Mexico Offers Banking Opportunities

“The recovery under way in the U.S. banking sector should enhance U.S. banks' ability to pursue the expansion opportunities unfolding in Mexico.”

Financial and economic reforms recently adopted in Mexico have enhanced the evolution of a strong and efficient financial services sector. The successful negotiation of the North American Free Trade Agreement (NAFTA) is the latest step in a series of policy actions designed to replace government intervention with market incentives as the controlling force in the Mexican economy.

These developments, together with favorable prospects (as of late 1992) for the ratification of NAFTA, provide unique opportunities for U.S. banking organizations to participate in Mexico’s increasingly vibrant financial market. In some important respects, the financial structure currently developing in Mexico provides a less restrictive banking environment than exists in the United States.

Mexican Bank Privatization

Mexican banks were auctioned to private investors from mid-1991 through July of this year. This move reversed the nationalization that occurred in 1982 and was part of a broader economic and structural reform package. These reforms came in response to difficulties precipitated by a combination of excessive government spending and falling oil prices. Mexico’s reforms emphasized fiscal and monetary discipline, privatization, deregulation and international trade. By the time Mexico’s banks were scheduled for auction, its economy already had responded favorably to these market-based reforms.

Mexico’s strong economic performance in recent years is largely attributable to the success of its reform efforts. That success also contributed to the generous prices investors were willing to pay for the privatized Mexican banks. Chart 1 shows the book value and selling price for each of the 18 Mexican banks auctioned under the privatization program. Each of the banks sold for more than two times book value, which was more than analysts had expected. This pattern of high auction premiums is consistent with a bullish outlook for Mexican banks.

In addition to prospects for continued economic strength in Mexico, key aspects of the financial structure adopted under the privatization program also enhanced the value of Mexican banks. The common ownership of commercial banks,

Chart 1
Auction Prices of Mexican Banks

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<th>Individual Mexican Banks</th>
<th>Millions of dollars</th>
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<tr>
<td></td>
<td>Premium</td>
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<td>Book Value</td>
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DATA SOURCE: Banco de Mexico.
securities firms and insurance companies was permitted, reflecting the commingling of these activities that existed prior to nationalization. Furthermore, Mexico’s financial structure includes large branch networks stretching throughout the country. (There were a total of 4,510 bank branches in Mexico as of September 1991.) Mexico’s financial structure creates synergies by offering a broad range of financial products through large retail networks. Under privatization, the largest Mexican bank was acquired by a mutual fund, while the second largest was purchased by an insurance company. Investors in these acquiring firms benefited from the opportunity to build the integrated financial services companies now permitted in Mexico.

**NAFTA and Financial Services**

While foreign banks have been able to enter the U.S. market, the Mexican banking market remained largely closed before the privatization program, which relaxed longstanding restrictions by allowing individual foreign banks to hold a 5-percent stake in a Mexican bank and capping aggregate foreign ownership at 30 percent. If ratified, NAFTA would be a further step toward free trade in financial services among the United States, Mexico and Canada.

A major component of NAFTA relating to financial services involves the *right of establishment*. U.S. banking organizations would be permitted to enter Mexico only through the establishment of foreign subsidiaries, referred to as “foreign financial affiliates,” not by establishing a branch of a U.S. bank. These foreign financial affiliates could be established either as a particular type of financial services provider, such as a commercial bank, or as a financial services holding company with common control of commercial banks, securities firms, insurance companies, and other types of financial services providers.

A second major component of NAFTA pertains to *national treatment*. NAFTA would permit the subsidiaries of U.S. banking organizations to operate in Mexico under the same rules that apply to Mexican financial services providers. This provision would enable U.S. banking organizations entering Mexico to compete on the same terms as Mexican banks. For example, banks established in Mexico by U.S. banking organizations would have the same freedom as Mexican banks to open branches across the country.

While NAFTA generally calls for free trade in financial services, it does include restrictions. Most of these restrictions relate to a transition period, which would occur from the time the agreement became effective until six years thereafter or January 1, 2000, whichever comes first. During the transition period, the capital of a bank established in Mexico by a U.S. or Canadian firm could not exceed 1.5 percent of the aggregate capital of commercial banks in Mexico. Moreover, in the first year, the aggregate capital of banks established in Mexico by U.S. and Canadian financial services providers could not exceed 8 percent of the total capital of commercial banks in Mexico. That limit would increase to 15 percent by the end of the transition period. If the aggregate capital of foreign-owned banks reached 25 percent of the aggregate capital of all banks in Mexico during the four years following the transition period, then Mexico would have the right to freeze the capitalization of foreign-owned banks at the then-existing level for three years. Also, even after the transition period, NAFTA would place market-share restrictions on the ability of individual U.S. and Canadian financial services providers to acquire Mexican banks.

**Outlook for Banking in Mexico**

NAFTA offers an important opportunity for free trade in financial services because the outlook for the Mexican financial services sector is quite good. Chart 2 shows that Mexico’s real gross domestic product has grown fairly rapidly since 1985, reflecting substantial gains in economic size and strength.

While the Mexican economy recently has shown signs of slower growth, the long-term outlook for growth in Mexico remains strong. The ratio of Mexican domestic commercial bank claims to gross domestic product, which serves as a measure of the importance of banks in Mexico’s economy, also has grown, as shown in Chart 2. The large increase in the importance of Mexico’s banks that has occurred since 1988 is partly attributable to rising incomes and an associated increased demand for financial services. As income levels continue to grow in Mexico, banks and other financial services providers operating there should continue to increase in importance, particularly in the areas of retail banking and consumer credit.

In further support of a vigorous outlook for Mexico’s banks, Chart 3 shows the inflation-adjusted claims of Mexican commercial banks on the private and public sectors from 1978 through 1991. Total claims on the public sector declined from their 1987 level, while claims on the private sector increased sharply during the...
same period. The recent robust growth in the private-sector activity of Mexican banks reflects government efforts to privatize industries, a shift away from the focus on public-sector lending that accompanied the nationalization of the banking industry, and the renewed strength of the Mexican economy. And prospects are good for continued high growth in private-sector relationships with Mexico's banks as the Mexican economy continues on its long-term expansionary course.

Although the outlook for banking in Mexico is promising, economic impediments to trade in financial services will remain, even if NAFTA is ratified. The information that Mexican banks currently have from established, long-term relationships will initially give them a competitive advantage over most U.S. banks in assessing the credit quality of existing and potential Mexican borrowers. In addition, the extensive branch networks of Mexican banks, coupled with the joint provision of commercial banking, brokerage and insurance services, will pose some hurdles that entering U.S. banking organizations would have to address to attract a broad base of retail customers.

One way U.S. banks could establish a toehold in the Mexican market would be to link their activities with those of U.S. nonfinancial firms operating in Mexico. The growing level of U.S. direct investment in Mexico and the prospects for further growth under NAFTA would provide an opportunity for U.S. banks to enter Mexico primarily to serve U.S. corporate clients. Because of their knowledge of U.S. firms, U.S. banks would likely have an information advantage over their Mexican counterparts when providing financial services to facilitate U.S. direct investment in Mexico.

Joint ventures with Mexican banks offer another avenue for U.S. participation in the Mexican financial services market. Under a joint venture, Mexican banks could build on U.S. technology to help meet the continuing expansion in the Mexican demand for retail banking and consumer credit services. The gradual exposure to the Mexican market that would be afforded to U.S. banking organizations by activities related to U.S. direct investment and joint ventures could help open the door to more in-depth involvement in the Mexican market.

U.S. Banking Conditions

The financial strength of U.S. banking organizations ultimately will influence their ability to use NAFTA or other avenues to compete in the Mexican financial services market. In this regard, the recovery under way in the U.S. banking sector should enhance U.S. banks' ability to pursue the expansion opportunities unfolding in Mexico.

Low interest rates, gradual improvement in commercial real estate markets, and reductions in troubled assets have helped boost U.S. bank profitability well above the depressed levels of the recent past. As shown in Chart 4, U.S. commercial banks recorded strong gains in profitability during the first three quarters of this year, both in the Eleventh District and elsewhere in the nation. District banks reported a return on assets of 1.08 percent for the first three quarters, while banks elsewhere in the nation earned 0.95 percent. For the third quarter alone, District banks earned a return on assets of 1.12 percent, compared with 0.70 percent in the same period last year. Similarly, banks in the rest of the nation generated a return on assets of 1.02 percent in the third quarter, compared with 0.50 percent last year.

In addition, rising capital levels have accompanied the increase in U.S. bank profitability. The banking sector's ratio of equity capital to assets has increased, both in the District and elsewhere in the nation, as shown in Chart 5. Similar trends have occurred in the risk-based capital ratios for the U.S. banking industry. These positive developments suggest that U.S. banking organizations should have the financial wherewithal to enter and com-
pete in the Mexican market.

On a less positive note, slow growth in domestic financial services opportunities also may prompt U.S. banks to increase their presence in the Mexican market. Inflation-adjusted loan volume at U.S. commercial banks has decreased in recent years, as shown in Chart 6. Growth in commercial and industrial lending, in particular, has been stagnant for an extended period. U.S. banks have been able to retain a portion of the profits from the lost lending business in the form of fees earned on loan origination and securitization. But their ability to meet the increasing competitive challenge in the financial services business continues to be strained in the U.S. market by legislative restrictions against geographic and product market diversification.

**Concluding Remarks**

A major distinction between the financial system adopted by Mexico and the current U.S. system is the relative freedom financial institutions possess in Mexico to provide a broad range of financial products and expand geographically. While restrictions on the geographic expansion of banks in the U.S. have eroded substantially over the past 10 years, significant legislative barriers remain. Many states have retained restrictions on the ability of banking organizations headquartered in other states to acquire or establish banks within their borders. And, with very few exceptions, U.S. banks are prohibited from branching across state lines. Similarly, while U.S. banking organizations now can engage in a broad range of securities activities, certain major types of securities activities can be pursued only in separate subsidiaries and only to a very limited extent. Also, U.S. banking organizations largely have been prohibited from realizing the potential synergies associated with the joint provision of bank and insurance products.

These restrictions provide a stark contrast with the more liberal product and geographic powers available to financial institutions under the privatization model adopted by Mexico. The subsidiaries of U.S. banking organizations established under NAFTA would, in some respects, find a freer business environment in Mexico than currently exists in their home country.

—Jeffery W. Gunther
Robert R. Moore