Mexico's 'SOFOM' Finance Firms Attempt to Broaden Loan Availability

By Michael Perez and Kelsey Reichow

ABSTRACT: The market presence of Mexican finance companies known as *SOFOMES* has expanded rapidly since the global financial crisis. The firms largely operate as independent outlets and provide financing to small- and medium-sized companies as well as to consumers for larger purchases. Authorities see SOFOMES as a way to expand credit to Mexico's informal economy.

Mexicans increasingly rely on regulated nonbank finance companies for their credit needs. Assets at these firms—known by the Spanish shorthand as *SOFOM ER*—have more than doubled amid a regulatory effort to formalize and consolidate the industry or sector beginning in 2013.[1] Meanwhile, the finance companies' share of the lending market has grown, driven by new market entrants (*Chart 1*).

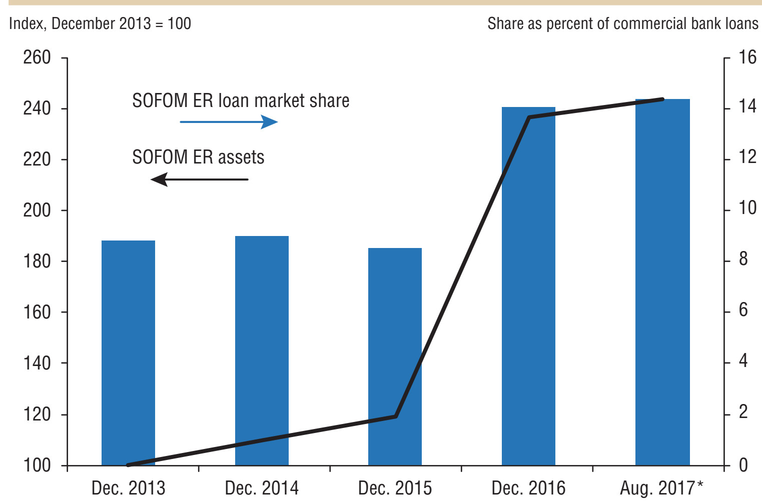
SOFOM ERs specialize in credit, lease financing and financial factoring services. They offer auto, personal and department store credit and commercial financing for small- and medium-sized enterprises. Some serve as captive finance companies—institutions providing customer credit for purchases of parent company products—at stores and dealerships.

Others operate as independent lenders or as off-balance sheet vehicles for larger banks. A total of 49 SOFOM ERs operated in Mexico as of August, with about 614 billion pesos ($33 billion) in loans outstanding.[2] Not all Mexican finance companies are SOFOM ERs. There are also more than 1,500 lesser-regulated companies (*SOFOM ENRs* in Spanish).

Mexico's regulated and lesser-regulated finance companies are collectively known as *SOFOMES*. As the country's financial system continues to develop and its commercial banks cater to more traditional established markets, regulators view SOFOMES as a means of addressing basic credit needs while providing an important source of liquidity to chronically underserved markets.

SOFOMES are not allowed to accept deposits. Instead, they raise capital from banks, government-sponsored financial corporations, venture capital entities or through debt issuance. To

Chart 1 Mexican SOFOM ER Assets, Lending Grow



*Represents partial-year activity.

NOTE: Total loans are calculated net of loan loss reserves.

SOURCES: Mexican National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores); authors' calculations.

comply with money laundering rules, SOFOMES must register with Mexico's banking and securities commission, the national financial consumer watchdog agency, the central bank and the finance ministry. They must comply with anti-money-laundering measures and report borrower credit profiles to a private credit bureau.

SOFOM ERs are subject to relatively light capital requirements and accounting standards.[3] Mexico's commercial banks must maintain a capital adequacy ratio (total capital to risk-weighted assets) of 10.5 percent, while SOFOM ERs must maintain an 8 percent ratio. Moreover, SOFOM ERs must follow additional regulatory requirements as a result of linkages with other regulated financial institutions, such as commercial banks' community financing firms.[4]

Filling Lending Gaps

Mexico is Latin America's second-largest economy, bolstered by strong fundamentals, reform initiatives and stable institutions.[5] Still, financial system development remains a challenge, especially financial inclusion. Credit to the private sector and households' use of deposit accounts are low, new loan origination by commercial banks has remained sluggish, and long-term financing is scarce (*Chart 2*). Instead of extending new lines of credit, commercial banks often consolidate their financial service offerings, choosing to improve their existing infrastructure and make larger loans to existing customers. As a result, a majority of Mexican adults don't use the country's financial system. The unbanked proportion is greatest in rural areas, where 71 percent of working-age residents lack access to formal financial services, far exceeding Mexico's Latin American peers (*Chart 3*).[6]

Micro-, small- and medium-sized enterprises also struggle to obtain credit. A study by the National Statistics Institute found that only 11 percent of microenterprises (those with up to 10 employees) have access to financing, compared with 28 percent for small enterprises (11–49 employees) and 40 percent for medium-sized entities (50–250 employees).[7] Moreover, when receiving offers of formal financing, 67 percent of all these businesses turn them down primarily because of high borrowing costs, including lenders' fees, and minimum balance and collateral requirements.

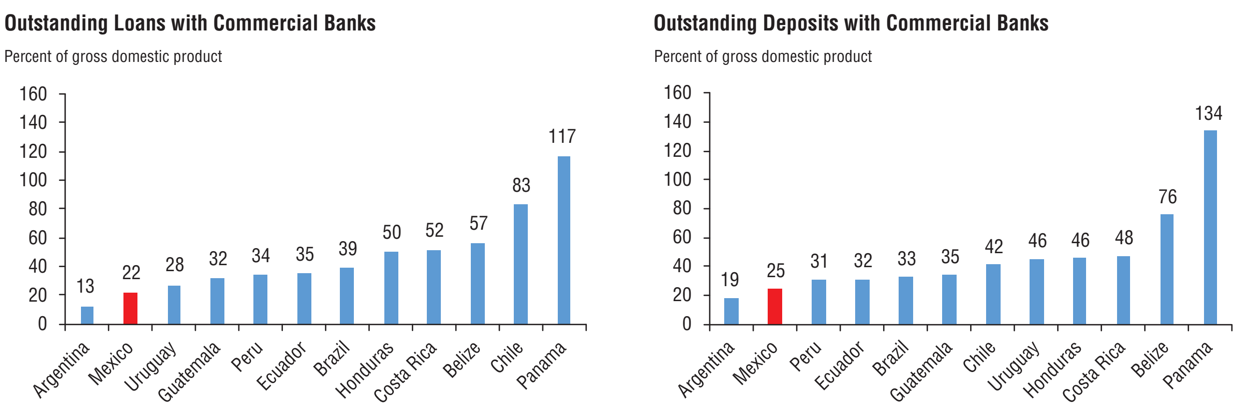
Many of these businesses and individuals lack established credit histories and operate in Mexico's large informal sector—the part of the economy where activity is not reported to the government and whose participants do not pay employment taxes or receive government-mandated benefits and pensions. The informal sector accounts for a quarter of Mexico's gross domestic product, according to the National Statistics Institute.[8]

The inability to access credit through a bank has considerable economic consequences. Credit-constrained individuals and firms often can't take advantage of growth opportunities or absorb financial shocks. Families are unable to invest in education and health; businesses struggle to expand and create jobs.

The SOFOMES offer an alternative borrowing channel. Specifically, because they do not face the same restrictions as banks, SOFOMES can more easily serve marginalized consumers without imposing credit, balance and collateral requirements. SOFOMES undertake higher-risk lending by charging higher loan interest rates. The average interest rate on a personal loan taken at a Mexican commercial bank in April 2017 was 31 percent while at a SOFOM ER, it was 39 percent. Nevertheless, the benefits of having access to high-interest financing often outweigh the costs of being denied credit by a commercial bank.

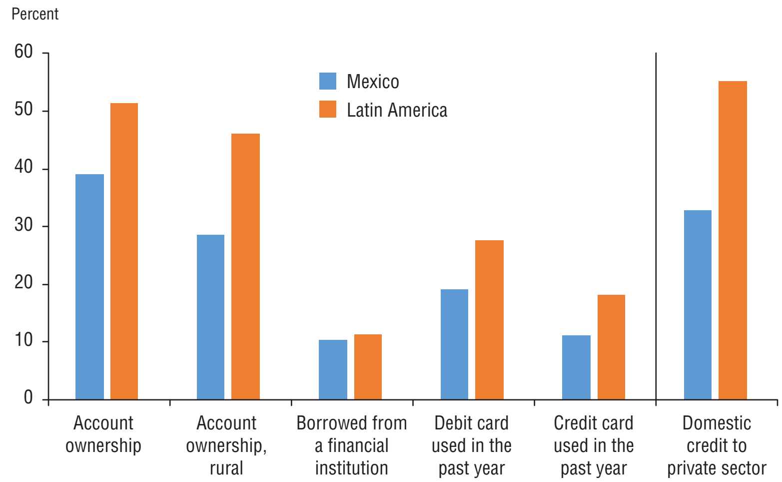
Mexico hopes that by striking a balance between formalization and innovation within the SOFOME sector, it can bolster credit, increase investor confidence and encourage new business formation while discouraging

Chart 2 Loan Issuances and Deposit Volume in Mexico Lag Latin American Peers



SOURCE: International Monetary Fund Financial Access Survey—2017 Edition.

Chart 3
Financial Inclusion in Mexico Trails Latin America



NOTE: Percent refers to share of respondents except for domestic credit, where it refers to share of gross domestic product.

SOURCES: World Bank Global Findex 2014 and International Monetary Fund; International Financial Statistics and data files; World Bank and Organization for Economic Cooperation and Development.

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reliance on costlier and less reliable, unregulated alternatives.[9]

Balancing Regulation, Innovation

Mexico has struggled to strike an optimal regulatory balance. The predecessors to SOFOMES, known as *SOFOLES*, first appeared in the mid-1990s after a sharp peso devaluation and political instability spawned the Tequila Crisis of 1994—both events disrupting banking activity. Banks struggled to rebuild their balance sheets, and the Mexican government sought to stimulate the credit market.

Nondeposit-taking finance company lending was authorized in the housing, consumer, small-business and automobile finance markets.[10] Initially, the finance companies, backed by the federal government, issued loans for low-income housing and real estate development.[11]

By the mid-2000s, nonbank lending was common, accounting for nearly half of Mexican mortgage loan originations. Commercial banks, operating in a less stringent regulatory environment before the 2007–08 global financial crisis, were drawn to the finance companies and their mortgage business with the informal workforce.

As the financial crisis unfolded, delinquency rates soared and SOFOLES struggled to maintain operations. Total loans issued by SOFOLES fell 69 percent between their peak in September 2007 and December 2009, drying up credit available to individuals and small- and medium-sized enterprises (*Chart 4*).

The stress spread to banks that had purchased finance companies before the crisis. The downturn exposed fraudulent practices, loose lending standards and inadequate servicing procedures in the nonbank financial sector.[12]

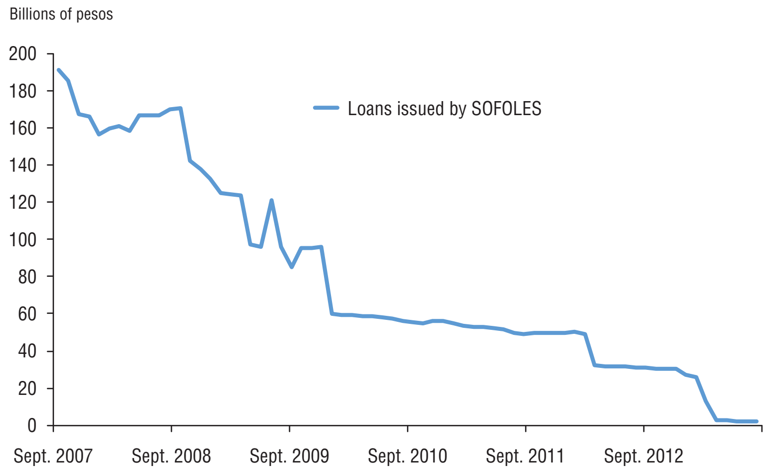
The SOFOLES' struggles in the wake of the crisis prompted regulatory change. Registration of the finance companies was required under laws passed in 2013, under which SOFOLES were required to convert into SOFOM ERs or SOFOM ENRs or dissolve. This led to the consolidation in the SOFOMES sector. Regulators also adjusted their oversight strategy, boosting protection for consumers, mitigating SOFOMES' lending risks and scrutinizing the firms for fraud and money laundering.

SOFOMES in the Future

SOFOMES' future growth may come via financial technology (fintech) companies, which leverage online, mobile and information technologies to deliver financial services. Fintechs in

Chart 4

SOFOLES' Lending Tumbles Following Global Financial Crisis



SOURCES: Mexican National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores); authors' calculations.

developing countries such as Mexico have objectives similar to SOFOMES, making financial products, including loans, available to underserved markets. To meet this goal, they rely on mobile device-based transactions and data analytics.

While regulatory constraints limit banks' adoption of these technologies, fintechs can register and become SOFOMES. Some existing SOFOMES have acquired equity stakes in fintech startups or have developed fintech business lines, technological tools, mobile apps and other electronic products; others are collaborating with fintech firms.[13]

The government's approach to fintechs appears in line with that of SOFOMES; regulators seek to balance innovation with oversight to allow growth and monitor for fraud.

Still, a large proportion of Mexico's population remains without access to credit, and the SOFOMES, perhaps with the fintech sector, may increase financial inclusion.

Perez and Reichow are financial industry analysts in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Notes

[1] SOFOM stands for sociedad financiera de objeto múltiple. ER stands for entidad regulada. ENR stands for entidad no regulada. SOFOLES stands for sociedad financiera de objeto limitado.

[2] Based on Comisión Nacional Bancaria y de Valores (Mexican National Banking and Securities Commission) data, authors' calculations.

[3] See "SOFOMES" by Comisión Nacional Bancaria y de Valores (Mexican National Banking and Securities Commission), www.cnbv.gob.mx/SECTORES-SUPERVISADOS/OTROS-SUPERVISADOS/Descripci%C3%B3n-del-Sector/Paginas/SOFOMES-Reguladas.aspx.

[4] See "Padrón de Entidades Supervisadas" (Census of Supervised Entities), Comisión Nacional Bancaria y de Valores (Mexican National Banking and Securities Commission), www.cnbv.gob.mx/Paginas/PADR%C3%93N-DE-ENTIDADES-SUPERVISADAS.aspx.

[5] See "Financial System Stability Assessment" by International Monetary Fund, November 2016.

[6] Working-age individuals are defined as those 15 years of age or older.

[7] See "Se Difunden Estadísticas Detalladas Sobre las Micro, Pequeñas y Medianas Empresas del País" ("Statistics on Micro-, Small- and Medium-Sized Businesses") by Instituto Nacional de Estadística y Geografía (National Statistics Institute), Instituto Nacional del Emprendedor (National Startup Institute) and Banco Nacional de Comercio Exterior (National Bank of Exterior Commerce), July 2016, www.inegi.org.mx/saladeprensa/boletines/2016/especiales/especiales2016_07_02.pdf.

[8] See "Actualización de la Medición de la Economía Informal" ("Actualization in Measuring the Informal Economy") Instituto Nacional de Estadística y Geografía (National Statistics Institute), December 2016, www.inegi.org.mx/saladeprensa/boletines/2016/especiales/especiales2016_12_08.pdf.

[9] See "A Study on the Effect of Financial Inclusion on the Relationship Between Income Inequality and Economic Growth," by Jong-Hee Kim, *Emerging Markets Finance & Trade*, vol. 52, no. 2, 2016, pp. 498–512, www.tandfonline.com/doi/full/10.1080/154046X.2016.1110467.

[10] See "The SOFOLES: Niche Lending or New Leaders in the Mexican Mortgage Market?" by Natalie Pickering, Harvard University Joint Center for Housing Studies, May 2000, www.jchs.harvard.edu/sites/jchs.harvard.edu/files/pickering_w00-2.pdf.

[11] SOFOLES typically issued credit for properties between $14,000 and $22,000 (U.S.). See "The Home Truths About Non-Bank Mortgage Lending in Mexico," by Knowledge@Wharton, The Wharton School, University of Pennsylvania, Oct. 5, 2011, http://knowledge.wharton.upenn.edu/article/the-home-truths-about-non-bank-mortgage-lending-in-mexico/.

[12] See "The Non-Bank Credit Crunch in Mexico: Rise and Fall of an Industry," by José Berrospide, Renata Herrerías, Fabrizio López Gallo and Ana Mier y Terán, Instituto Tecnológico Autónomo de México (Autonomous Technical Institute of Mexico), December 2012, http://daac.itam.mx/sites/default/files/nonbank_credit_crunch_mexico_dec2012.pdf.

[13] See "Es Importante Que las SOFOMES se Sumen al Huracán Fintech: Banxico" ("It's Important Sofomes Join the Fintech Hurricane: Banxico"), by Fernando Gutiérrez, *El Economista*, Sept. 10, 2017, www.eleconomista.com.mx/sectorfinanciero/Es-importante-que-las-sofomes-se-sumen-al-huracan-fintech-Banxico-20170910-0043.html.