Mexico Develops Niche Approach to Expansion of Banking Services

By Edward C. Skelton

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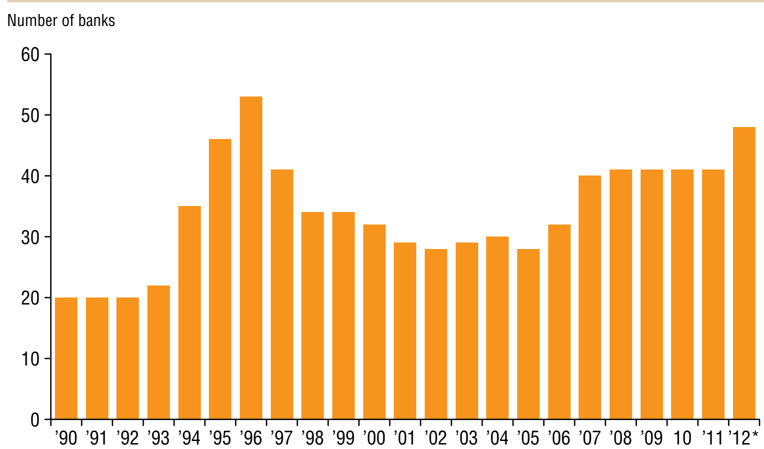
Mexico, a country where small business is still largely conducted without full financial system support, is looking to a creative solution to the problem—the niche banking charter. This emerging class of banks is an attempt by authorities to address a weakness in a financial system whose newfound resilience is in stark contrast to its historic volatility.

Niche banks are required to focus on a specific market or geographic region and operate using a simpler structure with a lower startup investment than for a full commercial bank. The new charter lowers barriers to market entry in Mexico at a time when many other countries are making the banking industry less inviting.[1]

Niche banking provides a recent example of Mexican authorities' efforts to build a world-class financial system that helps improve living standards. Financial institutions generally facilitate a country's overall growth and development, and niche banks may contribute much as community banks in the U.S. do with their local business focus.

These new institutions mark what appears to be a third wave of bank entrants into Mexico's financial system (*Chart 1*). The first two waves were in 1993–95 and 2006–07.

Chart 1 Interest in Bank Charters Growing Again in Mexico



*Three additional banks are in the process of applying for a charter.
SOURCE: Comisión Nacional Bancaria y de Valores.

Privatization and Crash

Commercial banks were nationalized in 1982 following a peso devaluation and financial system crisis. Of the 20 banks operating prior to privatization in 1991–92, 18 were government controlled. (Only Banco Obrero and Confia, a subsidiary of Citibank, were privately owned.)

When the government auctioned off its banks, investors typically paid a premium that averaged 3.5 times book value—by comparison, U.S. banks were selling for about 1.5 times book at that time. Purchasers anticipated limited competition, with profits remaining high. Those expectations were dashed in 1993 when the government began licensing new banks. In 1993 and 1994, 16 locally owned commercial banks began as de novo, or newly chartered, operations. Additionally, 17 foreign institutions opened commercial banks in Mexico by 1996.

The local banks aggressively extended credit in an attempt to generate the returns necessary to cover the high auction prices that purchasers had paid. With little lending experience, the banks were limited in their ability to assess credit and market risk.[2] Risky loans became more precarious by year-end 1994 as the peso collapsed and inflation and interest rates rose sharply. When borrowers struggled to repay debts the next year, the banks' financial condition severely deteriorated.

Failures and consolidation reduced the number of institutions in Mexico from 53 in 1996 to 34 in 1998. Most of the

Table 1
Banks Extend Their Reach in Mexico

Year	Branches	ATMs	Correspondents
2007	9,459	29,333	n.a.
2008	10, 726	29,640	n.a.
2009	10,736	33,648	n.a.
2010	11,294	35,942	9,303
2011	11,786	36,803	21,071
2012	12,338	39,830	*

*Data not yet available for 2012.

NOTES: Data for branches and ATMs in 2012 are as of November. Correspondent arrangements allow commercial banks to deliver basic services through businesses such as retail stores.

SOURCES: Comisión Nacional Bancaria y de Valores; Banco de México.

survivors were zombie banks, open only because of regulatory forbearance and government support. Ultimately, taxpayers paid about US$100 billion, or 17 percent of gross domestic product (GDP), to recapitalize the banking system. By comparison, the Federal Deposit Insurance Corp. estimates the savings-and-loan crisis of the 1980s cost U.S. taxpayers $124 billion, or 2.1 percent of GDP.[3] The Mexican financial system stagnated for a decade as the banks rebuilt balance sheets and strengthened their capital bases. Loan growth didn't resume until early 2005, when the banks returned to more usual operations, clearing the way for new charter activity.[4]

Niche Banks' Emergence

Authorities sought to increase financial penetration in the country, which they felt was underserved—constrained by geography and perceived high costs for consumer banking products.[5] A 2006 World Bank survey found that fewer than 25 percent of Mexican households possessed any type of formal financial product.

Efforts focused on expanding banks' geographic reach and reducing the cost of services by increasing competition and promoting the entry of new institutions. Fourteen new commercial banks were chartered from May 2006 to year-end 2007. Seven of the de novo banks' target markets were previously unbanked low- to middle-income households. Four of these seven banks were affiliated with retailers and focused on offering basic checking accounts, savings accounts and consumer loans in stores. Lower-income households, in particular, gained expanded access to finance. Existing banks also increased their geographic reach, making basic financial services available through businesses such as pharmacies and convenience stores in what are known as correspondent arrangements (*Table 1*).[6]

A Slow Start

During the pickup in de novo banks, the niche bank charter emerged.[7] Among the features of the new charter are its concentration on specific markets, reduced start-up costs, ease of entry into the banking industry and improved regulatory coverage for the financial system.

The new charter, introduced with some fanfare, did not catch on initially. In 2008, as the financial crisis roiled global financial markets, Mexican institutions retrenched. The national economy contracted more than 6 percent in 2009, suffering fallout from the U.S. recession.[8] Institutions potentially interested in niche bank charters deferred action until after the economy recovered in 2010.

The overall application process for niche banks mirrors that used for commercial banks. The first step is a business plan and application submission. The Comisión Nacional Bancaria y de Valores (CNBV), Mexico's financial regulator, authorizes the entity to organize. The entity must then establish its main operational areas: loans, funding and treasury services, capital adequacy, risk management, technological infrastructure, anti-money-laundering measures, accounting processes, internal controls and basic security measures.

After an operational infrastructure is installed, the CNBV performs a preoperative on-site examination. It tests and evaluates the resources, obligations and assets, and operations, performance and control systems of the institution. If the entity gets a passing grade, the regulator grants a banking license and operations can begin.

The process took about two years for the first two niche banks—Banco Agrofinanzas, focused on the agricultural sector, and Banco Bicentenario, concentrating on trade finance. Both banking licenses were approved in July 2012.

Niche Bank Surge

Six new banks were chartered, including four as niche banks, in the second half of 2012. CNBV also announced that three more banks have formally applied for a niche bank license, with two of them undergoing the preoperative on-site examination. Those banks are expected to receive a license in first quarter 2013. Table 2 shows niche banks that have either been licensed or have received initial authorization to form and are in the preoperative examination process.

Agricultural and cross-border businesses seem to offer especially attractive opportunities. The CNBV indicated that at least three other groups have completed the due-diligence process but haven't yet formally applied for a banking license.

Ordinary commercial banks, formally called "banca múltiple," must raise at least 439 million pesos ($33.9 million) in capital to open.[9] Recent de novo commercial banks suggest that the minimum investment is a binding constraint. Of the 16 commercial charters granted since 2006, nine came within 50 million pesos ($3.9 million) of the minimum startup capital investment and three were within 100 million pesos ($7.7 million). Lowering the minimum start-up cost would spur bank creation.

Within the niche charter, there are two types of niche banks, each with a different capital requirement (*Table 3*). Larger niche banks must raise at least

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Table 2 Niche Banks' Niches

Institution	Niche	Former charter	Date license approved
Banco Agrofinanzas	Agriculture	*Sofol*	July 2012
Banco Bicentenario	Export-import/trade finance	Credit union	July 2012
Banco Forjadores	Microfinance, specifically female entrepreneurs	*Sofom*	September 2012
Banco Pagatodo*	Payment systems	No financial system charter	September 2012
Corporación Financiera de Occidente (Finox)	Agriculture	*Sofol*	Pending
Unión de Crédito Progreso	Region encompassing the state of Chihuahua	Credit union	Pending

*Pagatodo operates under the smaller niche bank charter and is unable to lend directly to households or businesses.

NOTES: A *sofol* is a regulated finance company; a *sofom* is an unregulated finance company. In addition to these niche banks, two new commercial banks, Banco Inmobiliario Mexicano and Fundación Dondé Banco, were approved for a banking license in November 2012.

SOURCE: Federal Reserve Bank of Dallas.

263 million pesos ($20.3 million), while smaller niche banks must raise 175 million pesos ($13.5 million). In general, the larger banks cannot engage in trust activities, while the smaller banks cannot lend, except to other banks, and are limited in their ability to use the market for funding. In the U.S., an institution must lend to be considered a bank.

The goal of Mexico's smaller niche banking charter is to increase availability of simple checking and savings accounts. The institutions also generate cheaper funding by attracting deposits. To date, only one of the approved niche banks has chosen to operate under the lower startup capital requirement.

Mexican regulatory authorities are eliminating an existing financial system charter, further spurring the formation of niche banks. Each Sociedad Financiera de Objeto Limitado (*sofol*), or regulated finance company, must become a bank or an unregulated finance company (*sofom*) by July 2013. *Sofoles* specialize in offering credit to a specific market segment, making them a natural fit for a niche bank charter. The question is whether the ability to accept deposits is worth the regulatory compliance costs.

Of the 21 active *sofoles*, one has already launched a niche bank, a second is in the process of getting a niche bank charter and a third has purchased a commercial bank. The other *sofoles* focus on mortgages, as well as education, small business and agricultural lending.

Gaining Access

Mexico's high level of informality contributes to the low banking penetration, with commercial banks not fully tapping many segments of the economy. This leads to less access to credit and greater self-financing. Niche banks can address the issue by bringing more households and businesses into the formal banking system.

Much of the Mexican population still relies on informal finance—largely escaping taxes and the reach of the law. About 44 percent of Mexican households were outside the formal financial system in 2012, according to a survey by CNBV and the Instituto Nacional de Estadística y Geografía (Mexico's National Institute of Statistics and Geography).[10] More than half of Mexico's labor market is informal.[11] Still, many of these households earn steady salaries and could benefit from financial inclusion.

Moreover, small businesses continue to have trouble getting credit. At the beginning of 2013, only 35 percent of Mexican businesses with fewer than 100 employees had outstanding bank credit, compared with 54 percent of larger businesses, a quarterly Banco de México survey found.[12] More than half of the small businesses felt that banks were unwilling to offer them credit.

By focusing on a specific market or region, niche banks may be better equipped to reach small businesses and help them serve as an engine for the

Table 3
Permissible Activities by Niche Charter

Activity	Small niche bank (175 million-peso threshold)	Large niche bank (263 million-peso threshold)
Accept deposits	Yes	Yes
Issue bank bonds	No	Yes
Issue subordinated debentures	No	Yes
Make loans	Interbank only	Yes
Issue credit cards	No	Yes
Offer trust services	Yes	No
Receive deposit administration, custody or guarantees for third parties of titles or securities	Institutional investors or companies only	Yes
Offer leasing and factoring products	No	Yes
Derivatives (hedging only)	No	Yes
Engage in transactions involving precious metals or foreign currencies	Yes	Yes

SOURCE: Comisión Nacional Bancaria y de Valores.

country's overall growth and development. Within the U.S., smaller banks tend to focus on business lending, particularly to small businesses, and maintain a flow of credit to small businesses even during difficult times.[13]

Improved access to formal finance could help reduce the level of informality. For this to happen, however, the benefits of formality must exceed the costs of paying taxes and conforming to business regulations.

Potential Pitfalls

While niche banks lower barriers to entry and are able to focus on a specific market or geographic area, they face potential headwinds.

One concern is they must comply with the same prudential regulations and risk-based capital requirements as commercial banks and are subject to both on-site examinations and off-site monitoring. Their smaller size suggests regulatory burdens could be relatively greater. The burden would be spread across fewer assets and could result in disproportionate oversight expenditures. In turn, these higher compliance costs could be passed on to customers through increased prices or reduced service.

Another concern is that niche banks' exposure to a specific industry or region could make diversification difficult. Individual institutions are vulnerable to regional or industry downturns. Moreover, the institutions' small size could make it hard for them to obtain funding or recapitalize in tough times.

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Notes

[1] See "Regulatory Burden Rising," by Christoffer Koch, in "Financial Stability: Traditional Banks Pave the Way," Federal Reserve Bank of Dallas Special Report, January 2013, www.dallasfed.org/microsites/fed/annual/2012/e4/w1201e4.cfm.

[2] For a detailed account of the banking system's privatization and the foundation for the resulting crash, see "Liberalization, Privatization and Crash: Mexico's Banking System in the 1990s," by William C. Gruben and Robert McComb, Federal Reserve Bank of Dallas *Economic Review*, First Quarter 1997, pp. 21–30.

[3] "Cost of the Savings and Loan Crisis: Truth and Consequences," by Timothy Curry and Lynn Shibut, Federal Deposit Insurance Corp., *FDIC Banking Review*, December 2000. U.S. GDP as of December 1990 was used in the denominator. Although the crisis was over by 1990, the costs were spread over several years into the 1990s.

[4] For more detail, see "Mexico Emerges from 10-Year Credit Slump," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2005, and "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2002.

[5] See "Reaching Mexico's Unbanked," by Edward C. Skelton, Federal Reserve Bank of Dallas *Economic Letter*, vol. 3, no. 7, 2008.

[6] The Asociación de Bancos de México estimates correspondent banks have been growing 7.8 percent a month since they were introduced in October 2010.

[7] Formally, the charter is called "banca múltiple con objeto social acotado," or limited purpose commercial bank.

[8] For more detail on the 2009 recession, see "Mexico's *Año Horrible*: Global Crisis Stings Economy," by Erwan Quintin and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter 2009.

[9] The capital requirement is indexed to inflation using Unidades de Inversión, or UDIs. UDIs are a unit of account pegged to Mexico's official inflation rate. The minimum startup capital is UDI90 million for a commercial bank, UDI54 million for a large niche bank and UDI36 million for a small niche bank. As of Dec. 31, 2012, a UDI was worth 4.88 pesos, and the exchange rate was 12.9658 pesos:$1.

[10] The survey "Encuesta Nacional de Inclusión Financiera" as well as data measuring households' access to and use of financial services is published by CNBV.

[11] The most cited statistic is that, as of fourth quarter 2012, informal workers made up 59.9 percent of Mexico's labor market. Informal workers include those outside the country's social security system, subsistence farmers, those working for unregistered businesses, and other individuals who do not pay taxes. See "Resultados de la Encuesta Nacional de Ocupación y Empleo," published by the Instituto Nacional de Estadística y Geografía, for more information about the country's labor market conditions.

[12] See "Evolución Trimestral del Financiamiento de las Empresas," published quarterly by Banco de México.

[13] In the U.S., community banks held 17 percent of all banking system assets but accounted for more than half of all small business loans as of June 2012. See "A Lender for Tough Times," by Jeffery W. Gunther and Kelly Klemme, in "Financial Stability: Traditional Banks Pave the Way," Federal Reserve Bank of Dallas Special Report, January 2013, www.dallasfed.org/microsites/fed/annual/2012/e2/w1201e2.cfm.