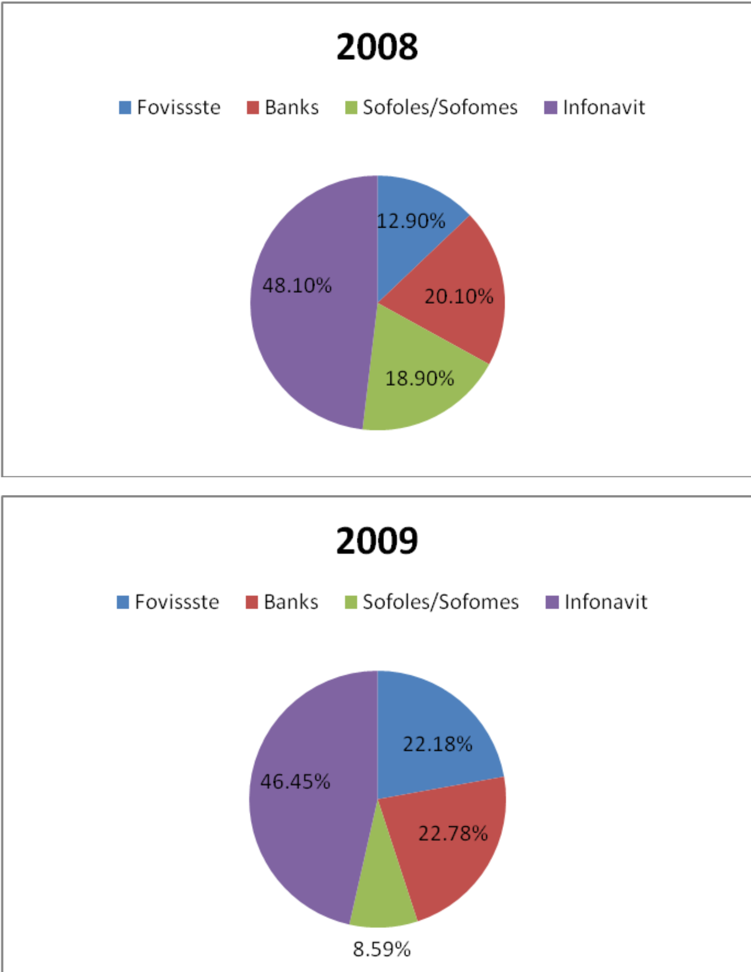
III.3. An overview of the experience

Since 2001 housing finance has experienced an unprecedented expansion in Mexico and, most importantly, around 80% of this credit was granted to individuals with low and moderate incomes.

Between 2001 and 2008 the number of houses financed through the mortgage market grew from 295,811 to 832,842; this is an impressive growth rate of 281.5% in eight years. The number of mortgage loans acquired in 2009 was 845,910; though this number increases substantially if loans for home improvements (894,496) are also included. Figure 9 shows the market share for credit origination of individual houses in the years 2008 and 2009. These pies illustrate that 60-70% of mortgage credit is granted by the housing provident funds of the federal government, while the remaining 30-40% is originated by private FSPs, either banks or SOFOLES.

Figure 9

Market share of the credit origination of individual houses



Source: AHM

The financial crisis and delinquency rates

Because of the sharp contraction of the economy in 2009 (a GDP growth rate of -6.5%) and the ensuing hike in unemployment rates, SOFOLES' issues of MBS experienced a steady increase in delinquency rates.[4] The performance of banks' securitized certificates also deteriorated, but their delinquency rates were not as high because they were backed by mortgages of high and middle income level houses. Similarly, CEDEVIS' deterioration was less pronounced because of the extension period of 12 months that workers received in cases of unemployment, and because mortgage payments are deducted directly from the borrower's paycheck.

Due to this bleak scenario, in May 2010, SHF launched a program to roll over the short-term commercial paper of six SOFOLES, with a public guarantee of 65% in case of delayed payments. Furthermore, SHF offered 20,200 million pesos in 2010 at a reduced interest rate (8%) to eleven independent SOFOLES, with the aim of funding bridge-loans. The withdrawal of private investors from the market during the financial crisis also forced SHF to support it by purchasing MBS for 18,372 million pesos between January 2008 and December 2009. Likewise, as of November 2009, securitized certificates acquired by SHF reached 35,255 million pesos, which is a large amount considering that at the end of 2009 its credit portfolio was 53,197 million pesos. Nonetheless, SHF's financial position remained healthy, with a net profit of 237 million pesos, although this profit implies a sharp drop of 353.6% and 640.1% with respect to the 2007 and 2008 annual results, respectively.

III.4. Limitations

The structure of the market and developers' conflict of interest

There is a conflict of interest when real estate developers are the main brokers in the origination of mortgages financed through SOFOLES, which is the present situation in Mexico. The developer who receives a bridge-loan to undertake a project has the incentive to sell the houses

[4] The delinquency rates (*índice de morosidad*) of the portfolio of SOFOLES specialized in mortgage credit increased from 8.89% in 2008-IV to 14.46% in 2009-IV. These two percentages are high when compared with the rates observed for the total population of SOFOLES (5.20% and 8.09%, respectively). For more details see Moody's Investor Service (2010) and AHM (2010).

quickly. The reason is that by using the down payment and the credit mortgages for individual houses, he or she can service the debt and start a new project. An accelerated sale may result in an origination process of poor quality, especially when the economy experiences a housing boom. Once borrowers fail to meet their payments, the originator does not pay a severe penalty for doing a poor job, as long as it is not disastrous. Reputation mechanisms do not work very efficiently as a deterrent when very large participants with market and political power exist. Further, most of the SOFOLES in Mexico are rather small in terms of assets, while developers are very large.

Conflicts of interest in housing provident funds and cross subsidizing

It is also important to scrutinize INFONAVIT's operations because it is a very large market participant, particularly in the issuance of MBS.[5] This fund also has a mandate to manage workers' savings that come from compulsory contributions. However, this objective cannot be pursued effectively, since offering a market return to account-holders contradicts the fund's other mandate to allocate subsidized credit for low-income housing. Therefore, when forced-savings receive attractive real returns, the subsidy amount has to increase or *vice-versa*. This situation becomes more problematic when it is considered that INFONAVIT faces many constraints on how to diversify its investments and what type of credit services it can offer.

Furthermore, the great majority of workers affiliated with INFONAVIT have very low salaries, on average below 4 VSM, which disqualifies them from being considered creditworthy candidates by private intermediaries. Unfortunately, even this institution grants a large share of its credit to individuals with an income above this threshold, either directly or through a system of co-financing with a private FSP. Consequently, those low-income individuals that are forced to save but who do not receive a loan are in fact subsidizing the low interest paid by those workers who do receive a loan—who are also mostly in the upper income brackets. Even though it is true that in recent years INFONAVIT has granted more loans to individuals in lower income segments, the subsidy will remain as

[5] INFONAVIT was the largest issuer of MBS in 2009 with 34% of the market.

long as there are relatively few programs that provide housing for low income workers in the formal sector.[6] For this population, INFONAVIT has recently designed a scheme to provide rental housing.

Unfair competition between private and public issuers

Despite the fact that CEDEVIS have been backed with non-standardized mortgages and that these bonds lack explicit financial guarantees, their spreads with respect to government bonds are extremely low. Perhaps this is due to the fact that their issuances have high levels of -overcollateralization (18-23%), or that there is a perception among investors and intermediaries that CEDEVIS (and TFOVIS) have an implicit government guarantee. Furthermore, public guarantees supported by non-recoverable funds cloud the process of market pricing for securities. Consequently, the recent financial crisis and the bankruptcy of two large SOFOLES have created an extremely bleak environment for private issues of MBS. During 2009, for the first time since the market was created and as a result of these asymmetric conditions, public issuers (INFONAVIT and FOVISSTE) dominated the origination of MBS.

III.5. Can this experience be exported?

The Mexican experience with MBS has been positive overall, despite the recent contraction in the housing credit market. The securitization process allowed a substantial increase in housing finance for households that were previously excluded from the market. In general, financial institutions—both public and private—have a healthy financial position despite the severity of the international financial crisis. A development bank's –SHF- backed effectively the supply of liquidity and guarantees to non-bank intermediaries. However, this experience also makes clear that some elements of the Mexican mortgage market should not be replicated elsewhere. Namely, even though there is no doubt that the modernization of the housing provident funds, such as INFONAVIT and FOVISSSTE, has boosted housing construction for middle-income individuals in the last decade, these institutions create unnecessary market distortions.

[6] Currently, there is a housing program (117 VSM – i.e. 204,483 pesos in 2010) for individuals with an income below 4 VSM, and another program for encouraging periodic savings until the individual becomes creditworthy.

Alternative forms of securitization

In spite of the high growth experienced by the MBS market in Mexico in the last seven years housing needs are far from being met. SHF's estimates show that the credit market for mortgages must increase from 9% of GDP in 2008 (1.1. billion pesos) to 36% in 2020 if housing demand is to be met. Therefore, a second stage in the evolution of the market seems evident in view of two complicating factors. First, perverse incentives are observed whenever origination is detached from default risk. Second, there is a need for achieving economies of scale that can make small SOFOLES more competitive when attracting investors, without inducing systemic risk. To address this need, two alternative securitized certificates are briefly described: (i) the Danish system that already operates in Mexico at a reduced scale, and (ii) a system of covered bonds (CB), which has been very successful in Chile and some European countries.

(i) Danish mortgage system

In November 2006, SHF established a technological platform, known as *Hipotecaria Total* (HiTo), with the objective of securitizing mortgages more expediently, reducing risks, and reducing funding costs. The Danish system is appealing to small FSPs whose standardized mortgages can be packaged in an issue of securitized certificates. This mechanism allows the borrower to maintain his or her financial stability because loans are made at fixed interest rates; however, borrowers can also take advantage of changes in economic conditions, given that mortgage payments can be made in pesos or in securitized certificates, (BonHiTos) according to the principal balance. The originator—or mortgage banker—also benefits because there is a reduction in funding costs, since working capital is required only for the time that elapses between the origination and securitization—approximately five days.

(ii) A market for covered bonds

Some analysts have suggested that it would be convenient to introduce a market for covered bonds (CB) in Mexico because it removes the negative incentives in the origination process. This is because as opposed to traditional MBSs, mortgage credit remains on the balance sheet of the FSP despite the fact that the funding is collected with the bond issue. If the issuer defaults, investors keep a claim on the cash flow generated with the mortgages. Likewise, if some borrowers fail to pay, their mortgages are removed from the portfolio that backs the CB issue. International experience with these instruments (Spain, Germany, France and Chile) has shown that the funding cost is much lower with

CBs than with traditional MBSs. In the European Union the total value of CBs issued is much higher than the value of MBSs [BBVA-Bancomer, 2009].

The complexity of its replication

Benefits from developing this type of market are evident. However, few countries have been able to do so because the required steps to make it viable are many and they cannot be implemented in a short time period [Chiquier, Hassler and Lea, 2004]. Recent evidence (Chiquier and Lea, 2009) indicates that around 18 countries have issued MBSs and only 8 have issued CBs. Likewise, the amount of funding obtained from capital markets has so far been very limited. Exceptions are Chile, Hungary and the Czech Republic, which, through CBs, have been able to raise around 70, 60 and 40 percent of housing funds in a specific year, respectively. The most successful countries in terms of raising housing funds from MBSs are Colombia and Malaysia, whose capital markets have provided up to 30% of housing finance in different years.

III.6. Reflections on the innovations in light of the CGD Task Force principles

The CGD Principles presented in the Annex can be used to further assess strengths and shortcomings of the innovation. The relevant principles to assess these innovations are 1, 2, 4, 8 and 9.

Principle 1. With SHF's support, new non-bank institutions, such as SOFOLES, were able to actively compete with traditional banks in the mortgage credit market. As a result, households generally benefited from a sharp reduction in interest rates and middle-income individuals in particular gained access to mortgage credit granted by private FSPs. This case illustrates that providing alternative sources of funding to new entrants may be crucial, given that switching costs favor incumbent banks with large deposit bases.

Principle 2. For banks to face contestability in the mortgage markets it was necessary to create a proper legal infrastructure that supported the creation of an MBS market. Above all, it was necessary to solve contract enforcement problems related to collateral foreclosure and the transfer of titles.

Furthermore, non-bank institutions were enabled to compete thanks to the liquidity provided by SHF and the possibility of issuing securities backed by public guarantees.

Principle 4. Although SHF exerted a regulatory role when standardizing SOFOLES' origination of loans and providing them with liquidity in the early stages of the MBS market, these FSPs were not regulated by the CNBV unless they belonged to a financial group. However, the current trend is towards more regulation of the SOFOMES, since the financial crisis has made it evident that, despite the fact that these entities do not receive deposits, they should be regulated if they raise funds in the capital markets and present systemic risk.

Principle 8. It is not very clear that SHF's multiple tasks in the MBS market as a provider of loans and public guarantees, market-maker, and supervisory agency can be easily redefined in the near future. This is partly due to the fact that FSPs face unfair competition from the government housing provident funds, which actively issue MBSs, and from the reticence of investors to buy private entities' bonds in the aftermath of the financial crisis..

Principle 9. INFONAVIT and FOVISSTE, the largest housing provident funds in the country, use subsidies to grant an extensive amount of credit. This makes the proper pricing of risk more difficult. Furthermore, it heavily distorts competition in segments where private institutions are willing to finance housing and, with the use of mandatory contributions, boosts the productive sector's incentives to channel activities towards the informal sector. For all of these reasons, the recent success of INFONAVIT and FOVISSTE in improving access to mortgage credit among low and middle income individuals is not sustainable in the future. Moreover, since Mexico's financial inclusion policies rely heavily on government sponsored schemes, emphasis should move from an active use of credit guarantees and subsidized interest rates towards lump-sum subsidies and seed capital. The latter instruments are more transparent than the former because they allow for budgetary control. They are also more efficient since they do not distort risk pricing.

IV. Regulation and promotion of popular savings and loan associations

IV.1. Antecedents

Individuals and microenterprises in the Mexican rural sector have historically lacked support from formal financial institutions, which have lacked incentives to expand their geographical coverage. In rural and semi-rural locations, poor coverage by commercial banks through branches and ATMs is still pervasive. Table 6 presents the number of municipalities with banking branches and ATMs. Only 36% of municipalities have at least one bank branch. ATM figures are just slightly better, since 37% of municipalities have at least one unit. Further, in reality, most bank branches and ATMs are located in urban and metropolitan areas.

Table 6

Bank branches and ATMs by type of locality, June 2009

Type of Municipality	Number of municipalities	Number of Municipalities with banking branches	Municipalities with ATM's
Rural	732	27	38
Semi-Rural	678	141	124
Semi-Urban	662	345	365
Urban	312	288	277
City	61	60	60
Big City	11	11	11
Total	**2456**	**872**	**909**

Source: *Comisión Nacional Bancaria*, Primer Reporte de Inclusión Financiera, Marzo 2010. A rural municipality is one with 2500 people or less; a semi-rural area has between 2500 and 15,000 people; a semi-urban area has between 15,000 and 50,000 people; and an urban municipality is considered one with less than 100,000 people. A city is an area with between 100,000 and 500,000 people. A big city has 500,000 people or more.

Bank participation by people's level of income presents a clear picture as well. The use of commercial banks by individuals with an annual income above 480,000 pesos is practically universal (96% of them live in urban locations). Unfortunately, this segment represents only 3% of the country's total population. In contrast, of the 30% of the country's population with an annual income below 50,000 pesos (half of them live in rural and semi-urban locations), only 12% are being serviced by commercial banks. [Seira et al 2010].

Limited credit access forces micro-entrepreneurs to use up their savings and assets. This, in turn, can have a detrimental effect on optimal asset accumulation at the household level. Credit rationing is an outcome of imperfect information if, for example, high interest rates or collateral requirements result in moral hazard and adverse selection problems that increase the risk of a bank's portfolio. Likewise, credit restrictions arise in countries where institutional monitoring and enforcement mechanisms are weak— which highlights the importance of principle 2 of the CGD Task Force. It is for all of these reasons that individuals who are looking for the capital to setup or run small businesses find it relatively easier to raise credit from their friends, relatives or moneylenders.

Even those with access to formal banks often utilize informal finance to complement their financial portfolios.[7] This situation was reinforced in Mexico with the liquidity shortage experienced in the aftermath of 1995 banking crisis. Therefore, the size of the informal micro-credit market in Mexico is significantly large. As expected, it experienced rampant growth and by the end of the 1990s a number of savings and loan institutions (*cajas de ahorro*), mainly in the countryside, went bankrupt due to mismanagement or fraud.

IV.2. The reaction: BANSEFI

All these factors convinced the Mexican government of the need to have a financial inclusion strategy centered on modernizing and regulating the so-called "popular financial institutions" (*cajas de ahorro*) [Taber, 2005 and De la Torre, Gozzi and Schmukler, 2007]. This experience is connected with principles 1, 2, 4, 5, 8 and 9. First, a Law for Popular Savings and Credit (LACP) was passed in 2001 and a new development bank (BANSEFI, *Banco de Ahorro Nacional y Servicios Financieros*) was established with the objective of facilitating financial access for low-income individuals, especially in poor

[7] See Hernández et al (2005).

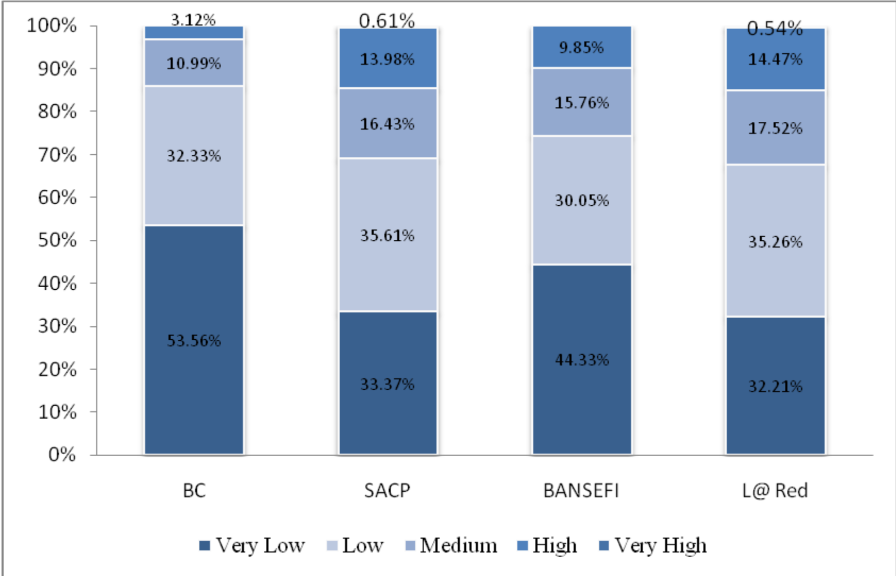
municipalities not serviced by commercial banks. Pulverization of the popular financial sector made necessary the presence of a centralized agency that, in the first stage, coordinated the consolidation and regulation of the savings and loan institutions (EACPs). In the second stage, it helped these institutions achieve economies of scale and scope with the support of a technological platform and the use of a system of strategic alliances with regulated ECAPs known as *L@ Red de la Gente* (L@ Red) –the "people's network."

IV.3. Bansefi: an overview of the experience

Data as of October 2009 shows that the EACPs, BANSEFI, and L@ Red have reached more localities than commercial banks. Moreover, while there are EACPs in 71.53% of localities, banks cover only 58.47%. In addition, popular sector FSPs have been more interested than banks in setting up offices in poor localities. Figure 10, below, indicates that commercial banks reach only 3% of the population in poor localities, while the popular financial sector institutions cover between 10% and 15% of them.[8]

Figure 10

Distribution of branches according to type of locality for different FSPs



Source: Seira et al (2010) with data from BANSEFI

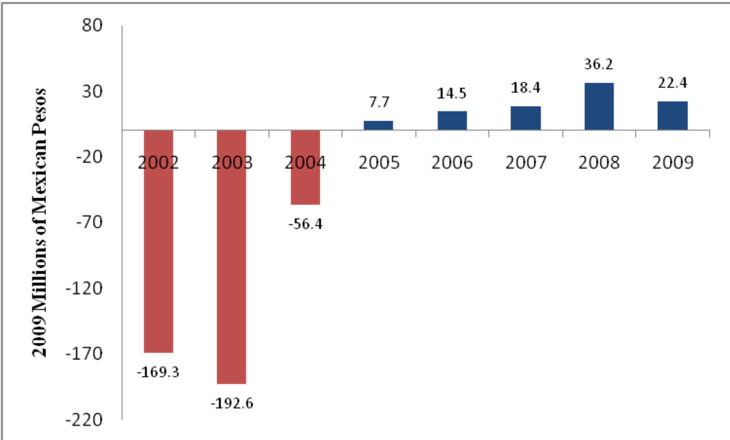
[8] This section is based largely on Seira et al (2010).

In addition to successfully opening offices in poor localities which previously did not have financial services, BANSEFI has been able to attract a large number of clients in a relatively short time period. Moreover, annual total deposits and the number of accounts had a steep increase during the period from 2001-2009; that is, there was nominal growth over six years of 245.5% in deposits and of 234.7% over seven-years in savings accounts. Another comparison shows that in December 2009 commercial banks as a whole managed 79,570 thousand accounts, while in that month BANSEFI alone administered 4,677 thousand accounts. It is important to stress that this steady increase in the number of accounts is not only due to the commercial efforts of the development bank, but also to the use of the bank's offices to disburse benefits of government programs.

Data of net annual profits and losses illustrates that this expansion has been achieved with a healthy financial position (see Figure 11). While in the first three years of operation there was a net loss because of the large expenses needed to set up the bank, in the following four years, up to 2009 when the international crisis hit the Mexican economy the bank had a steady increase in net profits. Nonetheless, in 2009 there was also a positive real profit (22.4 million of pesos). The ROA of 0.31% for 2009 is in line with the average of 0.46% observed in other development banks. Obviously, this percentage is much lower than in profit-oriented financial institutions; for instance, commercial banks had an average ROA of 12.77% (June).

Figure 11

Net profits/losses adjusted by inflation



Sources: Seria et al (2010) with data from BANSEFI

Advances in the regulation process

In a process of gradual regulation, the LACP established the re-composition of the EACPs under two legal entities: the Cooperative Associations of Savings and Loan (SCAP, non-profit motivated) and the Popular Financial Associations (SOFIPOS, limited liability firms). In addition, following the German and Canadian models, the law promoted the creation of federations and confederations of popular financial institutions with the aim of assisting the CNBV in its supervision functions. The large number of popular FSPs makes the presence of auxiliary regulatory entities indispensable.

Although the law originally established the year 2004 as a deadline for the regulation of EACPs, the task has not been easy since the transformation involves many operative and financial adjustments. Moreover, several EACPs have displayed reticence to enter into the program for political considerations and consider BANSEFI as a competitor in deposit-taking. Consequently, the closing date was extended and changes to the legal framework were implemented. Then, on August 2009 a new law was passed— the Law to Regulate the Activities of Savings and Loan Cooperative Associations (LRASCAP)—and several reforms were made in the LCAP. These reforms had the purpose of making the supervision regime more flexible and establishing an insurance scheme for depositors in large sized cooperatives. This scheme was based on a protection fund administered by a confederation. In the new legislation, EACPs were subdivided into Popular Financial Associations (SFPs) and Communitarian Financial Associations (SFCs), the latter with activities in the rural sector.

Advances in the restructuring process are still very limited. By February 2010, only 93 EACPs had met all the law requisites out of the 591 institutions identified by BANSEFI in 2007 that had an interest in normalizing their situations. According to CNBV data, the financial institutions authorized to work in this sector include: 1 confederation, 13 federations, 56 savings and loan cooperative associations and 37 popular financial associations. In addition, there are 7 additional entities whose files are under revision by the CNBV, 273 are under the status of “conditional deferral,” and 123 did not have to be regulated by the CNBV because they had assets below 6.5 million Udis (an accounting unit that reflects a constant real value). Nonetheless, regulated institutions have grown during the last seven years in terms of branches, membership, number of clients, and total deposits reflecting the fact that the legalization process itself provides a positive signal to clients.

A successful model of regularization

In regards to the creation and regulation of popular FSPs, it is important to call attention to a specific program that was implemented in 2000, coordinated by the *Secretaría de Agricultura, Ganadería, Desarrollo Rural, Pesca y Alimentación* (SAGARPA). This program, known as "Regional Project for the Technical Assistance of Rural Microfinance" (PATMIR), has the support of the World Bank. The program uses international consultants, and its aim is to strengthen existing financial intermediaries and create new ones so that low-income individuals in rural municipalities are able to access financial services. Supported institutions receive temporary subsidies that decrease over time, and they are channeled to the creation of infrastructure, technological modernization, human capital investment, and knowledge transfer.

According to SAGARPA functionaries, the objective in 2012 is to benefit a total of 1,022,500 members. As of June 2009, 139 popular financial institutions (i.e. 43.5% of the eligible universe) had been supported by four consulting firms that were awarded contracts, benefiting 126,328 members in 23 States of the Republic. As of the date of this writing, data from PATMIR indicates that on average members keep savings accounts with balances of 4,415 pesos and obtain loans in the amount of 4,814 pesos. This may illustrate some evidence of improvement in financial access, considering the target population of the program. However, it is small if we consider that the number of members represents only 1.26% of those states' population. Nevertheless, the program does push in the right direction. The remaining challenge has to do with principles 8 and 9, since it is hard to evaluate ex ante what would happen if public resources are removed.

Advances in the networking process

As part of BANSEFI's strategy to attain economies of scale and scope in the popular financial sector, in recent years it has established a series of strategic alliances with several EACPs so that financial products and branches can be shared. Popular financial institutions that are further along in the transformation process set up by the LACP can, if desired, become members of BANSEFI's L@ Red. At the end of 2009 L@ Red was already integrated with 254 partner organizations, 2,054 branches (including 513 in BANSEFI), and it served around 5 million members and clients. The mean annual average growth in the number of branches for the period of 2002-2009 was 16.72% (see Table 7).

Table 7

Expansion of L@ Red

	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Partners	6	17	58	68	108	174	205	254
Branches	696	699	737	1168	1236	1594	1703	2054
Municipalities	420	429	485	626	710	750	770	820

* Source: BANSEFI

These numbers make L@ Red the largest financial network in the country in terms of the number of branches (2,054 *versus* 1,797 for BBVA-Bancomer and 1,624 for Banamex, the two largest commercial banks) and coverage of national territory; it incorporates 820 municipalities (*versus* 801 for all commercial banks) out of a total of 2443municipalities located among the 32 states. In fact, in many of these localities L@ Red is the only FSP offering formal services. The incentives for EACPs to form part of L@ Red are related to reductions in transaction costs (marketing, selling points) and the possibility of offering new services that are already available through BANSEFI's offices.

A study cited by Seira et al (2010) shows that the median amount of savings (246 pesos) in the accounts of beneficiaries of *Oportunidades* is larger than the median amount of savings (101 pesos) in the traditional accounts of BANSEFI. Therefore, the transferring of these subsidies through banking accounts seems to contribute to promoting a financial savings culture. Given that the government provides recurrent subsidies to more than 8 million beneficiaries, the objective in the short term is to take advantage of the process of disbursements in branches of popular FSPs to create a culture for using banking products and services.

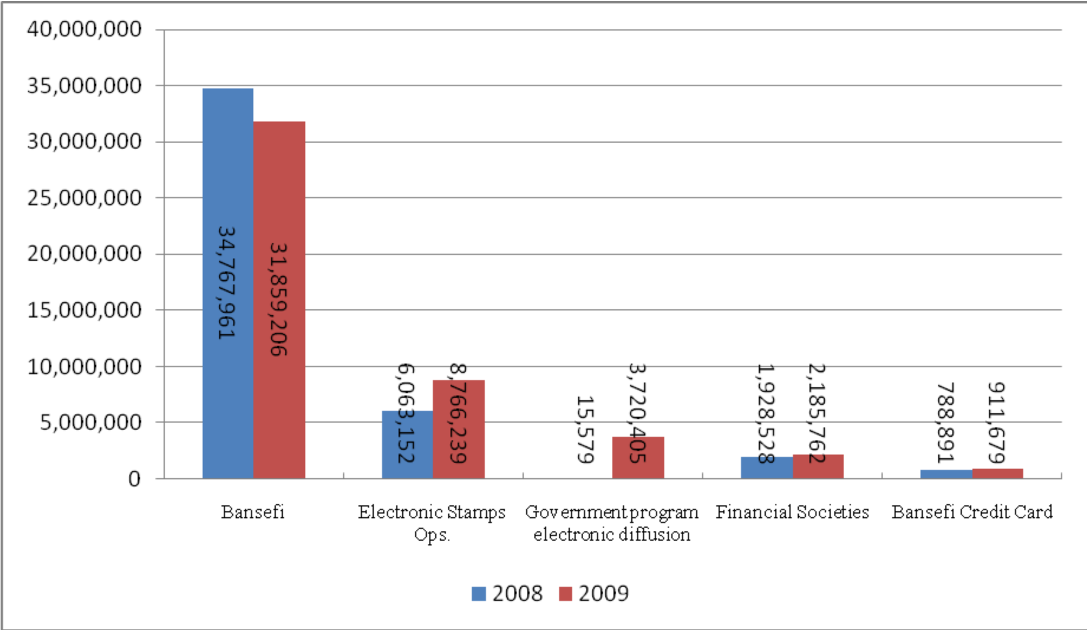
Technological platform

BANSEFI has also developed an electronic platform with a wide variety of applications, the most important being core banking services; that is, basic services to deal with the operations of retail customers throughout all inter-connected branches. The technological platform of BANSEFI (PTB) also has applications for risk management and the administration of credit and debit cards, as well as offering the possibility of paying services to third parties. It also includes a module to electronically deposit recurrent subsidies so that the beneficiary can use his or her card in ATM and EFTPOS

terminals. As of December 2009, there were already 523,580 accounts using this electronic service, and 49 FSPs had used the PSB for the management of 5 million accounts belonging to 4.6 million clients in 716 branches. Although most transactions took place through BANSEFI branches in 2008-2009 (see Figure 12), it is expected that more FSPs will use the PTB in the near future.

Figure 12

Number of transactions with the PTB by type of FSP



Source: Seira et al (2010) with data from BANSEFI

The use of financial services in popular FSPs

It is also important to analyze whether or not the availability of an EACP is associated with an active use of financial products. Cotler and Rodriguez-Oreggia (2009) study this issue with a panel data sample collected by BANSEFI in two waves for the years 2004 and 2005. They estimate a probit model where the dependent variable indicates whether or not a household with access to an EACP in its locality obtained a loan in the last 12 months. Because most of the clients/members of these EACPs do not have formal documents to prove income flows or the guarantee of assets, these researchers considered the use of financial services to be basically a demand decision. The estimations are

consistent with the idea that EACPs' credits are used for productive purposes, since the probability of getting a loan increases for those who are self-employed and those whose wealth is above certain level, which are both required to start an informal business. Econometric results also indicate that credit helps to cushion adverse financial events at the local and household levels.

IV.4. Limitations

BANSEFI has conflicting mandates in so far as the bank works as a deposit-taking institution at the same time that it coordinates the regulation and networking efforts (L@ Red and PTB) of popular savings and credit entities. This situation created distrust among some popular FSPs and was a crucial element in slowing down the regulation process. Reacting to this problem, authorities of the development bank and the Ministry of the Finance (HACIENDA) have pointed out, repeatedly, that BANSEFI has no intention to compete with EACPs.

For this assertion to be credible, however, interference from BANSEFI has to be effectively prevented either by legal initiatives or increases in its costs of competing with EACPs. For instance, some authorities suggest that the development bank should socialize its shares among all actors involved in the popular financial sector. Furthermore, if BANSEFI is restricted to operate only as a second-tier bank, new forms of earnings must be created for the bank, since nowadays, part of the second-tier operation is financed by first tier activities. For the time being, however, BANSEFI has decided to send a credible signal that it does not intend to compete directly with EACPSs. In June 2009, the bank stated that it was willing to sell 40 branches located in areas already covered by EACPs, which had an average of 2,700 clients. As of February 2010, 22 branches had already been sold.

Additionally, the high costs implied by the management of a regulated entity and the competition from BANSEFI's branches have to be compensated; otherwise EACPs will reduce their credit supply. Perhaps the seal of the CNBV or economies of scale obtained through membership in L@ Red might, in the near future, reduce the funding costs of EACPs'. However, competition for savings in locations where BANSEFI has a presence, which has clearly benefited from the disbursement of government transfers, is probably constraining their supply of loanable funds.

IV.5. Can this experience be exported?

The historical relevance of popular and cooperative banks in developed economies is reflected in the strength of organizations such as *WOCCU, Desjardin, DGRV* and *Sparkassen*. From these cases it is evident that the creation of networks, federations and alliances is indispensable to achieving economies of scale and financial soundness, where the latter is attained through the use of flexible and auxiliary supervisory bodies. With this experience as a background, it seems that the scheme implemented by BANSEFI may be replicated wherever there are geographic zones without an FSP and unregulated moneylenders proliferate.

The list of countries with members in international associations, such as the International Co-operative Banking Associations (ICAP) and the International Confederation of Popular Banks (CIBP), reveals that the use of popular FSPs is already widespread in emerging countries. Among the countries with popular and credit banks participating in these associations are Ethiopia, Kenya, South Africa, Tanzania, Uganda, Zambia, Morocco, Turkey, Greece, India, Sri Lanka, Thailand, Argentina, Bolivia, Brazil, Chile, Paraguay and Uruguay.

Data collected by Durán (2010) for Latin America show that savings and loan cooperatives, both supervised and unsupervised, are present in all the region's countries. In December 2009 Mexico was the country with the largest membership of individuals in these institutions, even larger than in Brazil, which has a larger population (see Table 8). However, Brazil is larger in terms of the absolute dollar value of several different indicators, including equity, credits, and deposits. This study's data also show that the number of Mexican cooperative banks increased from 308 to 670 between 1998 and 2009. Undoubtedly, the different policies implemented by BANSEFI are a key factor in explaining the observed expansion of 117.5%. It is true that cooperative banks' participation in the financial system indicates that they are much more important in several countries—notably Colombia (4.14%), Costa Rica (8.91%), Ecuador (11.69%), El Salvador (6.53%), Honduras (4.56%), Guatemala (3.83%) Paraguay (22.3%) and Bolivia (8.51%)— than in Mexico (1.41%).[9] However, the Mexican case is a very relevant example of successful policy-making given the current size of the system and the chaotic situation that prevailed a decade ago.

[9] Size is measured in terms of assets and the financial system includes only cooperative FSPs and banks.

Table 8

Saving and Loan Cooperatives in Latin America

(December 2009)

Country	**Institution Type**	**Capital (USD Millions)**	**Credit (USD Millions)**	**Deposits (USD Millions)**	**Number of associates**
Argentina	Cajas de Crédito	21	207	130	4.752.428
	CC no supervisadas	-	-	-	
Bolivia	CAC	79	361	410	450.000
Brasil	Cooperativas de Crédito	6.516	14.530	12.801	4.500.000
Chile	CAC (SBIF)	639	2.112	1.082	969.692
	CAC (DECOOP)	135	177	70	
Colombia	Cooperativas	302	1.376	816	341.462
	Financieras	1.077	2.154	1.282	1.737.796
	CAC				
Costa Rica	CAC supervisadas	345	1.400	945	702.189
Ecuador	CAC supervisadas	330	1.314	1.423	1.500.000
El Salvador	Bancos	107	239	235	614.163
	Cooperativos	166	565	251	91.829
	Caja y Bco.s Trab. no sup.				
	CAC				
Guatemala	CAC	94	404	368	800.000
Honduras	CAC	332	425	170	606.067
México	**SOCAP**	**344**	**2.183**	**2.400**	**6.153.666**
Nicaragua	CAC	n.d.	n.d.	n.d	n.d.
Panamá	CAC	171	363	230	105.239
Perú	CAC	274	814	766	741.274
Paraguay	CAC	476	1.419	1.139	1.067.287
Dominican Rep	CAC	97	315	332	329.676
Uruguay	Coop. de	5	11	8	40.000
	Intermediación	n.d.	n.d.	n.d.	200.000
	Coop. de Capitalización				
Venezuela	CAC	n.d.	n.d.	n.d.	n.d.

Source: Durán (2010).

IV.6. Reflections on the innovation in light of the CGD Task Force principles

CGD principles 1, 2, 4, 5, 8, and 9, which are set forth in the annex, are relevant to the discussion of savings and loan associations.

Principle 1. Because for many years traditional banks were not interested in developing products suited to low-income individuals, financial authorities helped to modernize and regulate popular FSPs in poor urban locations and rural areas in order to create an orderly environment where these institutions could flourish and compete for clients. Development of innovative products focused on individuals living in rural areas should be encouraged with non-distorting government incentives.

Principle 2. Part of the explanation for the reticence of banks to enter into the low income segment of the market in the past has had to do with the high transaction costs of pooling financial savings from the poor and granting small credits. For this reason a development bank, BANSEFI, was developed and some economies of scale were achieved. Although the development bank has extensive first tier operations, in the near future the institution should be refocused to operate exclusively as a 'central bank' for popular savings and loan institutions.

Principle 4. The small size of popular savings and loan intermediaries required a specific government institution to coordinate the regulatory process in the first stage. Then, it was necessary to establish auxiliary regulatory agencies through the use of confederations and federations in order to add flexibility to the process of integrating popular FSPs into the formal financial system. However, financial authorities have not succeeded completely in the regulation of non-bank financial intermediaries, such as SOFOLES and popular savings and credit institutions.

This experience shows that the regulatory framework has to be more flexible when dealing with FSPs that are involved with small firms and middle and low-income individuals. While fostering effective "subsidiary" supervision for smaller intermediaries that have been successful in deepening the financial system, authorities should tighten regulation of those non-banks that could represent significant risks because of size, links with other FSPs or because they conduct extensive funding in

capital markets. In particular, it is advisable to broaden information disclosure by requiring financial statements and financial soundness indicators.

Principle 5. The previously unregulated status of these institutions meant that they were prone to recurrent acts of fraud, which is in violation of a prerequisite for financial access: the safety of poor individuals' savings. Now individuals with savings in the largest popular FSPs are backed by an insurance scheme because these institutions are regulated by the CNBV.

Principle 8. In the regularization process, BANSEFI's coordination efforts have been relatively successful. Nowadays many savings and loan institutions are managed more efficiently than in the past and the network of these institutions has increased substantially. However, this development bank still competes to attract savings with the same institutions that it coordinates with. Thus, its dual role creates a conflict of interest that handicaps the further expansion of the sector.

Principle 9. Because BANSEFI does not offer credit products or subsidize loans granted by FSPs, this public policy does not distort risk pricing. All public funding has been channeled as seed capital with the following purposes: developing a common technological platform, modernizing FSP' branches, and improving personnel's financial knowledge and administrative capabilities.

V. An e-market for reverse factoring

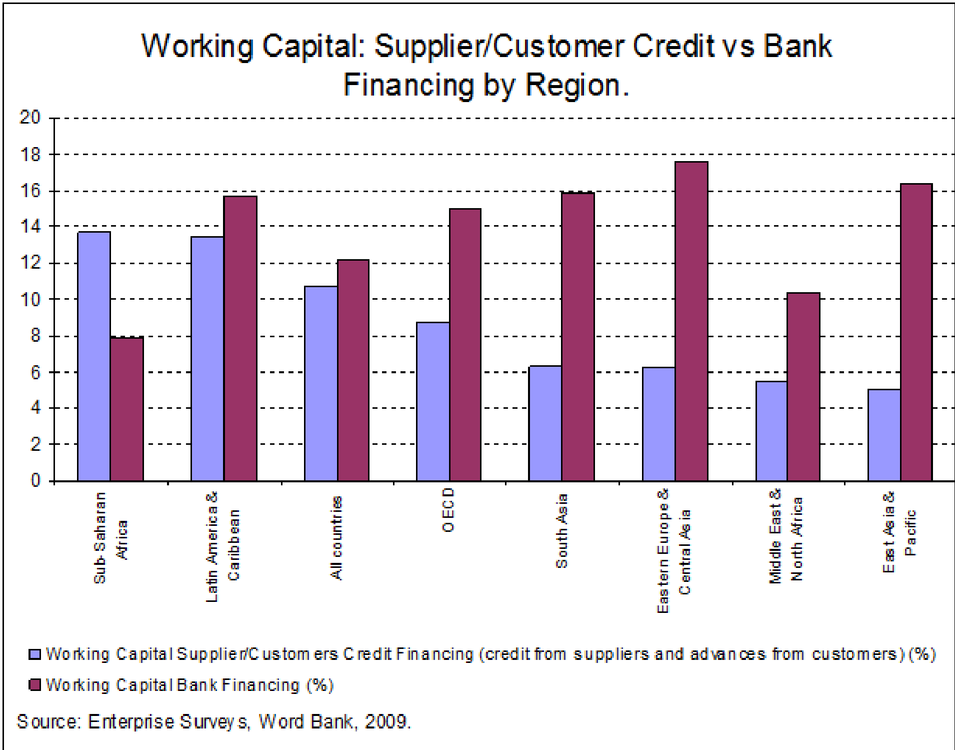
V.1 Antecedents

The creation of an e-market for reverse factoring to promote financial access among small and medium sized enterprises constitutes a second best innovation to solve the basic problem of the lack of an adequate infrastructure to implement contract and collateral laws in Mexico (principle 2). This solution took the form of a public bank developing an infrastructure to allow for Mexican firms to substitute away from using credit from suppliers and customers' advances, on which they traditionally rely, towards using bank credit. Moreover, we will see that in such a scheme the requirement to use government funds, in the form of public bank credits, limits the scheme's expansion possibilities. This

clearly calls for rethinking both government's role in this market (principle 8) and the instruments it should use for channeling resources to financially constrained firms (principle 9).

Cross-country data of firms' access to credit is only available for a set of countries and years, limiting these types of comparisons. However, the data from the World Bank's Enterprise Survey helps to shed some light on this issue. According to this survey in contrast with other regions, manufacturing firms in the countries of Sub-Saharan Africa and Latin America and the Caribbean (LAC) rely more on suppliers' and customers' credit than those of other regions. For LAC firms, this channel is almost as important as bank financing (see Figure 13).

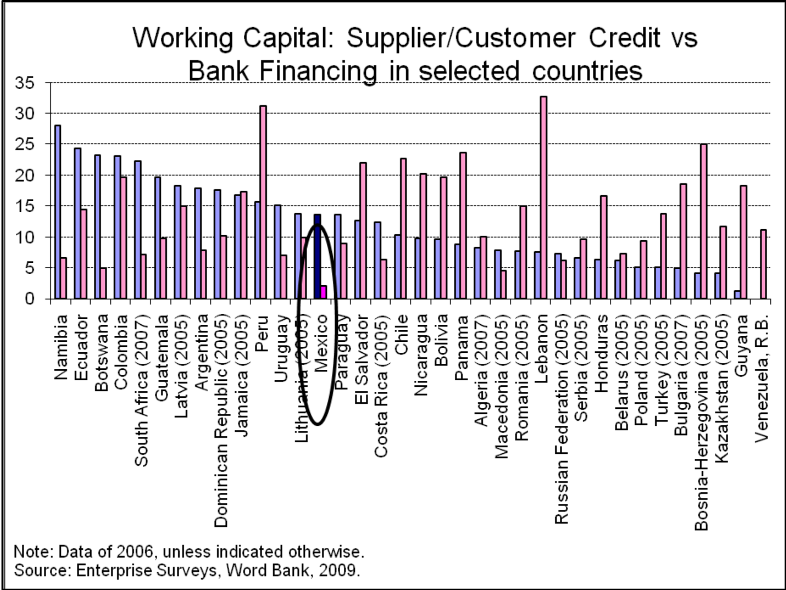
Figure 13



In addition, among LAC countries and those with an upper-middle income level (according to the World Bank's benchmark), Mexico stands out as a country with a low level of bank financing for working capital (see Figure 14). In addition to a weak framework for protecting creditors (principle 2), the Mexican economy was characterized in its recent past by recurrent economic crisis. Such

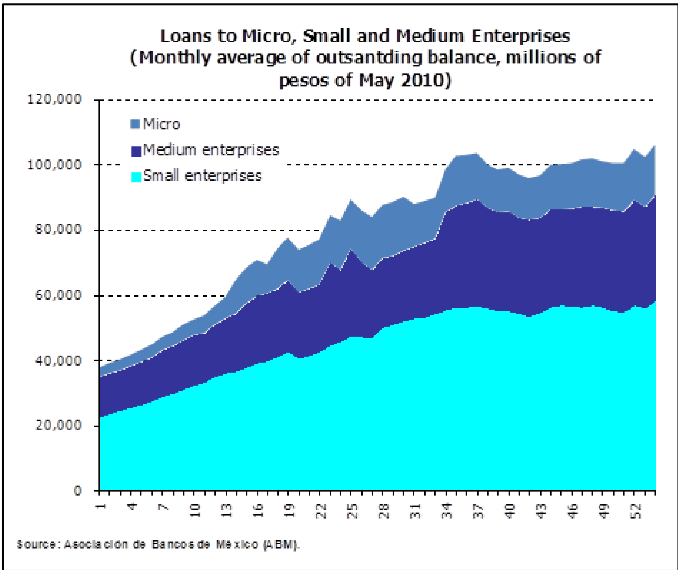
uncertainty about the timing of payments for goods and services in the economy is a condition that limits firms' demand for bank credit, especially from micro, small and medium enterprises (SME). In fact, recent data confirms this trend in Mexico. Specifically, data from Mexico's Bank Association (*Asociación de Bancos de México*, ABM) shows that the outstanding balance of bank credit to SMEs has remained around the same level since 2008 (Figure 15).

Figure 14



Note: Data of 2006, unless indicated otherwise.
Source: Enterprise Surveys, Word Bank, 2009.

Figure 15



Source: Asociación de Bancos de México (ABM).

V.2. The reaction: NAFIN and a system of reverse factoring

In 2001 a Mexican development bank, *Nacional Financiera* (NAFIN), designed a system of reverse factoring that forms part of a program for financing working capital, known as *cadenas productivas,* or "productive chains". A group of large firms with high quality credit were invited to participate in an emerging e-market where their SME-suppliers could discount their accounts receivable with private financial intermediaries. This is considered a reverse variant of factoring since suppliers do not search for a factor to discount their accounts receivable; instead, the large client-firms post their accounts payable with intermediaries interested in providing financing [Klapper, 2006].

NAFIN's technological platform for electronic transactions permits the completion of a factoring operation in less than three hours. The buying firm uploads on its web page the negotiable documents that correspond to the accounts payable that will be financed. Usually, 100% of the invoice is solicited. Following this, all FSPs registered in the market see these documents, and those that are interested bid for the assets in an auction. Once all bids are established the supplier selects the intermediary that will discount the accounts receivable. The winner then deposits the discounted value of the negotiable document in the supplier's banking account. The factor absorbs fully the risk involved in case the buying firm fails to meet its obligations when the payment is due—that is, NAFIN's market operates under the scheme of non-recourse.

The implementation of this form of reverse factoring represents an especially good example of how the government can identify some barriers to the creation of a market and put in place the resources to overcome them (principle 8). However, NAFIN also acts as a second-tier bank because it requires FSPs to use public funding. NAFIN neither charges commissions for being registered in this market nor for performing transactions. Accordingly, it achieves solvency in its operations by charging interest on the funding it provides. NAFIN sets a maximum rate that the factor can charge when discounting the documents, which is above the rate of funding needed to guarantee the profitability of the intermediaries. However, data show that this cap has never been reached because of the auction mechanism used in the market.

Nowadays, a relatively large percentage of the buying organizations in the factoring market are public entities and state-run firms. Moreover, since 2007, there has been a mandate that all federal public entities must incorporate into the "productive chains" program, where they have to upload their

accounts payable for the acquisition of goods and services, leasing, and public works. When resources are channeled to public infrastructure and related services, funding comes from programs of the national public works bank (*Banco Nacional de Servicios y Obras Públicas,* BANOBRAS). According to Hacienda authorities, this factoring mechanism also improves certainty, transparency, and efficiency in government agencies' payments.

V.3. An overview of the experience

The productive chains program grew from a share of 2% in the factoring market in 2001 to 60% in 2004. The financing of working capital and other programs with a pro-market stance, such as credit guarantees, further allowed NAFIN to become financially sound and to move from a deficit of $429 million pesos (with $23.9 billion pesos in assets) in December 2000 to a surplus of $13.23 million pesos (with assets of $26.75 billion pesos) in December 2003. In 2009, the reverse factoring program was integrated into their operations by almost 700 large buyers (35% from the public sector and 65% from the private sector). Further, around 215,000 SME-suppliers were affiliated with the program (70,000 with a digital file), and 39 FSPs (banks, factoring firms and other non-bank financial intermediaries) discounted negotiable documents using the program. As a result, that year approximately 27,000 SMEs were funded through "productive chains," in an amount totaling 204,773 million pesos.

Between 2008 and 2009, the flow of credit increased 26% and productive chains provided 45.3% of the total credit to the private sector granted by NAFIN (see Table 9). Thus, this factoring scheme has allowed financial access for SMEs that in the past had been excluded by commercial banks. In particular, financing was granted at a rate of TIIE + 4 points on average, which is well below the traditional banking rate for businesses, which was set at TIIE + 14 points on average.

Figure 16 shows NAFIN's outstanding portfolio in the 2006-2009 period, and in particular, how the balances of productive chains increased steadily. Further, during 2009 there was a substantial boost to this program, which experienced a real increase of 46.3% in its outstanding balance in only one year. This was achieved without adversely affecting the financial position of the bank. At the end of 2009, the delinquency rate was 0.2%, the index of capitalization was of 12.55%, and there was a net profit of 570 million of pesos (see Figure 17).

Table 9

Flow of credit to the private sector

(Millions of pesos)

2008	**Concept**	**2009**	**Difference 2009/2008**	
			Absolute terms	**Percentage**
	Second-Tier banking			
162528	Productive Chains	204773	42245	26
2686	Equipment	8912	6227	231.8
6320	Microenterprisess	10734	4414	69.8
31657	Tradition discount	40010	8353	26.4
7524	Construction	10499	2974	39.5
210716	**Total Second-Tier**	**274928**	**64212**	**30.5**
439	**Direct activity (first Floor)**	**50**	**[389]**	**[88.6]**
211154	**Private Sector Total Credit**	**274978**	**63824**	**30.2**
85763	**Guarantees**	**176760**	**90996**	**106.1**
296918	**Private Sector**	**451738**	**154820**	**52.1**

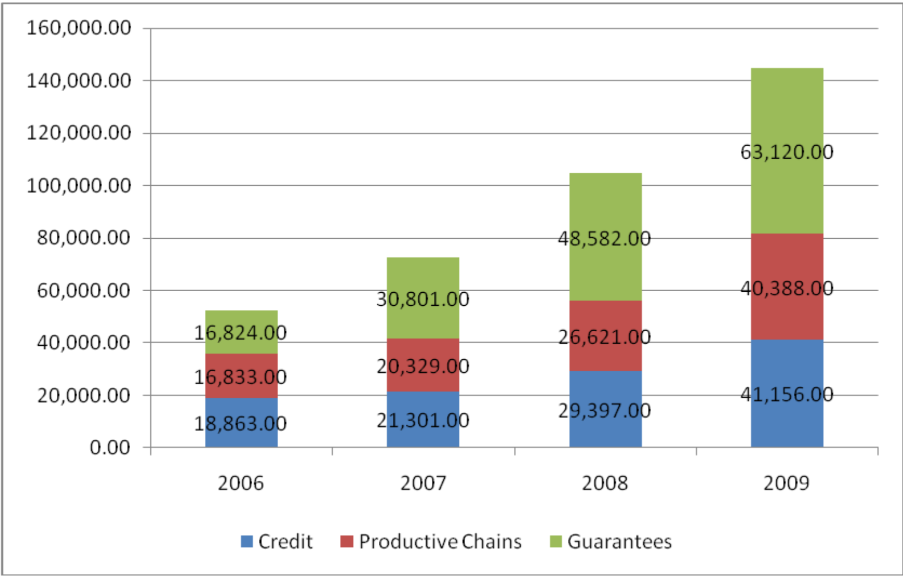
*Source: NAFIN, Reporte Anual 2009

The productive chains program of the federal government is also showing excellent results. Indeed, in 2009, it financed 7,547 SMEs with 62,304 million pesos; that is, a real increase of 27% with respect to 2008. Total accounts payable of the federal government in 2009 totaled 238,748 million

pesos and, hence, 26% of these accounts were financed through NAFIN's working capital programs. Therefore, the remaining 142,469 million pesos financed in that year corresponded to productive chain operations with states, municipalities, and the corporate sector.

Figure 16

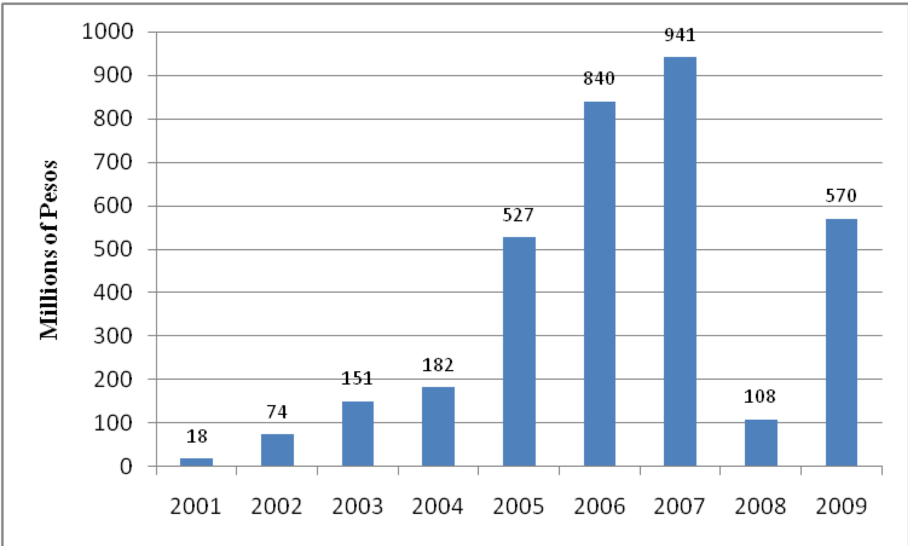
NAFIN portfolio by type of financing to the private sector



Source: NAFIN, Annual Report 2009

Figure 17

NAFIN Net profits



Source: NAFIN, Annual Report 2009

V.4. Limitations

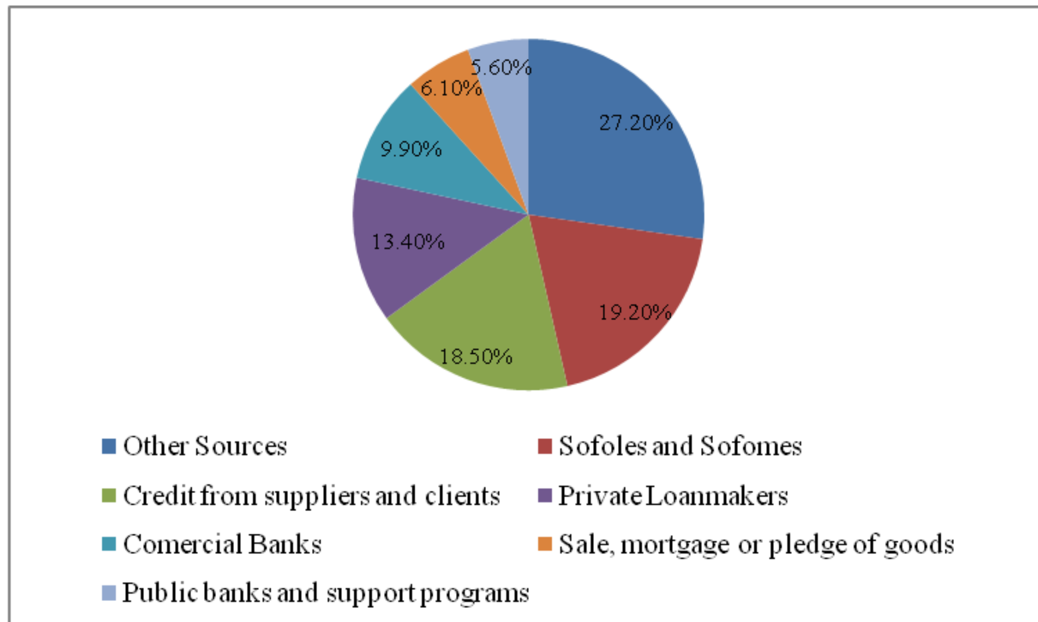
The requirement to continue using NAFIN resources in the factoring scheme instead of the private intermediaries' own funding is due to the fact that the official evaluation of Mexican development banks' performance is made mainly in terms of the amount of assigned resources. This policy implies an unnecessary subsidy to private FSPs involved in the factoring operation, since the default risk does not depend on the SME's financial soundness but on the creditworthiness of the large buyers issuing the invoice. In addition, the fact that the cap set by NAFIN is always above the contracted rate, after a competitive bidding, indicates that risk premiums are not very high and, hence, these operations are profitable for the private intermediaries. It also means that there is no need for subsidies (principle 9).

It should also be noted that the scheme is somewhat regressive because in order to be included in the productive chains program it is necessary to be a formal business with a bank account and tax records. Thus, informal micro and small firms are disqualified from this program, even though their access to bank credit has also traditionally been limited and they would in the margin benefit more from the factoring scheme than medium sized firms. According to the latest National Micro Enterprises Survey (*Encuesta Nacional de Micronegocios*, ENAMIN) data, in 2008 there were 8.1 million firms that employed 16 or fewer workers in the manufacturing, mining, construction, trade, transport and services sectors. Further, one million of them required some sort of external financing. Among micro enterprises, the share of financing from suppliers and customers was twice as much as credit from private bank and four times as much as credit from public bank and support programs (see Figure 18).

Furthermore, as Cotler (2008) indicates, large firms receive an indirect subsidy because the program reduces their costs of treasury management. Many of these firms had to finance their suppliers when NAFIN's reverse factoring was not available. As far as we are aware, there is no hard evidence suggesting that SMEs participating in this program are newcomers in the productive chains fostered by NAFIN or that they had to use their internal sources of funding prior to enrollment in this program.

Figure 18

Distribution of financing by source for micro-enterprises that required it in 2008



Source: National Survey of Micro Enterprises, 2008 (INEGI)

V.5. Can this experience be exported?

In principle, the factoring scheme solves some of the asymmetric information problems that in the past had hampered factoring operations in Mexico. The large buying firms free the factor of the task of monitoring suppliers' soundness and, hence, minimize the possibility of discounting fraudulent invoices. Likewise, uncertainty about the credit quality of the invoice issuer is minimized since NAFIN has previously screened the large firms that participated in the market. Financial intermediaries also benefit because they can gather information with respect to buying and selling firms, and this allows FSPs to create extensive databases with credit histories that are extremely useful for future transactions.

The type of problems that led to government intervention in the case of Mexico very likely affect other economies in which firms depend heavily on suppliers' and customers' credit. Moreover, market performance indicators of the number of firms assisted and the amount of credit provided suggest that this factoring scheme solved many important problems related to starting up the market

to finance working capital. In fact, it contributed to its expansion. But as this market has expanded, the case for the government's continued intervention is becoming less understandable (especially because the scheme is not directly targeting unbanked firms). Therefore, Mexico's experience plainly illustrates the importance of stipulating clear goals (i.e., scope and length) for government intervention in fostering this type of project. It also illustrates the need to evaluate those goals to ensure that they are met so that scarce public funds are always directed to the use with the highest social benefit (principles 8 and 9).

The applicability of this e-market for factoring in other developing countries seems highly feasible, especially since Mexico is not a unique case. A noted example is, the Development Bank of Philippines (DBP), which built a market of this sort [Klapper, 2006]. Moreover, among other Latin American countries, in recent years NAFIN signed agreements with development banks in Colombia, Venezuela, El Salvador, and Peru to replicate the Mexican model. Nonetheless, we think that to fulfill the goal of widening financial access for SMEs NAFIN should implement some measures to withdraw from this scheme and shift its attention to designing other mechanisms or performing other tasks.

The e-market for reverse factoring could operate as a private concession from the government, with clear regulation and a goal to expand outreach. After all, this is the way that other financial markets in Mexico, like the stock and the derivatives markets, already operate (under the supervision of CNBV and the Bank of Mexico). Once these resources are freed, NAFIN would be in a better position to dedicate funds to develop other infrastructure. Even though private credit bureaus already have firm registries, the SME segment is still underrepresented. Therefore, there is scope for a public SME credit bureau and, at least at this nascent stage, NAFIN may be in an excellent position to start it up.

V.6. Reflections on the innovation in light of the CGD Task Force principles

Further assessment of this innovation can be done by reference to CGD principles 2, 8, and 9, noted in the annex.

Principle 2. Lack of good databases containing financial information about small and medium sized enterprises (SME) and the inadequacy of contract enforcement make it very difficult to finance working

capital. NAFIN built an e-market for reverse factoring that took advantage of the creditworthiness of large corporate clients in order to promote banking credit for small suppliers.

Principle 8. The development of a centralized technological platform permitted the reduction of operation costs through economies of scale. But once the system had taken off, there is no good reason to keep the e-market under the umbrella of NAFIN, since it is highly profitable. Even more, this strategy creates the misguided view that all credit financing to SMEs must be supported with government funding. A policy strategy for dealing with market failures in the financial system through the continuous use of development banks has a serious shortcoming in so far as there are no sunset clauses that specify a deadline for the involvement of these public entities.

Principle 9. The allocation of public funds through NAFIN's second tier operations creates unnecessary subsidies that favor private banks. Although banks compete to acquire large firms' invoices, they do not compromise their own resources and, as a result, market size is constrained by the amount of government resources involved in the program.

VI. New banking institutions: Store Banks, Niche Banks, and Bank Correspondents

VI.1. Antecedents

After the Tequila Crisis, financial authorities prioritized buttressing the fragile banking system (principle 4). But it was not until 2001 that more flexible entry requisites started to be implemented and, with time, the banking system evolved, as Store Banks and Niche Banks were created (principle 1). Another recent wave of reforms to the Mexican financial system is concerned with the institutional infrastructure related to widening access and, in particular, with new service platforms and products (principle 2). Even though since 2004 traditional banking infrastructure (branches, ATM and EFTPOS terminals) has expanded substantially in Mexico, the existence of many rural and semi-urban locations with low population densities and per-capita incomes poses a limit to such expansion. In view of this situation, there were a series of modifications to the LIC (*Ley de Instituciones de Crédito*) with the aim of improving the number of bank correspondents.

VI.2. Store-banks

The reaction

The LIC reform of 2001 removed an important entry barrier. Before then, there was a 20% cap on the ownership of bank stocks. The reform substituted this cap with the requirement of an authorization by Hacienda to own shares of a bank or holding group when the ownership exceeded 5% of its social capital. In a country like Mexico, where many large firms are family owned and income distribution is very unequal, this measure lets some business groups dedicated to retail goods sales create banks. In turn, this motivated additional changes to the legal framework in order to avoid conflicts of interests and promote soundness in new banks; that is, to guarantee operative and organizational separation between banking and commercial businesses, to avoid public confusion regarding their respective autonomy, and to ban anti-competitive commercial practices (principle 4).

Overview of the experience

Perhaps the most salient example of the type of bank formed under the new framework is *Banco Azteca*. *Grupo Elektra*, one of the largest retailers of electronic and household appliances in Mexico, received a license to open this bank in March 2002. Because the group's large network of stores were spread throughout the country, the bank began operations in October of that same year with 815 branches. Besides the physical infrastructure, *Elektra* had vast experience selling appliances in installments to low-income individuals who, in addition, also felt more comfortable visiting a retail store than a traditional bank branch. What is more, *Elektra's* databases, with historical records of 4 million clients, its network of motorcyclists that collected payments, and the financial practices it used to target this segment of the population, made the bank an immediate success (principle 2).

As a result, after only three months since its activities started, *Banco Azteca* had 250,000 savings accounts. Between the last quarter of 2002 and the last quarter of 2004, its credit portfolio grew from 2 to 10 billion pesos. Although this amount seems small when compared to the credit granted by traditional private banks at the time (550 billion in the last quarter of 2002), it is very considerable when compared to the amounts of other FSPs that specialize in granting credit to low-income individuals.

The experience of *Banco Azteca* also presents a natural experiment to test whether the presence of a new banking institution exerts a positive impact on economic performance. With this objective, Bruhn and Love (2009) compare different indicators before and after the arrival of this bank in municipalities that had an *Elektra* store during the last quarter of 2002 and in those lacking one. Results show that the opening of the bank produced a 7.6% increase in the number of proprietors of informal businesses—essentially men that keep the business running—while total employment increased by 1.4%, mainly because of more female wage-earners. Additionally, average income increased by 7%.

The financial success of *Banco Azteca* is evident by looking at the large growth in the number of clients and their relatively low delinquency rates. It is clear that *Banco Azteca* still has a small share of the Mexican banking market, either measured in terms of assets, credit, or liabilities; it currently occupies the 11th position in terms of total credit (see Table 10). Nonetheless, it is very large when compared with the rest of the store banks created by other retail chains (*Banco Wal-Mart, Banco Ahorro Famsa, BanCoppel and Bf Bancofácil*), and its performance is noticeably better than that indicated by the rather discouraging negative median for ROE (-35.91) and high median for IMOR (13.64) of store banks, which are not close to the average for the Mexican banking system as a whole in the same quarter (12.77 and 3.08, respectively).

Table 10

Comparative analysis on size and performance

(Last quarter of 2009)

	Total Assets %	Total Credit %	Total Liabilities %	ROA	ROE	IMOR
Compartamos Bank	0.19	0.39	0.19	18.04	44.46	2.44
Azteca Bank	1.33	1.08	2.12	0.78	11.36	8.32
Store-Banks	1.72	1.66	2.66	-5.07	35.91	13.64
Banking System	100.0	100.00	100.00	1.25	12.77	3.08

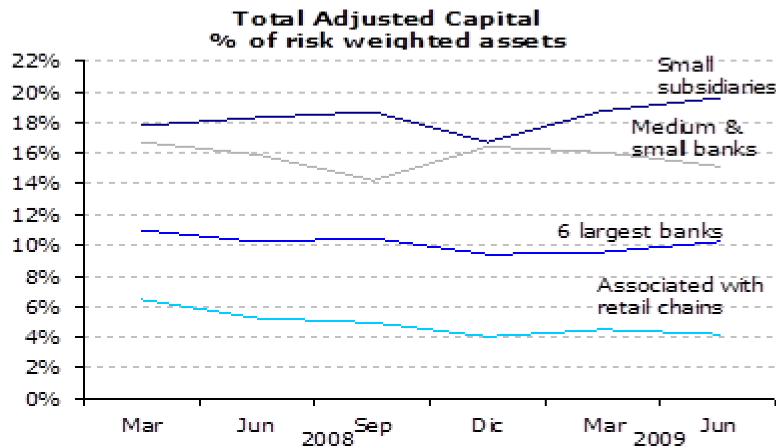
Notes: (1) Store-banks included in the list are the following: *Banco Azteca, Banco Ahorro Famsa, Bancoppel, Banco Wal-Mart and Bf Banfácil*; (2) the data for *Bf Bancofácil* corresponds to November 2009 because of delays in its reporting schedule; (3) ROA = Net accumulated results in 12 months / 12 months average of the total asset adjusted with Repo operations; ROE = Net accumulated results in 12 months / 12 months average of the book value of equity; IMOR = delinquency rate = non-performing loans / outstanding loans; (4) the ROA, ROE and IMOR for Store-banks correspond to median values observed in this segment.

Source: Own calculation with data from the CNBV.

Limitations

Although during the global financial crisis of 2008-2009 all Mexican banks maintained adjusted capital as a percentage of risk-weighted assets within healthy levels, store banks as a group registered the lowest level in the system (see Figure 19). Partly due to this situation, in January 2010 there was another regulatory reform to reduce the limit on credit that multi-purpose banking institutions can grant to applicable related parties; that is, to individuals or business entities (national or foreign) that maintain a 20% or greater share in the capital stock of the bank in question. This modification is aimed at promoting a greater degree of diversification and soundness to the operations of the multi-purpose banking institutions (principle 4)

Figure 19



Notes: Banks associated with retail chains: Banco Azteca, Banco Wal-Mart, Banco Ahorro Famsa, BanCoppel and Bf Bancofácil. Small subsidiaries: American Express, Bank of America, Barclays, Credit Suisse, Deutsche Bank, ING, JPMorgan, Prudential, RBS, Tokyo-Mitsubishi, UBS and Volkswagen. Six largest banks: BBVA Bancomer, Banamex, Banorte, HSBC, Santander and Scotiabank. Medium and small banks: Afirme, Amigo, Autofin, Banregio, Bansi, Compartamos, Consultoría Internacional, Del Bajio, Inbursa, Interacciones, Invex, Ixe, Mifel, Monex, Multiva, Regional and Ve por Mas.

Source: BBVA Bancomer (2010), which uses data from the CNBV.

VI.3 Niche Banks

The reaction

As a business strategy, niche banks restrict their operations to certain activities or regions and, hence, their level of initial capital is usually lower than that of other banks, although other regulatory requirements remain the same. Regulations established in 2008 have allowed the granting of new concessions in the last two years, so that by the first quarter of 2010 the system was composed of 41 banks (principle 1). Moreover, in the near future there will probably be more niche banks because SOFOMES and other non-bank FSPs have more incentives to become fully fledged banks given the increased sources of funding that banks enjoy and in spite of the more stringent regulation. Twelve new banks have begun to provide services in areas that were previously not covered, including electronic-payments, services and retail for low-income individuals, as can been seen in Table 11.

Table 11

Bank institutions according to the type of service provided*

Corporate and wholesale bank	Focused commercial bank	Retail bank (high-income)	Electronic payments bank	Service bank	Retail bank (low-income)
Monex	IXE	IXE	Volkswagen Bank	Monex	Banco Azteca
Inbursa	Interacciones	Inbursa	Banco Wal-Mart		Banco Wal-Mart
Invex	Banco del Bajío	American Express			Compartamos
Prudential Bank	Afirme			Prudential Bank	Banco Ahorro Famsa
UBS					Bf Bancofácil
Deutsche Bank	Banco Ve por Más				BanCoppel
The Royal Bank of Scotland	Bansi				
Credit Suisse					
ING	Banco Amigo				
Bank of America	Consultoría Internacional	Consultoría Internacional			Consultoría Intenacional
Barclays	Bank of Tokyo-Mitsubishi UF	MULTIVA		MULTIVA	
JP Morgan	Grupo Financiero Mifel				
Bank of New York Mellon	Banco Regional				
	Banregio				
	Banco Autofin México			Banco Autofin México	Banco Autofin México

* Traditional banks cover all segments with the exception of retail banking to low-income individuals: BBVA-Bancomer, Banamex, Santander Serfín, HSBC, Scotiabank and Banorte (it has a division for low income)

Overview of the experience

Because at present niche banks are still in their infancy, it is not possible to evaluate thoroughly their performance in terms of how they may have improved financial access and exerted a positive impact on poverty alleviation. However, under the retail banks segment for low-income individuals, besides the store-banks, *Banco Compartamos* stands out. This bank is three times smaller than *Banco Azteca* in terms of credit, but its financial performance excels due to its very high profitability (ROA and ROE) and low delinquency rate (IMOR) (see Table 10).

The success of *Compartamos*, a non-profit microfinance institution reconfigured as a bank, reached international headlines when in April 2007 the majority owners issued stock in the BMV, raising 30% of their equity among non-controlling investors and increasing the stock value by 22% on the first day of trading [Acción, 2007]. When its stock was issued in the BMV, the market value of the firm went up to $1.5 billion; consequently, the internal rate of return for the original investors was close to 100% annually over a period of eight years.

Banco Compartamos grants credit mainly to low-income women (those who earn less than $10 per day) who receive loans of around $500 without offering collateral. These loans are used for financing micro-businesses, ordinary consumption needs, and for covering eventual expenses. Accordingly, credit approval does not depend on a business plan or documentation of a formal source of income. Its operation takes place mainly under the scheme of a village bank, although in recent years it has also offered credit to groups and individuals.

The spectacular growth of *Compartamos* has been possible thanks to retained earnings coming from very high interest rates, which in 2007 were around 94%. But even though *Compartamos* paid interest—before value added taxes—on the order of 86.3% in 2007 (which is very high by international standards), it is important to note that administrative costs were also higher. The reason for this is that its loans were—and continue to be—rather small when measured as a proportion of income per-capita.

The high-interest-rates strategy has allowed *Compartamos* to meet the objectives established by the pre-IPO investors who wanted to generate large sums of retained earnings to expand its market and offer banking services to a wider segment of the population (Danel and Labarthe, 2008). Between 1996 and 2000 the annual growth in the number of clients was 24%, while between 2000 and 2006 the

growth increased to 46%. Therefore, the high-interest rate policy can be seen as an inter-temporal transfer where initial clients made it possible to acquire a large number of clients in the following years. As of March 2010 *Compartamos'* network of branches is integrated into 334 offices in 32 States of the Republic, and the default rate is only 2.4%, a rate far below the average observed in the Mexican banking system.

We are not aware of any formal study that measures the effect of such a policy on the well-being of *Compartamos'* clients. Nonetheless, attracted by publicity through word of mouth, the fact that the number of clients has increased exponentially, and that former clients continue asking for loans point towards a positive impact. Further, as Rosenberg (2007) suggests, this growth is not a consequence of a vicious circle where high debt obligations increased, since such a perverse spiral is not compatible with the low delinquency rates observed. In fact, according to a recent study by Ipsos-Bimsa, 94% of *Compartamos'* clients are satisfied with the bank and 98% with the credit granted. Another indicator of loyalty gives *Compartamos* 74 points, a number far higher than the 48 points registered by traditional banks.

Limitations

The commercialization of *Compartamos* has raised serious concerns among many analysts about whether or not it can maintain its original socially-conscious objectives. Presumably, in the future a conflict of incentives can arise between the founders of the NGO and socially conscious donors, on one side, and the private investors, on the other. If firm profitability is sustained in the coming years with high interest rates and the bank pays very large dividends or offers large capital gains, the suspicion that the bank's success is due to an unjustifiable transfer from poor debtors to rich investors will increase (principle 5).

The transition of some microfinance institutions (MFI) towards commercialization does not imply that non-profit MFIs (in effect, those that do not distribute profits among investors) should vanish, since the latter are the only ones that can reach the poorest people (Cull, Demirgüc-Kunt and Morduch, 2009). Therefore, increased access to financial services in the years to come will be produced not only by institutions that are profit-oriented (like *Banco Compartamos*), but also by those whose strategies are compatible with individuals' economic incentives and that remain undisputedly socially conscious (like the *Grameen* Bank).

In any case, *Compartamos'* combination of high interest rates and impressive returns on assets suggests that there exists a monopolistic structure in the regions where this institution operates (principle 1). This is another example where the entry of additional financial providers does not necessary generate a level playing field that reduces interest rates. As Cotler (2008) points out, the ROA of *Compartamos* was astonishingly high in spite of the fact that in only 14% of the municipalities did it not face direct competition from other MFIs. Therefore, barriers to competition that need to be addressed in policy-making have to do with the cost of funding, clients' loyalty, information databases, and learning curves (principles 2).

VI.4. Bank Correspondents

The Reaction

Reforms to the LIC for improving bank correspondents were approved in February 2008. Banks will be permitted to sign contracts with third parties (either commercial or service establishments, including other credit institutions or financial entities) to offer diverse basic financial services (principle 2). Under this model, the correspondent agent always carries out the operations in the name of the bank, and uses its account as well. Later, the first step in promoting the population's access to banking services through mobile phones was taken in June 2009, when Banxico issued the regulation on Mobile or "Simplified File" Accounts, which have fewer information requirements about the customer than usual accounts (namely: complete name, date of birth and address). But it was not until last March 2010 that the CNBV published the rules that determine the contract requirements for commissionaires managed by an "Administrator of Mobile Telephone Correspondent Agents".

Overview of the experience

According to CNBV data, the opening of 29,817 new contact points in commercial and services establishments, in addition to bank branches, could reduce the number of municipalities without coverage of bank services from 67% to 20% in a few years (see Figure 20). The type of establishments considered include large self-service store (or supermarket) chains, convenience stores, Telecomm

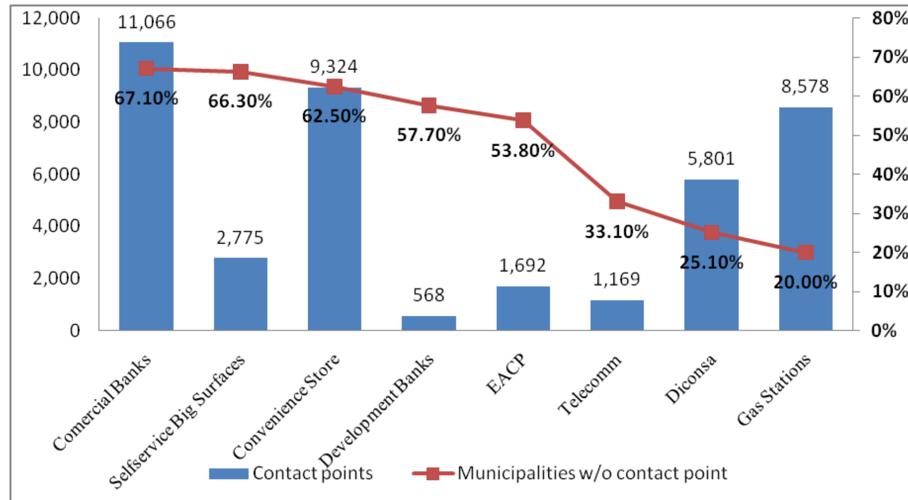
offices, networks of the development banks, EACPs, the network of concessionaires that sell gasoline, and the DICONSA (government owned) store networks.

However, it is worth noticing that CNBV's estimations do not take into account the possibility that the companies operating mobile phones (some of which may get the authorization to operate as correspondents soon) have networks of over 54,000 distributors, service centers, and points of sale.[10] which would more than double its projection of points of contact through correspondents. This is important because, after all, "Mobile Phone Correspondents" constitute a Mexican innovation on the common correspondent model. Furthermore, this addition to the correspondent's network seems very likely if we look at the experience of money transfers through mobile phones in Kenya through M-PESA [BBVA Research, 2010]. Therefore, if mobile phone distributors, service centers, and points of sale eventually become correspondents, the number of bank correspondents in Mexico would almost match Brazil's, which is the country that has implemented the correspondents model most successfully (see Figure 21).

[10] Estimate based on the Table 7 data of the Federal Competition Commission Resolution, Pleno, EXP. DC-08-2007, of January 21, 2010.

Figure 20

Contact points for banking services (branches of commercial banks, development banks, popular saving and loans entities and correspondents)



Notes:

Commercial Bank: Includes service offices of *Compartamos*

EACP: Includes Cooperatives, *Cajas solidarias,* Credit Unions and Sofipos

Large self-service stores: Wal-Mart, Soriana, Chedrahui, Comercial Mexicana, Sears, Sanborns, Coppel

Convenience Stores: Oxxo, 7 Eleven, Farmacias Benavides, Farmacias del Ahorro, Farmacioas Guadalajara, Waldos, Office Max, Mix Up, Muebles América, Pittico, Promujer

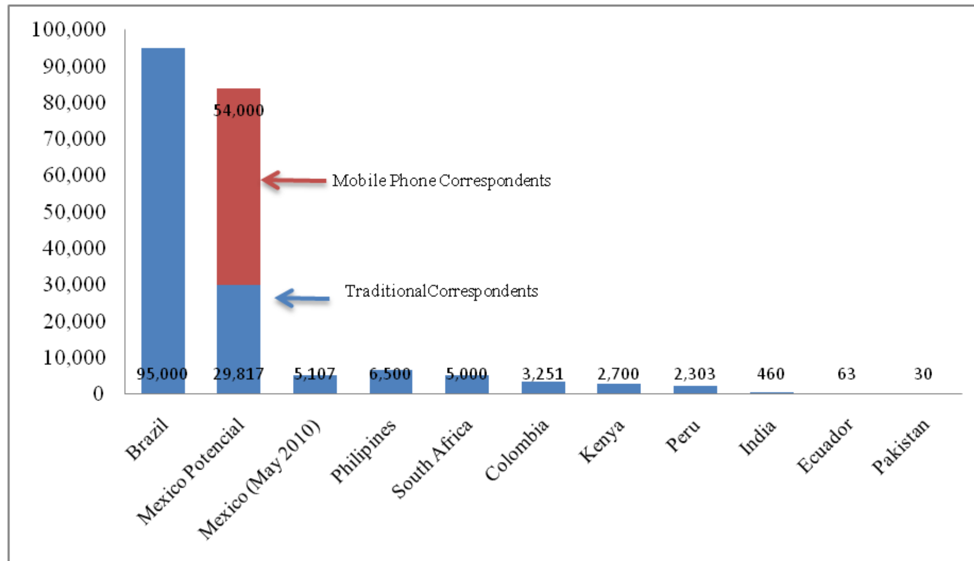
Diconsa: Considerate only 25 % of the stores (5,801 of 23,500) because of the technologic capacity. If 100% is considerate, Diconsa will be present in the 90% of the municipalities (in 2,199 of 2,456)

Source: CNBV

According to the CNBV, as of September 2010 correspondence had been established with 660 commercial businesses, constituting a network of 16,190 establishments. As a result, the correspondents' network already is larger than the current bank branch network and surpasses those in other developing countries where this model operates, such as South Africa, Colombia, Kenya, Peru, India, Ecuador and Pakistan (Figure 21).

Figure 21

Number of correspondent agents in selected countries, 2008 (for Mexico, data as of May 2010 and estimate of potential)

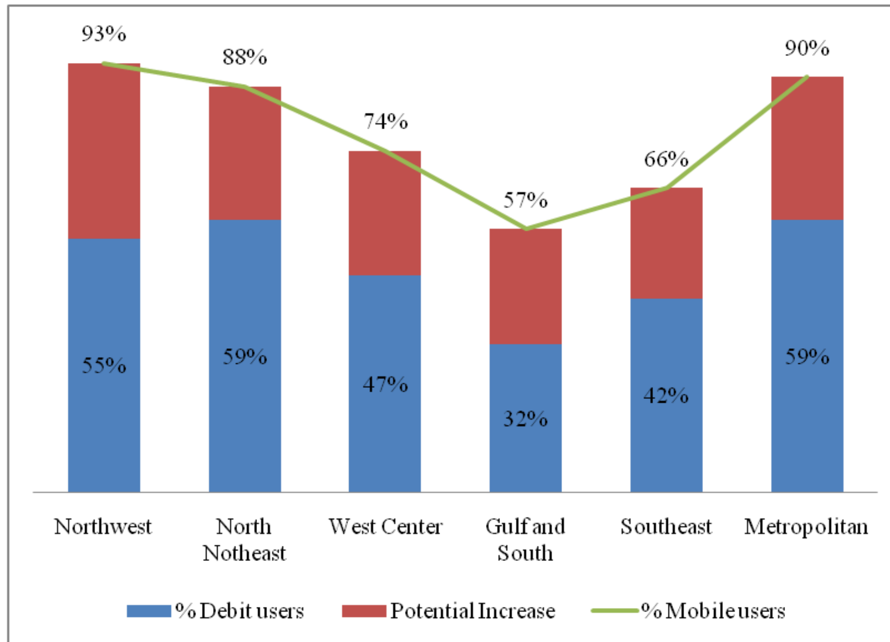


Source: For Mexico, CNBV and BBVA Research (2010); the estimate of mobile phone correspondents is based on the Table 7 data of the Federal Competition Commission resolution, Pleno, EXP. DC-08-2007, of January 21, 2010. For the other countries: "Note on Regulation of Branchless Banking in Brazil". CGAP, February, 2008

Mexicans are very used to mobile phones and current network penetration is 77% (that is, the number of subscriptions of mobile phones per 100 inhabitants). Hence business models for providing financial services through these devices could lead to a major transformation in being able to access financial services in Mexico very soon: at present the penetration of the mobile phone network across all regions is considerably higher than that of debit cards (see Figure 22). In fact, during 2010 many banks have hastened to launch new financial products that will operate on mobile phones. For example, last September Bancomer reported that, just eight months after it launched its platform to offer financial services on mobile phones on January 18, 2010, more than 100,000 customers had carried out 1.2 million transactions.

Figure 22

Possible impact of using mobile phones as correspondent agents



Source: Segundo Reporte de Inclusión Financiera, CNBV, September 2010

Limitations

One aspect of CNBV's projections that attracts attention is that, although the increase in the number of contact points attributable to supermarkets and convenience stores is substantial, it produces a very small increase in municipal coverage of financial services. This is due, on the one hand, to the fact that several commercial businesses are correspondents of several banks at the same time and, on the other hand, to the fact that the geographic location of those establishments largely coincides with that of the bank branches (see Table 12). Thus, two important elements for increasing financial access in semi-rural and rural communities through correspondents are: (1) conditioning the networks for the provision of public services, as has already been done successfully in the case of Telecomm and is being done with DICONSA (at present, only 300 of its outlets are operating as correspondents) (principle 2); and (2) analyzing ways of reducing certain regulatory burdens at the

federal, state and municipal levels, so that more commercial businesses can meet the regulatory criteria of eligibility (principle 1).

Table 12

Distribution of Correspondents per Bank

	Soriana	Telecom	Sanborns	Wal-Mart	Suburbia	Vips	Sears	Chedraui	Comercial Mexicana	Farmacias Guadalajara	Assis tu vestir	Small business	Total
Banamex	X	X										X	3
Banorte		X											1
HSBC		X											1
Inbursa		X	X										
Santander		X											
Scotiabank		X											
Wal-Mart				X	X	X							
Bancomer		X		X	X								
Am. Express	X		X	X			X	X	X	X			
Compart.								X					
Invex	X			X				X			X		
Total	3	7	2	4	2	1	1	3	1	1	1	1	

Source: CNBV, Press Conference June 22, 2010

Another important lesson for Mexico is that it can get a very strong boost from disbursing government subsidies and payments to retirees through debit or pre-paid cards. BANSEFI has already created alliances with PEMEX gas stations, National Lottery outlets and DICONSA stores to pay out allowances from government programs. In this agreement BANSEFI agreed to set up EFTPOS terminals to disburse payments in saving accounts or pre-paid cards. Although these alliances are not fully operational, the pilot programs have been successful. For instance, in a project with 270 beneficiaries of *Oportunidades* and six DICONSA stores in the locality of Hueytamalco, Puebla, where no other FSPs are available, there was a substantial impact in money savings (74%) due to a reduction in the distance needed to travel when collecting the disbursed benefits. Moreover, these stores also increased the value of their sales during the week that the experiment took place [Seira et al, 2010].

Finally, evidence shows that the correspondent system in Brazil has been successful in terms of fostering an electronic means of payment, but not as much in terms of promoting credit and savings. Therefore the model still poses the challenge for both financial institutions and authorities of designing and implementing products that are adequate for the population segments that this platform is expected to serve.

VI.5. Can the experience of Store Banks, Niche Banks and Correspondent Banks be exported?

Mexico is not an early adopter of either sector specific capital requirements to set up banks or of the bank correspondent model. Nevertheless, its experience shows that supervisors should pay attention to setting flexible rules that promote soundness and good practices among FSPs. Simultaneously, these rules should create the proper incentives for FSPs to foster financial access. *Compartamos* and *Banco Azteca* are good examples of how these two goals can be achieved. It is also important to emphasize that financial authorities have been, in many cases, very quick to adjust the regulatory framework when potential problems have been detected and need to be curbed. Moreover, the Mexican case also highlights the fact that the system of correspondent banks has to be adjusted to local conditions if it is intended to work as a policy of financial inclusion. This is illustrated by the relevance placed on mobile phone correspondents and on the disbursement of government transfers through offices of public agencies.

VI.6. Reflections on the innovations in light of the CGD Task Force principles

CGD principles 1 and 2, included in the annex, provide a context for further analyzing Mexico's progress in implementing new financial institutions that expand financial access.

Principle 1. The recent creation of different banking models addresses the historically anti-competitive stance of Mexico's banking system. New types of banks (store banks) and low capital requirements to set up a bank (niche banks) have encouraged the entry of new participants and increased competition to attract private savings and grant credit. Moreover, to level the strength of new banks with small networks of branches, bank correspondents were recently introduced.

Principle 2. Although building new infrastructure for private banks does not involve public funding, the role of the financial authorities has been critical to establishing the proper legal framework so that stores and other outlets can carry out financial activities. In addition, extending financial outreach through bank correspondents at semi-rural and rural locations may require that the government adjust some of its infrastructure to provide public services, such as the DICONSA shops.

VII. Conclusions and policy recommendations

This study argues that although financial access in Mexico is still low, in the last decade several innovations to improve this situation have been implemented. We discussed four initiatives that have represented important advances. These advances, which can be assessed in reference to the CGD Principles (see the Annex), include the following: the increase of market competition (principle 1), the development of legal institutions and hard infrastructure (principle 2), the improvement of the regulatory framework and transparency of financial intermediaries' operations (principle 4), and the active use of development banks to support the creation of new markets and the modernization of non-bank financial intermediaries (principles 8 and 9). We have also pointed out some of the limitations of these policies. Next, we will briefly summarize these limitations, as well as put forth several policy recommendations to overcome these obstacles.

SHF was a key institution in developing the market for MBSs in Mexico. This institution played the important roles of providing regulation to standardize SOFOLES' origination of loans and also of providing them with liquidity in the early stages of the development of the MBS market. The introduction of CBs issued by regulated private financial intermediaries may contribute positively to re-launching the MBS market by mitigating mistrust over the securitization of mortgages and improving funding conditions for SOFOLES. If the CBs are not used to re-package other financial instruments, opportunities for financial alchemy are precluded and the distance between the ultimate investor and the borrower is reduced, so incentives are properly aligned. Hence, it is highly desirable to pass the necessary legal reforms, which were announced by the government as part of a set of financial sector initiatives last August 2010. However, as of this writing, they have not been presented to the Congress or Senate for discussion.

On the other hand, in order to properly redefine SHF's multiple tasks in the MBS market as a provider of loans and public guarantees, market-maker, and supervisory agency, authorities should evaluate the fact that FSPs face unfair competition from the government housing provident funds. For almost 10 years, these funds, particularly INFONAVIT, have been offering mortgages to middle income individuals traditionally catered to by banks at better conditions because these funds have lower operational costs. (For example, mortgage payments are automatically discounted from workers' wages as mandatory contributions, and the institute's rules for rating and provisioning loans in default are more lenient than those for banks.) They also use subsidies to grant credit in an extensive manner, complicating proper risk pricing. Small, new non-bank FSPs will not be in a better position than banks to face competition from provident funds when these institutions advance their objective of providing housing credit to the lower income market segments, which constitutes the market niche of these FSPs.

Moreover, as we explained before, the operation of INFONAVIT and FOVISSSTE is still highly regressive and, as Levy (2008) has pointed out in the case of Mexico's Social Security Institute, discourages formal employment and has adverse effects on firm productivity and growth. Finally, no formal employment means no additional mandatory contributions to fund INFONAVIT and FOVISSSTE activities, which constrains their expansion possibilities. Obviously, this strategy to eliminate housing provident funds has political economy consequences that should be addressed, and it must be backed by comprehensive fiscal reform. Nonetheless, to deal with the most delicate issue of the contributions' use, authorities could consider dedicating those resources to buttress workers retirement funds or unemployment insurance (Aguilera, 2010).

BANSEFI's creation has provided the government a proper vehicle to develop a service platform for the small popular savings and loan intermediaries (EACP) that offer financial services in rural and poor populations. Banks have mostly neglected these segments of the market in the past because of the high transaction costs of pooling financial savings from the poor and granting small amounts of credit. With BANSEFI, some economies of scale were achieved in terms of marketing, cash flow and risk management, the administration of debit and credit cards, financial education, training of personnel, and developing a network of branches for EACP. All of these initiatives completed authorities' efforts to improve EACP's institutional framework. As a result, nowadays many saving and loan institutions are

managed more efficiently than in the past. Moreover, the networks of these institutions have grown substantially. This in turn promotes the innovation of financial products focused on individuals living in rural areas.

However, this development bank still competes with the same institutions that it coordinates, in terms of attracting savings, creating a conflict of interests that handicaps the further expansion of the sector. In fact, BANSEFI is at present the only institution to open accounts of the CETESDIRECTO program that the government put in place last December. CETESDIRECTO is an electronic system where any individual can acquire small amounts of government bonds (CETES) in primary auctions and reinvest them at accrued gains, with no transaction costs. Of course, once CETESDIRECTO is widely used, competitive interest rates will exert pressure on incumbent depositary institutions, benefiting savers. Besides, the higher rates that institutions will have to pay on term deposits will undoubtedly level the playing field between banks and other FSPs, because this will narrow the funding gap between them. However, BANSEFI's exclusive right to operate CETESDIRECTO particularly boosts its advantage with respect to EACPs, further worsening the conflict of interests.

We recommend two measures for improving the present framework. Firstly, the privatization of BANSEFI's branches in those locations where there is already a private FSP, which recently started and should continue. In the near future the institution should altogether refocus to operate exclusively as a "central bank" for popular savings and loan institutions, being careful that all public funding is channeled as non-price distorting seed capital. Secondly, all FSPs legally authorized to receive deposits should be allowed to offer the CETESDIRECTO accounts to their customers as a "basic saving account;" that is, FSPs should be enabled to connect to the electronic platform in which the program operates in NAFIN.[11] This could then become another carrot that provides incentives that push EACPs into the regulated financial sector. In addition, new financial products should be developed, For instance, payments of mortgage and other types of credit can be indexed to the price of agricultural products. If a sharp downturn in prices occurs, debtors can service their loans using 'sweat capital" provided with earnings from transitory employment programs sponsored by the government.

[11] Except for financing, at present EACP does rely on banks for multiple services related to cash and account management. Banxico's experience of opening the interbank electronic payment system (*Sistema de Pagos Electrónicos Interbancarios, SPEI*) to the participation of non-bank FSP, such as insurance companies and afores, shows that this type of measure helps to diminish service fees. For more details, see Reporte sobre el Sistema Financiero 2006, Banco de México (2007).

NAFIN should withdraw from the reverse e-factoring scheme and dedicate its resources to developing other platforms and infrastructure that expand financial access among excluded population segments. As a first step to privatizing the e-market for factoring, NAFIN should immediately stop using its second-tier loans to finance working capital through this channel. Once the profitability of the market is recognized by financial institutions, it should be auctioned to any private interest in the financial sector with sound financial and moral credentials. Competition in the e-market for factoring finance can be preserved by allowing the participation of any FSP regulated by the CNBV. Although the database of suppliers and large firms involved in these financial transactions is the property of the acquiring firm, authorities should guarantee that it is widely disseminated; it should be accessible to any interested entity for a fee (regulated by the CNBV). Better yet, the data could be added to the credit bureau. Lastly, if the owner of this e-market is interested in selling it, the government should have the right to administer the transferal of the database to a different provider.

The recent creation of different banking models and adoption of new technological platforms to provide financial services addresses the historical anti-competitive stance of Mexico's banking system. New bank technological platforms, such as "traditional" and "mobile phone" correspondents, constitute the surest way to increase financial services outreach. Therefore, in close collaboration with FSPs, authorities should continue trimming the institutional framework in order to accelerate the implementation of these new technological platforms and create confidence among users. DICONSA shops and gas stations must be conditioned to become correspondents. Also, state governments should more broadly adopt the use of electronic means to pay out salaries, distribute social program benefits, and buy supplies. This requires changing the government procurement and disbursement laws of 25 states and stipulating that only currency or checks can be used for such purposes. As electronic payments increase, they will become cheaper and boost the attractiveness of the correspondent banks' platform.

To broadly improve the competitive framework there is a reform to the competition law under discussion that would give the Federal Competition Commission more powers to investigate anticompetitive practices, make penalties on anticompetitive practices more severe, and institute sanctions for the abuse of joint dominant positions (*poder sustancial de mercado conjunto*). This reform has already been approved by the Congress and is being discussed by the Senate, although

some analysts suggest that since it is not creating a specialized court on economic affairs to oversee competition cases that will be used instead of the federal tax court (*Tribunal Fiscal de la Federación*), it still falls behind best international practice.

To improve credit bureaus, which provide an essential input to credit risk decisions, initiatives to add information about payments on public utilities, (electricity, water, etc.), taxes, and mandatory contributions by firms (such as those to IMSS and INFONAVIT) should be studied further. They deserve thorough consideration in light of the recent experiences in the United States and elsewhere suggesting that such data produces scores that are comparable to those based on traditional credit sources. Recently, the CNBV has used data on firms' contributions to INFONAVIT to improve the models for determining the amount of provisions for credits losses, with encouraging results. This being the case, we believe that adding this data to credit bureaus would give all FSPs the ability to grant credit on safer grounds.

Lastly, implementing a policy of financial inclusion implicitly requires the existence of a stable financial system. Nonetheless, as private FSPs widen their scope towards SMEs and low-income households that lack credit histories, default risk becomes higher. Because of this, regulation and supervision must ensure that risks are properly priced and loss provisions are sufficient. This is even more true in the case of new FSPs, such as SOFOLES and SOFOMES, and new platforms, such as traditional and mobile phone correspondents on which public confidence must also be built.

Annex

Policy Principles for Expanding Financial Access

(Summary of a report by the Center for Global Development Task Force)

Despite the rapid growth in finance worldwide over the past quarter-century—which was interrupted by the global financial crisis—many low-income households and small firms remain excluded from access to many financial services, especially in developing countries. While traditionally seen by many financial-service providers (FSPs) as less attractive customers, a growing number of mainstream FSPs have joined microfinance firms in extending the range of their service provision, and important advances have been made in expanding access. At a time of increased focus on financial-sector policy and of regulatory tightening, it is important not to lose sight of the goal of increasing the access to appropriate financial services essential to the escape from poverty and the achievement of firm growth. It is in this spirit that the Center for Global Development proposes 10 principles for financial-sector policymakers—including national authorities, donors, private-sector participants, international financial institutions, and others—on the facilitation, regulation, and direct provision of financial services.

I. INSTITUTIONAL INFRASTRUCTURE FOR PROMOTING ACCESS

Principle 1: Promoting entry of and competition among financial firms

Policy should encourage competitive provision of financial services to customers such as low- and middle-income households and small firms. Policy should favor entry of qualified suppliers that are likely to improve the quality and price of services to such customers (in a manner consistent with financial stability and consumer protection). Competition policy should empower the active investigation of anticompetitive behavior.

Principle 2: Building legal and information institutions and hard infrastructure

Policymakers should work with market participants to eliminate barriers and identify gaps in the institutional infrastructure relevant to small-scale supply. This includes ensuring that payments and

collateral systems and hard infrastructure elements for retail transactions are available and have a low unit cost. In particular, collateral and information infrastructures need modern supportive legislation and regulations. The state has a central role in ensuring the availability and maintenance of much of this infrastructure.
(Where appropriate, the public sector can provide administrative and financial
support to help create such infrastructures.)

Principle 3: Stimulating informed demand

As a complement to other consumer protection activities, policymakers should facilitate education and confidence-building measures among those currently excluded by coordinating, setting standards and curricula, and possibly cofunding private efforts. Financial-service providers play a crucial role in fostering informed consumers, among others, by making information available in a manner suitable to small-scale clients.

II. REGULATION OF FINANCIAL-SERVICE PROVIDERS (FSPs) AND FINANCIAL SERVICES

Principle 4: Ensuring the safety and soundness of financial-service providers

The rules and procedures for prudential regulation of financial-service providers should be carefully designed for consistency with financial-service provision at a small scale. In particular, regulation should be assessed for its impact on access and should reflect the risks faced by low-income households and small firms. Prudential regulation need not be restricted to deposit takers. To avoid regulatory arbitrage undermining sustainable access, consistent protection should drive cross-agency regulatory harmonization.

Principle 5: Protecting low-income and small customers against abuses by FSPs

Low-income and small customers need regulatory protection against abuses by service providers. FSPs should be subject to legislation designed to ensure that they do not sell customers products that are unsuitable for their needs. Market conduct and other regulations in this area (including anti-money laundering and combating the financing of terrorism, AMF/CFT) need to minimize
compliance costs while retaining effectiveness.

Principle 6: Ensuring usury laws, if used, are effective

Regulated ceilings on interest rates have often proved to be an ineffective or even counterproductive measure against predatory lending and have often tended to work against increasing access. Where such ceilings are retained, they should be pitched at realistic levels in relation to FSP costs in each market
segment and adjusted over time, in line with movements in the wholesale cost of funds.

Principle 7: Enhancing cross-regulatory agency cooperation

Where regulation of financial firms or services is split, agencies should cooperate in policy/regulatory development and supervisory practices to ensure consistent standards of consumer protection, especially of activities related to low-income households and small firms. Even if some FSPs are not covered directly by a regulator, policymakers should ensure that access-related issues relating to those FSPs are not neglected.

III. DIRECT POLICIES USING PUBLIC RESOURCES

Principle 8: Balancing government's role with market financial-service provision

The design of any direct government interventions should seek to respect the commercial market logic as much as possible—especially in regard to cost-effectiveness— and avoid damaging distortions to market functioning.

To facilitate maximum scale through leverage of private capital and initiative, the design of policies and interventions to increase access should avoid stifling private provision.

Some forms of direct government involvement in financial-service provision may be justifiable—for example, when it is otherwise difficult to overcome market failures or to deal with incompleteness of private market provision. Generally such problems require only temporary and catalytic interventions, and they should be explicitly time-bound.

There need to be safeguards at state firms against political interference, especially where credit is being extended. Governance of such firms should be transparent to the public, modeled on best practices for non-government owned firms. Any noncommercial objectives of such firms should be publicly known, quantified, and costed.

All policies for improving access should have clear and measurable objectives and their effectiveness should be quantitatively monitored with transparent public reporting.

Principle 9: Using subsidies and taxes effectively and efficiently

While some permanent element of subsidy can in some cases be necessary to foster access, the design of subsidies should, where possible, be time-bound and aimed at making institutions and access self-financing and sustainable.

All forms of subsidies and policy costs should as far as possible be accounted for and be itemized clearly in the national budget. Any government-provided or -directed credit or other (implicit or explicit) subsidy should be free of political influence, particularly in the credit underwriting process. The taxation of financial services should be access-friendly.

Principle 10: Ensuring data collection, monitoring, and evaluation

Governments should ensure collection of sufficient data to

- allow for the determination of the gaps in access to financial services that will facilitate private-sector solutions;

- provide accountability of public policy for monitoring and evaluation of the effectiveness of pro-access policies; and,

- help build a better, research-based understanding of what works in relation to access.

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