Manuel Sánchez: Mexico's banking system – opportunities from reform

Speech by Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the BNP Paribas Economic Forum, Mexico City, 4 March 2014.

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It is an honor to participate in the BNP Paribas Economic Forum. I would like to thank the organizers of this conference for the invitation to speak to you about some of the current challenges and opportunities faced by the Mexican economy.

I would like to focus my comments today on how financial intermediation in the country could develop further, thus enhancing economic potential. To this end, I will begin by reviewing the main features of Mexico's banking system, in order to identify likely channels of improvement; then, I will examine how these possibilities are addressed by the recently approved financial reform; and finally, I will discuss Mexico's economic outlook with an emphasis on inflation and monetary policy.

The Mexican banking system

A well-functioning banking system is a prerequisite for the adequate operation of any economy. Its central role of financial intermediation allows for the efficient allocation of resources, by attracting savings and meeting the society's credit needs, especially by supporting the most profitable investment projects. In performing this task, banks take advantage of economies of scale and scope in information, diversify risks, and facilitate economic transactions.

In the last decade, real bank lending to the private sector has been growing, with a transitory decline during the global financial crisis. The average rate of annual expansion has been higher than that of GDP, a phenomenon that had not occurred in many years, backed by high portfolio quality as reflected by relatively low past-due loan ratios.

In spite of higher loan growth, bank penetration, as measured by the ratio of private-sector credit to GDP, continues to be low, even compared to other nations at an equivalent stage of economic development. Something similar can be said about total domestic financing to the private sector, which amounts to less than one-third of GDP.

Other indicators of insufficient bank penetration are small numbers of savings accounts and delivery channels per inhabitant, a fact that still holds true despite a notable increase in branches, ATMs, and point-of-sale terminals over the last couple of decades. All this reflects low financial inclusion, where large segments of the population do not use formal banking services.[1]

Due to the well-established long-run positive relationship between financial deepening and GDP growth, this scenario presents a significant upside opportunity for Mexico. In particular, bank credit expansion needs to pick up pace in a sustainable way.[2]

In this aim, the first order of business is to understand why Mexico is behind other nations in building a deeper, more accessible banking system. If we turn to recent history, higher levels of financial deepening have been attained but not sustained. In fact, the total domestic

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[1] International indicators of bank penetration and financial inclusion are available in: World Development Indicators (2013), The World Bank; Financial Access Survey (2013), International Monetary Fund; and Demirgüç-Kunt, A. and L. Klapper (2012), "Measuring Financial Inclusion: The Global Findex Database", *World Bank Policy Research Paper* 6025.

[2] For a review of the literature regarding the effect of financial development on long-term economic growth, see Levine, R. (2004), "Finance and growth: Theory and evidence", *NBER working paper* no. 10766.

financing to the private sector over GDP at the beginning of the 1970s and just before the crisis of 1995 reached new highs before swooning.[3]

Three key reasons help explain historical high volatility and average low levels of financing ratios. One was the accumulation of macroeconomic imbalances fueling excessive inflation, which created uncertainty and distortions, rendering lending activities more costly. The widening fiscal deficit of the 1970s and 1980s and financial repression resulted in the diversion of resources to the government. Also, the nationalization of the banks which occurred in this context carried with it a drastic loss of skills and expertise in making loans.

Later, in the mid-1990s, macroeconomic imbalances presented themselves again under a different guise. High short-term dollar-linked government debt and an unsustainable currency peg contributed to the emergence of a severe crisis. Debtors found it difficult to make suddenly rising repayments on variable-rate loans in the face of surging inflation.

A second factor stems from the financial liberalization that took place in the late 1980s without adequate bank regulation and oversight. This circumstance, together with the re-privatization of banks in the early 1990s, led to a huge expansion in low-quality loans to the private sector. Existing poor accounting and provisioning standards, as well as insufficient capital, inevitably fed a subsequent credit bust.

A third factor then became evident in the form of weak contract enforcement, particularly noticeable in widespread abandonment of credit obligations and difficulties in the repossession of collateral assets. The system reached an almost total impasse, with the banks in desperate need of capital, but inadequate laws in place in an environment of extreme uncertainty making it hard to draw any new funding. The recapitalization process took a painstakingly long time, requiring at the end the elimination of remaining restrictions on foreign direct investment in the banking system.[4]

Significant policy changes in the wake of the 1995 crisis suggest that recent bank lending growth to the private sector may be on a more sustainable path than in the past. Mexico's fiscal position has been strengthened and monetary policy under a flexible exchange-rate regime has been successful in putting a lid on inflation, which has remained relatively low during the last decade.

Furthermore, banking regulation and supervision have improved considerably, including the strengthening of accounting, portfolio rating, reserves and capital requirements. As a result, throughout recent years, the banking system has maintained high solvency and liquidity indicators. These improvements, along with better business models in the sector, explain why Mexico's banking system was remarkably resilient during the global financial crisis.

Although some progress has been made in making it less costly for banks to defend their legal rights and implement collection efforts, adding to certainty in the sector, there is still a long way to go. In particular, in cases of nonpayment, the judicial, sentencing and enforcement processes remain time consuming and arduous. The significant risk of nonpayment, in turn, contributes to higher interest rates for debtors.[5]

All in all, in order to keep loan growth on a sustainable path, the name of the game is prudence on the part of the banks, which need to eschew the excessive risk-taking that

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[3] Data for the whole period is available for domestic financing to the private sector, in which the banks play a predominant role in Mexico; see World Development Indicators, The World Bank (2013).

[4] For empirical evidence of the dependence of financial deepening on property rights, see La Porta, R. F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny (1998), "Law and Finance", *Journal of Political Economy*, 106(6).

[5] For indicators of contract enforcement see World Bank (2013), *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises*. Washington, DC, World Bank Group.

inevitably leads to crisis, as global economic experience dramatically confirms. Only consistent momentum in credit growth can lead to strong net benefits for the economy.

The recent financial reform

The recently approved, multi-layered financial reform contains measures that may strengthen the banks' institutional framework, allowing for more robust and sustainable credit expansion, among other benefits. Three sets of measures that stand out seek more effective property-rights protection for creditors, more formal regulation and the promotion of competition among financial intermediaries.

On the subject of creditors' property rights, the reform makes significant progress towards correcting problems observed in the application of the bankruptcy law approved in 2000. Specifically, the new legislation closes loopholes which debtors had been using to prolong the debt resolution process in areas such as intercompany liabilities, director and manager responsibility, while it makes bridge lending in cases of liquidity crunches more feasible.

The reform reduces obstacles to expediency in the judicial process to recover collateral, illustrated by the possibility for debtors to choose the court level and select assets to be seized. An important innovation is the founding of specialized commercial-law courts at the federal level.

In the field of regulation, the reform provides rules for the authorities to manage the resolution or liquidation of banks in cases of liquidity squeezes and insolvency. The specifics cover lending of last resort with equity shares as collateral, bank contingency plans for adverse scenarios, and ring-fencing actions, for example, in the case of majority shareholder problems. An expedient bank judicial liquidation process and a legal framework for transfer of assets and liabilities are established.

The capital requirements to comply with Basel III guidelines are now mandatory under Mexican law. The procedures for applying liquidity requirements are also determined.

With respect to competition in the sector, a new law facilitates mortgage substitution by debtors, allowing them to choose banks offering more favorable terms. Other measures that work in the same direction include greater facility for the mobility of deposits and consumer loans, meaning that customers can transfer their accounts and loans to other banks with less red tape and shorter delays. Importantly, bundled sales of financial products and services are prohibited.

These measures will potentially foster a more competitive, consumer-friendly and healthy banking system. Along with other reforms, they may contribute to higher potential economic growth. However, as is true with the overall current reform agenda, the effectiveness of these measures will depend heavily on the quality of pending legislation needed to put the changes in place, and adequate implementation.

The current economic cycle

After a full year of slowing, economic growth began a rebound in the 2013 third quarter. Expansion continued in the fourth quarter, although at a much slower pace. The upturn has been supported by a pick-up in external demand, particularly from the United States, and the normalization of public expenditures, factors which had contributed to the previous deceleration amid weaker global economic growth.

Despite the change in trend, the recovery is still weak as most economic drivers have recently lost steam. The industrial sector was flat at the end of last year, with manufacturing contracting and construction output continuing to decrease. Construction, hit by the insolvency of major developers, has been a drag on the medium-term performance of this sector.

Consumption appears to have continued expanding in the fourth quarter, although probably at a lower rate, amid relatively more dynamic retail sales but a significant deceleration in services. Perhaps most worrisome is a deterioration in consumer confidence, which has posted a drop this year of a magnitude not seen since the global financial crisis.

On the positive side, formal job creation has remained stable, with an unemployment rate that has been stagnant but at its minimum since 2009. In addition, total investment showed an increase last November, mainly as a result of a surprising bump in construction, the continuation of which could be challenging.

Notwithstanding recent signs of weakness, consensus analysts' estimates have remained relatively stable, positing successively higher growth rates in 2014 and 2015. This outlook is consistent with that for the global economy. In particular, growth for Mexico's key trading partner, the United States, is expected to continue gathering momentum.[6]

However, in the short run, downside risks to economic expansion apparently prevail. Potential adverse effects could come from further declines in consumer confidence, the time needed to restructure the real estate market, and tighter external financial conditions.

Even in the face of these short-term headwinds, in the long run, upside risks may predominate due to the potential effects of structural reforms. If well implemented, the reforms, encompassing not only the financial sector but also the labor market, education, telecommunications, the previously closed energy sector, and competition in the economy as a whole, could go a long way toward attacking the most insidious problem behind the unsatisfactory long-term performance of the Mexican economy, stagnant productivity.

Inflation developments

In December 2013, annual inflation started to pick up, this year surpassing the upper limit of the Bank of Mexico's variability interval around its 3 percent permanent target. Fueling the upsurge were rises in public-sector prices and tax hikes approved for the current year.

These factors should by nature exert only temporary pressure on general price increases. Annual inflation in the first half of February declined, although still above 4 percent, which could lend support to the expectation that these price pressures will fade.

Nevertheless, the balance of risks for inflation has deteriorated. Some developments that should be monitored include: a recent upward revision in analysts' short-term inflation forecasts, the possibility that inflation could exceed 4 percent several months this year, and potential second-round effects, which cannot be ruled out.

Furthermore, additional financial volatility resulting from uncertainty on the pace of monetary unwinding in advanced countries, as well as spillover effects from heightened risks in some emerging markets, could put pressure on the exchange rate, with some pass-through on inflation. These considerations take on added significance given that analysts' inflation expectations for all terms remain above target.

The Bank of Mexico expects inflation to renew its convergence towards the 3 percent permanent target by the beginning of next year. In any case, the Governing Board has stated repeatedly that it will remain vigilant in order to identify any factors that may put convergence at risk, and act appropriately.

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[6] Consensus forecasts for Mexico GDP growth are 3.4 and 4.0 percent for 2014 and 2015, respectively. See Consensus Economics (2014), *Latin American Consensus Forecasts*, February.

Concluding remarks

Allow me to say by way of conclusion that lags in the development of the Mexican banking system are a clarion call for much deeper and more inclusive intermediation. The recent financial reform is one step toward a stronger institutional framework for the banks. Further measures in the mold of those recently approved, especially measures that foster the effectiveness of the judicial processes and law enforcement, would improve the foundation for sustainable credit growth.

Prudence is a sine qua non for such an expansion, meaning that it would likely take some years for financing ratios in Mexico to reach international levels. Credit growth, along with benefits from other structural reforms, would allow Mexico to enjoy a higher rate of economic momentum, and eventually, a long-sought, much-desired higher standard of living.