

Mexico's Nascent Fintech Offers Promise, Faces New Rules

By Michael Perez

ABSTRACT: The number of financial technology startups in Mexico has rapidly increased, promising to expand financial services to a large portion of the unbanked population. Officials are hopeful new regulations will aid the industry's development.

Financial technology in Mexico has increased rapidly. The number of fintech startups rose 40 percent on a year-over-year basis to a total of 334 as of September 2018.¹

Mexico's fintech sector originally focused on expanding financial access through mobile payment applications, but entrants are spread across an array of financial segments and offer a mix of services (*Chart 1*).²

Although the sector remains relatively small, 36 percent of Mexicans who are active online have adopted fintech, according to the accounting firm and consultancy EY.³ The share exceeds the average global adoption rate of 33 percent.

A separate study shows that 60 percent of Mexican individuals are active online, compared with 77 percent in the United States.⁴

Fintech firms—specializing in technologically enabled financial service innovation—use computing power, artificial intelligence, mobile telecommunications and cloud-based systems to provide financial services.⁵

The services include electronic payments and remittances, crowdfunding, automated loan applications, and asset trading. Some fintech firms compete directly with traditional banking and financial institutions, while others partner with existing institutions.

A survey of Mexican fintech firms reveals that the majority have business models aimed at reaching financially excluded markets—those with limited or no access to basic financial services such as checking and savings accounts (*Chart 2*). Consumers in these markets are chiefly “underbanked” and “unbanked” individuals, as well as small businesses (11–50 employees) and medium-sized enterprises (51–250

employees) lacking relationships at established banks.

A smaller share of fintech firms focus on providing business-to-consumer products—online lending and credit-scoring services—for banked customers and business-to-business solutions such as cross-border business payment platforms for large firms. Still others deal in products for banked small and medium-sized enterprises.

Fintech products are generally easier to access relative to traditional banking alternatives for those outside the mainstream, who may potentially realize financial inclusion. The fintech sector benefits from comparatively streamlined business models, greater ability to develop products for specific customers and less regulatory oversight.⁶

Greater financial inclusion comes with challenges, especially cyber risks, which are inherent with high interconnectivity in diverse environments where participants often function with a degree of anonymity. For example, most fintechs leverage internet access to collect client data and provide services, creating an opening for hackers looking to steal funds or customer identities.

Money-laundering concerns also exist given drug cartels' presence in Mexico. Moreover, because fintechs operate with minimal oversight relative to banks, the lack of consumer protections is a concern, especially in the event of firms failing.

Mexico's financial regulators responded in 2018 with regulations that establish a framework for the authorization and supervision of fintech firms, particularly those focusing on online lending and payments. Moreover, officials seek to incentivize collaborative relationships to allow innovation to occur as regulations are developed.

Fintechs Seek Traction

The majority of Mexican fintechs are venture-capital startups.⁷ More than 85 percent are less than five years old, and about 12 percent fail annually. Over half of Mexico's fintech firms employ fewer than 10 people, while only 8 percent have more than 50 employees. The value of fintech transactions in Mexico is expected to total US\$36 billion in 2018, representing 7 percent of commercial banking assets and 14 percent of commercial loans. Fintech volume is projected to reach \$68 billion by 2022, assuming growth at the current rate.⁸

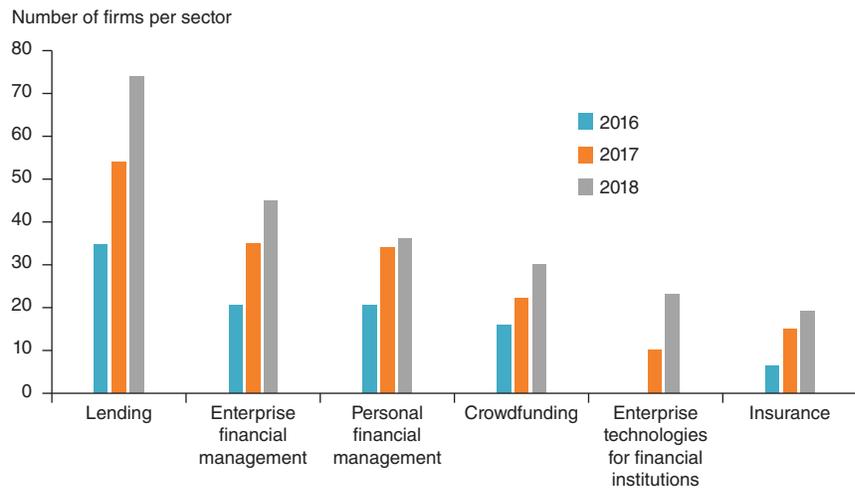
Traditional financial institutions are entering the sector through direct investments in fintech companies, consulting, and development of fintech-like platforms such as mobile banking applications. For example, BBVA Bancomer, Mexico's largest commercial bank, purchased Openpay, a Mexican fintech startup that offers electronic payment applications for businesses.⁹ The bank said it would launch a \$250 million fund that will focus on early- to late-stage fintech investment opportunities.¹⁰

Mexican banks' growing fintech presence reflects the banks' desire to enter new markets and offer new products as well as the fintech firms' need for funding and access to payment systems. Fintech originally sought to unbundle banking through digital disintermediation. However, fintech firms cannot accept traditional deposits, making it difficult for them to attract cheap and stable funding. As a result, they generally rely on banks for their financial support and customer base. Fintech firms gain access to banks' payment systems and financial data through these partnerships.

The blurring lines between fintech and traditional finance sectors present numerous regulatory challenges, particularly related to financial stability. As the interconnectivity between banks and fintechs increases, so do the risks for contagion. For example, fintech lender losses could spill over to banks funding the firms.

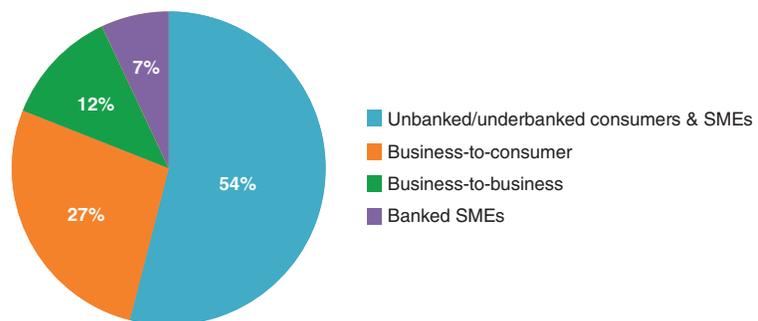
Accurately assessing the financial-stability implications is challenging given the limited availability of official

CHART 1 Mexico Fintech Industry Diversifies, Expands into Multiple Segments



SOURCE: Finnovista Radar 2018; author's calculations.

CHART 2 Mexican Fintechs Primarily Engage in Unbanked, Underbanked Markets



NOTE: SME refers to small and medium-sized enterprises.
SOURCE: Finnovista Radar, 2018.

and privately disclosed fintech operations data. Moreover, a lack of internationally accepted guidelines or best practices renders regulatory frameworks fragmented across countries. Given the level of uncertainty regarding fintech vulnerabilities, there exist material risks that regulators have yet to realize or understand. For example, numerous cases of disappearing crowdfunding receipts have been reported in Mexico.

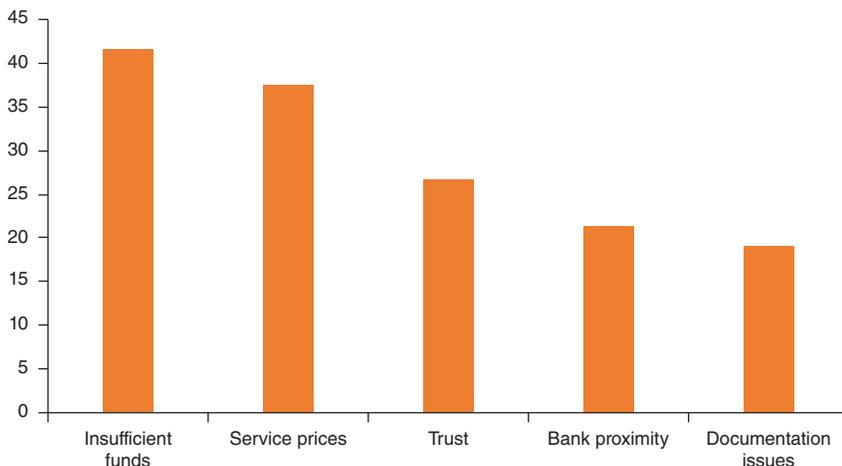
Inclusionary Opportunities, Costs

Financial system development, especially inclusion, remains a challenge in Mexico. In a reversal of prior trends, the share of the adult population with a bank account fell between 2014 and 2017. Lack of required funds, high costs and distrust are the main contributors to the decline (*Chart 3*). However, the rise of alternative financial arrangements, such as those fintechs offer, could also play a role.

CHART
3

Bank Account Ownership Down in Mexico amid High Costs, Lack of Trust

Top reasons for not having a bank account (percent)



SOURCE: World Bank, Global Findex, 2017.

Banks tend to focus on existing clients, for whom they consolidate financial service offerings and make larger loans. As a result, fewer Mexicans access formal credit and instead seek out less-reliable, unregulated channels for accessing financial products (such as payday loans) via informal arrangements among friends (*tandas* in Spanish) and loan sharks.

Mexico’s microbusinesses and small- and medium-sized enterprises (SMEs) face similar issues accessing formal finance. The majority of Mexico’s enterprises are microbusinesses and SMEs operating in the country’s informal sector, leaving many of them without access to key financial services.

These businesses account for 52 percent of Mexico’s gross domestic product (GDP) and 72 percent of its employment, though most are ineligible to receive credit from commercial banks.¹¹ There are indications that Mexico’s recent financial reforms are helping boost lending to smaller enterprises. Still, the base from which those improvements occur is small.¹²

While banking penetration remains low for consumers and smaller enterprises, the diffusion of technology is on the upswing—a necessary condition for the expansion of fintech. Cellular phone penetration is high, bolstered by

structural reforms designed to increase competition in telecommunications.

An estimated 75 percent adults report having access to a mobile phone—up from 69 percent in 2016—and 42 percent of those phones are smart devices.¹³ Meanwhile, mobile and internet subscription rates are trending higher (*Chart 4*).

The delivery of financial products through fintech comes at an added cost to customers. For example, fintech firms specializing in online lending can, more easily than banks, serve marginalized consumers without imposing credit, balance and collateral requirements.

These firms gauge borrowers’ creditworthiness using unconventional models and algorithms before assessing relatively high interest costs that make up for high default risk.¹⁴ Conversely, the unconventional borrower screenings and significant financial burdens on borrowers may increase default rates and ultimately reduce confidence in the sector.

Moreover, fintech’s increasing reliance on the internet renders consumers subject to cybersecurity attacks and identity theft risks. Financial education is another concern because users must feel comfortable using financial technologies, be able to identify issues and understand what recourse is available

if something does go wrong. Challenges specific to Mexico’s rural areas include a lack of electricity to power mobile phones and computers, spotty network coverage and a limited regulatory presence to provide consumer education and legal protection.

Laying Regulatory Groundwork

Regulators recognize challenges accompanying the benefits of wider fintech adoption. These considerations prompted passage of a comprehensive fintech law in 2018, making Mexico one of the first countries to craft legislation exclusively dedicated to the sector.¹⁵

The law seeks to provide legal security to fintech consumers, trigger greater competition in financial markets, combat money laundering and fraud in accordance with international standards and regulate transactions involving digital assets and platforms.¹⁶

The law identifies key fintech institutions and rules for their authorization, regulation and supervision.¹⁷ The institutions—primarily crowdfunding platforms and electronic payment services—first receive an initial consent to operate from an interagency committee comprised of two members each from the Ministry of Finance and Public Credit, the Bank of Mexico, and the Banking and Securities Commission. The Banking and Securities Commission provides final operational approval.

Fintechs must remit funds they receive to deposit accounts in approved banks and must obtain special dispensation to receive foreign funds. Each institution is subject to capital requirements, and the value of transactions sent via online payment is capped.

The law also lays out rules to facilitate the exchange of data and promote innovation. It encourages the sharing of financial consumer data between banks and fintechs through public application programming interfaces—platforms that aggregate consumer financial data without violating financial secrecy regulations.¹⁸

The law also provides fintechs with regulatory sandboxes—testing grounds for new business models not protected by existing regulation. Sandboxes

permit fintechs to experiment with innovative products in a controlled environment with limited oversight by regulators, who in turn can develop regulations around fintech products while directly observing them in action.

Additionally, the law created the Financial Innovation Group, a forum for startups, banks and public sector entities to promote fintech.

The Road Ahead

Mexico's traditional banks have historically struggled to offer financial inclusion. Private sector credit as a share of GDP is among the lowest in Latin America. Fintech, while relatively small, has the potential to deepen Mexico's financial system while offering improved access to credit for the unbanked and underbanked.

Regulators have formally acknowledged the importance of fintech and implemented prudential regulations that seek to balance stability with the freedom to innovate in order to ensure the sector can serve markets effectively. Fintech's growth will depend on the sector adhering to the new standards while innovating and providing value to consumers.

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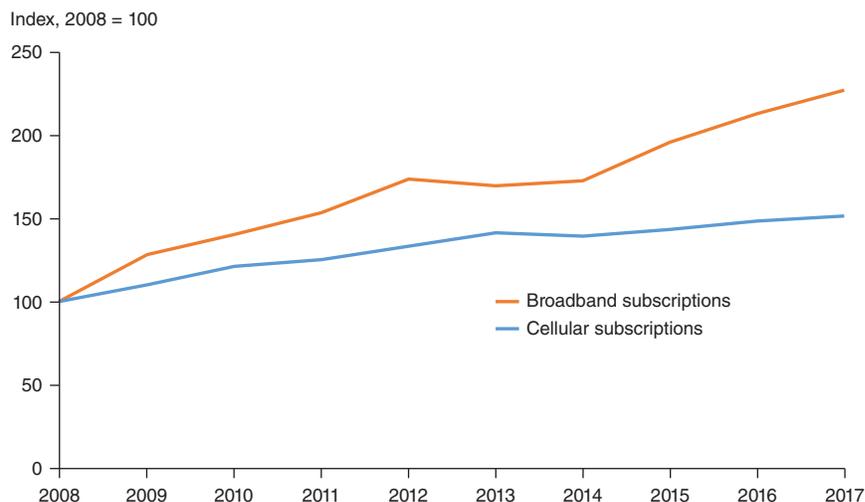
Notes

¹ Brazil is Latin America's largest fintech hub, while Colombia is the third largest. See "Mexico Exceeds the Barrier of 300 Fintech Startups and Reinforces Its Position as the Second Most Important Fintech Ecosystem in Latin America," *Finnovista*, 2018, accessed Nov. 9, 2018, www.finnovista.com/actualizacion-finnovista-fintech-radar-mexico-2018/?lang=en.

² See "Mobile Payments Promise to Improve Financial Accessibility in Mexico," by Michael Perez, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter, 2016, www.dallasfed.org/-/media/documents/research/swe/2016/swe1603g.pdf.

³ This survey was based on more than 22,000 online interviews in 20 international markets. Fintech users are defined as individuals who have used two or more fintech services in the past six months. See "EY FinTech Adoption Index 2017: The Rapid Emergence of FinTech," Ernst & Young, www.ey.com/Publication/vwLUAssets/

CHART 4 Mexican Mobile and Broadband Subscriptions Exhibit Long-Term Upward Trend



SOURCE: World Bank.

ey-fintech-adoption-index-2017/\$FILE/ey-fintech-adoption-index-2017.pdf.

⁴ International Telecommunication Union statistics, 2016, accessed Nov. 9, 2018, www.itu.int/en/ITU-D/Statistics/Pages/stat/default.aspx.

⁵ See note 2.

⁶ "FinTech and Financial Inclusion," World Bank, slide 6, <http://pubdocs.worldbank.org/en/877721478111918039/breakout-DigiFinance-McConaghy-Fintech.pdf>.

⁷ See note 1.

⁸ See "Reporte Nacional de Inclusión Financiera" ("National Financial Inclusion Report"), Consejo Nacional de Inclusión Financiera (National Financial Inclusion Council), no. 9, 2018, p. 99, www.cnbv.gob.mx/Inclusi%C3%B3n/Documents/Reportes%20de%20IF/Reporte%20de%20Inclusion%20Financiera%209.pdf.

⁹ See "BBVA Advances Its Fintech Strategy with the Acquisition of Openpay," by María del Carmen Peña Álvarez, *BBVA*, April 2017, www.bbva.com/en/bbva-advances-fintech-strategy-acquisition-openpay/.

¹⁰ "BBVA Shuts In-House Venture Arm, Pours \$250M into New Fintech VC Propel Venture Partners," by Ingrid Lunden, *TechCrunch*, February 2016, <https://techcrunch.com/2016/02/11/bbva-shuts-in-house-venture-arm-pours-250m-into-new-fintech-vc-propel-venture-partners>.

¹¹ See "Pymes (small- and medium-sized enterprises)," by Comisión Nacional para la Protección y Defensa de los Usuarios de Servicios Financieros (National Commission for the Protection and Defense of Service Users), www.condusef.gob.mx/Revista/index.php/usuario-inteligente/educacion-financiera/492-pymes.

¹² See "Mexico Development Bank Lending Rises Following Financial Reforms," by Michael Perez, Federal

Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2015, www.dallasfed.org/-/media/documents/research/swe/2015/swe1504f.pdf.

¹³ See "Smartphone Ownership on the Rise in Emerging Economies," by Jacob Poushter, Caldwell Bishop and Hanyu Chwe, Pew Research Center, June 2018, www.pewglobal.org/2018/06/19/2-smartphone-ownership-on-the-rise-in-emerging-economies.

¹⁴ For example, rates on loans from online lenders can range from 180.0 percent to 417.6 percent annually.

¹⁵ Mexico follows in the steps of the U.K., which was the first country to develop comprehensive regulatory standards and policies specifically for fintech.

¹⁶ See "Decree Enacting the Financial Technology Institutions Law ('Fintech Law)," by Ramón Bravo, Héctor Cuevas and Alfredo Chavero, Deloitte Legal, March 2018, www2.deloitte.com/content/dam/Deloitte/mx/Documents/legal/2018/Fintech-Law-Decree.pdf.

¹⁷ See note 8, pp. 18–20.

¹⁸ See "Mexico Financial Technology Law Passes Final Hurdle in Congress," by Sheky Espejo and Julia Love, Reuters, March 1, 2018, www.reuters.com/article/us-mexico-fintech/mexico-financial-technology-law-passes-final-hurdle-in-congress-idUSKCN1GD6KX.