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A REVOLUTION IN CONSUMER BANKING

Developments in Consumer Banking in Latin America

Teresita P. Obermann, Senior Foreign Banking Analyst, Federal Reserve Bank of Atlanta. August 2006

This overview was compiled from publicly available information and does not express the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

INTRODUCTION

This paper explores the recent surge of interest from both domestic and foreign banks in Latin America's long-ignored consumer sector.[1] In the past few years, banks in the region have shifted much of their attention to diversifying products for the consumer market and adapting lending strategies to the retail segment, supported by improved economic stability, controlled inflation, lower interest rates, and the gradual modernization of the financial structure in some countries. Nonetheless, Latin America still has the lowest retail-banking penetration in the world, as measured by private sector credit to GDP because despite significant variations in the banking sectors in the region, some similar factors continue to hinder the full participation in the banking system of large portions of the population.

The paper first ***identifies historical conditions that have hindered the development of a banking environment*** inclusive for people of all income levels. Factors such as unequal income distribution, weak contract and property rights, lack of laws to record and disclose property ownership, lack of regulations to protect consumers and lenders, the absence of standardized credit history information, and unreliable judicial systems to enforce creditors' and borrowers' rights. Next, the paper ***discusses the changing environment in the region and highlights some of the new products and services*** recently introduced by financial institutions, governments, and private non-bank entities in their efforts to deepen banking penetration. As a rule, the first entities to tap the sub-prime market in the region have been the credit card divisions of foreign banks,
non-bank private entities, and large local department stores, which have offered credit cards with low credit limits and high interest rates and fees for several years to satisfy the credit demand of the large underbanked population. Not until recently have local financial institutions in the region begun to develop innovative consumer marketing and pricing strategies to offer credit cards, conventional mortgages, car loans, and other banking services to consumers in the lower income segments in their efforts to participate in this untapped source of new profits and expand market share.

Lastly, the paper ***addresses the gradual development of laws and supervisory strategies and consumer regulations*** in the past few years to facilitate and accommodate the growth of consumer products and marketing campaigns.

The paper ***concludes that although progress has been slow and uneven in the region, the recent trend towards greater financial penetration in Latin America is positive*** and the momentum remains strong and irreversible as the banking sector recognizes the potential for profits and governments understand the economic benefits embedded in making credit accessible to all income levels of the population.

RETAIL BANKING: A HISTORICAL PESPECTIVE

Driven by increased competition and developing demand for consumer banking services, banks in Latin America, in search of future income and higher market share, are finding innovative ways to increase their penetration into the low- and middle-income sectors by providing retail products and services specially designed for these groups.

While in the mid-1990s, financial institutions in the U.S. recognized the potential earnings in providing financial services to the lower income and sub-prime sectors and reached these groups through offering credit cards, car loans, debit cards, and other forms of consumer credit, financial penetration in Latin America remained slow and uneven, hindered by high inflation rates, high interest rates, and frequent financial crises. Even today, despite financial institutions' concerted efforts to develop new retail products and find ways to reach new sectors, access to basic banking products, such as checking accounts, debit cards, and consumer loans is out of reach for a large percentage of the population in the region as income inequality and weak, although improving, legal and regulatory frameworks keep Latin America's private sector credit to consumers at 30 percent of GDP, compared with 73 percent in the Asia-Pacific area and 34 percent in Central Europe.[2] If the income gap in the region was not already a formidable hurdle for financial penetration, some of the key factors that make financial systems function efficiently in the developed world are either missing or inefficient in Latin America, including equitable property rights to facilitate secured transactions, access

[1] The paper focuses mainly on the developments in Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Perú, and Venezuela.

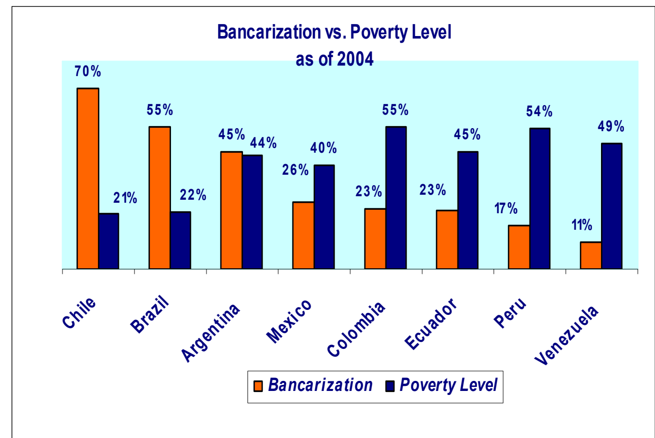
[2] "Banks in Latin America: Why so little credit allocated to the private sector?" Economic Research – BNP Paribas. August 2005.

to efficient and affordable property registries, dependable credit history bureaus, and reliable enforcement of creditor and consumer laws. Nonetheless, most of the major governments in the region seem aware of these deficiencies and are taking steps in the right direction to either institute reforms or strengthen the existing framework.

Per capita and banking penetration. Uneven income distribution is one of the main culprits of the region's low financial penetration, which translates into modest and in some cases non-existent economic growth creating a vicious cycle.[3] Although the economic performance and prospects of most major economies in Latin America have arguably improved in the past few years, high rates of unemployment, informal employment, and a certain degree of economic and political instability continue to contribute to low average per capita income and a high percentage of the population living below poverty levels, which in turn results in less disposable income and low savings capacity. *(Refer to Exhibit I).*

A comprehensive report on access to credit in Latin America issued by the Inter-American Development Bank in 2004 concludes that "economic growth in Latin America has been so slow in the past decades that it would require about a century for the region to attain the current income levels of developed nations".[4]

As reflected on the following chart, the level of *bancarization* or financial penetration (defined as private credit/GDP) varies widely from country to country, and while there may be specific reasons for the pace of bancarization in each country, generally, it appears to have an indirect correlation with the country's poverty level: the higher the percentage of the population living below the poverty level (less than $2 a day), the lower the country's banking penetration.[5]



Sources: EIU Country Risk Reports – 2005 and CIA Fact Book 2005

Chile reports the highest penetration in the group and the lowest percentage of its population living below the poverty level followed by **Brazil**, where the majority of households have checking accounts because most payrolls in the formal economy are disbursed electronically. Nonetheless, access to consumer credit in Brazil is mostly limited to the middle and upper class, and even foreign banks target primarily customers within the socio-economic status "A" (SES A are those with an annual income of at least $20,000). Historically, the lower-middle and working classes resort to the practice of paying for goods with post-dated checks and obtain credit through small credit unions ("cooperativas") and government development banks, which offer deposit and lending services, particularly in the rural areas. However, since 2003, a law was enacted permitting the issuance of payroll loans to federal public servants, private-sector employees, and retirees. More about these loans is explained later in this paper.

In **Argentina**, private credit collapsed from 23 percent of GDP in 2000 to 11 percent in 2004, following the financial crisis in that country. Currently, the uncertain economic and regulatory environment continues to constrain the supply and demand for loans despite the return of liquidity in the banking system.

In **Mexico**, the formal banking sector has historically targeted only the top 15 percent of the population, while the other 85 percent is considered too risky and unprofitable. This unbanked segment of the population is serviced by niche players, although since 2004, more foreign banks in the sector have begun to pay closer attention to the retail credit card business and other remittance-linked products. Only 25 percent of households in Mexico City have bank accounts compared with 91 percent in the U.S. Bank credit in Mexico has been growing in excess of 25

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[3] Poverty and inequality, although relevant to the topic of consumer credit, is not fully discussed in this paper other than to point out the correlation between per capita and banking penetration.

[4] "The Business of Growth". Economic and Social Progress in Latin America 2001 Report. Inter-American Development Bank.

[5] For the purpose of this paper, private credit refers to credit issued by commercial and universal banks and does not include credit issued by nonbank financial institutions such as credit unions or cooperatives.

percent annually for the past two years, mostly led by mortgages. However, consumer and small-business lending represents only 11 percent of GDP, according to Mexico's central bank.

In **Colombia,** where 55 percent of the population lives under poverty level, access to bank credit is low at 23 percent, and only 41 percent of households in Bogotá reported having a bank account in 2004. Despite the fact that consumer products are well developed in Colombia, most consumer products target the middle- and upper-income classes, while the low income individuals continue to make purchases in cash and have access to small loans only through cooperativas.

In **Ecuador**, consumer banking is the focus of the top-tier banks' marketing and growth strategy that see consumer lending as an untapped market with growth potential. However, consumer lending is still in the development stages and not very advanced in terms of banks' experience or consumer culture. The principal consumer products offered include mortgages of up to 10 years, auto loans, and credit cards, which are offered only on a secured basis.

In **Perú** where 54 percent of the population lives below the poverty levels, only 17 percent of lending activity comes from the banking sector, while 50 percent is conducted by unregulated lenders and another 31 percent by formal nonbank financial institutions.

In **Venezuela**, in addition to a large percentage of the population living below poverty levels, credit demand has declined in recent years due to a rise in poverty levels, unemployment, and recurrent capital flight resulting from political and economic uncertainty.

Property rights & registries. A critical aspect of creditor rights has to do with the right to repossess collateral. Even in the case of consumer lending, the role of property rights and registries is significant because the infrastructure for perfecting a security interest enhances the credit transaction by allowing assets to become valuable collateral for the borrower and by protecting the creditor's position in case of default. Moreover, studies have shown that there is a positive correlation between the growth in private sector credit and investments and the degree of creditor protection because well defined property rights and efficient property registries reduce borrowing costs.

However, property rights are not widely defined and protected by law in Latin America and offer little protection to creditors in the event of default. The absence of an efficient legal framework for the registration of property is a serious problem because borrowers cannot efficiently register their assets, thus reducing their use as collateral. Inefficiencies in the recording of deeds are an especially serious problem in large cities in Latin America, where most housing has been built in informal settlements, and also for farmers who could perhaps pledge lesser value assets such as livestock or used equipment to access small amounts of credit. Moreover, access to property information in the registries in Latin America, when they exist, require cumbersome manual searches given the lack of linkages between registries of different types of assets or different locations, making it time consuming and costly to perfect a security interest. Modern property registries allow for searches of an asset to be used as collateral, either by the borrower's or the lender's name, the pledge date, the asset serial number, or other standardized criteria.

Merchants in some countries, like **Brazil**, have found innovative ways to extend credit to those without credit cards or credit history by retaining title to large-ticket goods, such as cars and jewelry, as collateral.

Collateral recovery. Even where property rights have been defined, the complementary legal framework is either weak or lacking, hindering the enforcement of security interest to support financial transactions in cases of default. In most instances, the recovery costs can absorb up to a quarter of the debt and court proceedings may take from one to five years to conclude, therefore becoming another discouraging factor for lenders even when a title is available to facilitate the legalization of collateral. *(see chart on page 4)*.

Availability of credit information. Financial institutions want to have assurance that the borrower is solvent and willing to repay his loans. Consequently, the more information banks can access on potential borrowers' creditworthiness and payment track record, the more willing they would be to extend credit. Credit bureaus are especially important because they reduce the time and cost associated with loan processing, and strengthen credit quality by allowing lenders to evaluate credit risk and in its more developed form, promote the use of credit scoring models. Supported by comprehensive consumer payment histories, creditors can apply statistical scoring models to estimate an individual's repayment

TIME AND COSTS OF RECOVERY OF MORTGAGE GUARANTEES	
Argentina	**Argentina** is an especially interesting case because it is a federal country where the procedures and effectiveness of the judicial system vary from one jurisdiction to another. According to provincial laws, the costs for foreclosing a $200,000 mortgage can range from 7.7 percent in Buenos Aires to 13.2 percent in Cordoba. However, information from court cases shows that the actual costs of recovery could reach 33 percent of the claim amount, and the process takes an average of 18.4 months in some of the slowest jurisdictions compared with a cost of 25 percent and duration of 9.8 months in the best-performing jurisdictions. Typically, in provinces where the judicial system performs worst, the loans families receive as a proportion of their incomes are one-third of what they are in jurisdictions with the best court systems. Recent government intervention has arbitrarily blocked mortgage foreclosures for periods of 120 to 180 days, further increasing concerns about the enforcement of creditors' rights in the country.
Chile	In **Chile**, the costs of recovering guarantees are moderate. Various companies in the business have estimated costs at between 7 and 13 percent of the total sum of the debt, with recovery periods ranging from 12 to 18 months. However, these periods depend on the diligence of the judges, whether the parties are engaged in parallel negotiations outside the courtroom, and whether the debtor decides to appeal rulings issued by the court. Hence, even when average costs are low, these processes are shrouded in a great deal of uncertainty.
Colombia	Recovery processes are also slow and expensive in **Colombia**. On the basis of information from three mortgage banks, the process typically takes 32, 46, or 58 months. Studies estimate that for a loan of 15 million pesos (about US$5,530) secured by a property appraised at 30 million pesos, the costs of recovery would be around 3.7 million pesos, which represents a quarter of the value of the loan. In 2002, a law was approved seeking to reduce the recovery process to around 1 year and make it notably less expensive. However, the law did not produce the desired effect and a similar reform is scheduled to receive Congressional approval in late 2006.
Perú	In **Peru**, the direct costs of recovering a guarantee are relatively low. According to a survey of litigation lawyers, court costs range between $422 and $607, depending on whether the liquidation of the property takes place at the first auction and whether the decisions on the appraisal and allocation of the property in the auction are appealed. However, total costs are much greater because debtors make numerous appeals in order to stretch out the process. The average duration of the process of recovering a guarantee is 31 months. If there are no appeals, the process can be reduced to 18 months; otherwise, it runs more than 36 months. These periods do not include additional court cases for compensation.
Source: The Inter-American Development Bank. November 2004.	

risk with remarkable accuracy, potentially improving the efficiency of credit markets and bringing lower prices, as well as more equitable treatment, and more credit products to millions of households who would have been turned down as too risky. Credit registries provide an incentive for borrowers to repay their debt and maintain good credit history for future transactions.

Not surprisingly, credit reporting has a disproportionate effect on improving access to credit for the lower-income segments of the population. For example in the U.S., the lowest income segment or sub-prime segment, has seen a 70 percent increase in their access to credit in the past 30 years as a result of the introduction of sophisticated risk modeling techniques that rely on standard databases contained in the national credit reporting systems.

In Latin America, weak property rights, inefficient property registries, and lengthy recovery processes have made collateral less reliable, while increasing the importance of credit history as a factor in the selection of potential borrowers. Accordingly, most countries in Latin America have public credit registries (PCR) or private credit bureaus, and in some cases, both. PCRs are generally administered by the central bank or the banking superintendency and offer information on the identity of the borrower and on past due, defaulted, or non-accrual loans ("negative information"). However, information on the borrower's overall credit exposure, unused lines of credit, and positive payment history is not always available.

Private credit bureaus in all the major countries in the region are generally owned, partially or fully, by foreign entities, although Brazilian-owned SERASA is the largest private credit registry in Latin America supported by multiple agreements with similar entities around the world. Generally, the quality of services of private bureaus is better than that of the PCRs.[6]

Brazil's PCR, *Cadastro Positivo*, was established in 1998 by the central bank, but focuses only on credit information of large commercial loans. To reduce check fraud, the *Sociedade de Proteção ao Crédito* (SPC) keeps an up-to-date database of individuals whose checks have bounced twice. This information is shared with banks, credit institutions, and companies that accept post-dated checks.

In **Chile**, the Superintendency of Banks maintains the public registry that collects credit information from all financial institutions, while the Santiago Chamber of Commerce operates one of the oldest

[6] Experian, Equifax, TransUnion, and Fair Isaac have already entered the markets in Brazil, Argentina, Chile, El Salvador, Perú, and Uruguay. These entities agree that privacy laws that prohibit the gathering of positive credit information create a challenge for them to expand their services to consumers.

retail credit databases in the region and in many ways is considered superior to the information administered by the Superintendency. DICOM, S.A., a private credit bureau partly owned by Equifax, provides a broad and updated nationwide credit database that can be accessed by all issuers of credit in the country. However, DICOM's information does not aggregate all outstanding credit for individuals (positive information), which creates a potentially risky situation in view of the recent aggressive lending from local retail stores to consumers.

In **Colombia** there is no public credit registry; however, there are three private credit bureaus: DataCrédito (owned by Computec, S.A.), Cifin (administered by the banking association), and Covinoc, S.A. All three bureaus report positive and negative information. Initially, the operations of these entities were regulated under the country's Financial Reform Law, but since 1999, their regulation has been transferred to the Constitutional Courts, which review and rule on consumer complaints. Ongoing consumer education on the benefits provided by credit bureaus is evident by the frequency of articles on the subject published in the local newspapers.

In **Ecuador**, a PCR exists for commercial clients only, which is a major challenge for the further development of consumer lending. A private credit bureau opened in 2004, but was strongly rejected by the public under allegations that it violated their privacy and that personal information could be disseminated indiscriminately. As a result, the Superintendency of Banks established clear guidelines to ensure that credit reporting is only handled by institutions approved by the regulatory agency. The guidelines include specific procedures for data collection, ratings, delivery and use of the information, responsibility for erroneous information, grievance resolution, and applicable penalties for non-compliance. However, even after the public is educated on the critical role of credit bureaus, it will take some time for the credit bureaus to collect the credit history necessary to develop reliable individual credit reports.

Following the financial crisis of 1995, **Mexico** introduced several structural changes, which included the creation of private credit bureaus, stricter financial discipline, extensive consumer education, and a robust supervisory and regulatory regime. However, historically low interest rates have created a boom in credit card lending when there is still a lag in the collection of credit history for many new borrowers and the infrastructure for consumer credit scoring is still weak. Analysts are generally confident that the problem exists only in the short term while adjustments are made to the country's consumer credit reporting and to the credit scoring models, and in the long-run, more consumers will benefit from increasing access to bank lending and the use of bank services.

In October 2005, the International Finance Corporation (IFC), private sector arm of the World Bank, and Visa International introduced a program to support the development of private credit bureaus in more than 30 countries through feasibility studies, legal and regulatory advice, research, public awareness projects, and long-term coaching and support. Further, Visa International indicated that it will provide technical support where needed, which may include sharing expertise on credit risk management and disseminating best practices to banks.

A study commissioned by TransUnion to the Information Policy Institute concluded that full-file reporting (reporting of positive and negative credit information), widespread participation of data sharing within the financial community, and private ownership of credit bureaus, are key elements for economic growth and the modernization of financial sectors. The study compared the consumer lending system of 65 countries, some with private, full-file systems and high participation rates and others with lower participation and limited reporting. It noted that in countries where these key elements are present consumer lending has increased to 45 percent of GDP, with fewer loans to high-risk borrowers and more loans to low-risk consumers with thinner credit histories, including women and young borrowers.[7]

In conclusion, access to standard credit information increases transparency and allows for more affordable interest rates and related fees because the complexity and increasing sophistication of modern credit markets combined with the increasing trend to reach the unbanked sector, make it impossible for lenders to evaluate individual borrowers based solely on personal knowledge.[8]

THE REGION'S CHANGING ENVIRONMENT

Despite the hurdles to the expansion of retail credit in the region, banks are finding innovative ways to reach

[7] "The Benefits of Full-File Credit Reporting in Latin America." The Information Policy Institute. May 2006.

[8] "Congress Faces Critical Decision about Consumer Credit Legislation." Forum on Emerging Issues. Business Economics. July 2003.

the lower- to middle-income sectors in search of future income and market share.

Narrowing interest margins as a result of low average interest rates, intense competition from foreign banks and non-bank entities, and the migration of corporate borrowers to capital markets, are just some of the key factors driving financial entities' new interest in the traditionally underserved segments of the population. No less significant is the social pressure on governments in the region to reduce the currently unacceptable levels of poverty by, among other recommendations, the inclusion of all citizens in the formal economy. Finally, new technologies and access to credit scoring models are making it easier for banks in Latin America to create products and services for the underserved segments at lower costs and risks.

Credit scoring models provide an objective, analytical method of assessing credit risk. Lenders in countries where credit-scoring methods have been developed, use it to allocate credit and manage risk on an on-going basis. Mostly introduced by foreign banks' credit departments and foreign credit bureaus, such as Experian and Equifax, the credit-scoring concept in Latin America is in its infancy.[9]

Banks have also shown an interest in devising innovative ways to make basic personal banking accessible to the lower-income sector. Personal banking commonly includes checking accounts, savings accounts, residential mortgages, personal loans, auto loans, credit cards, and services such as electronic banking, custodial arrangements, and foreign exchange transactions. Traditionally, these banking products have been geared towards the middle and upper income clients in the region, and the challenge has been to modify them to suit individuals who depend on income that is minimal and/or informal, have no prior credit history or poor credit history, and in most cases do not own any fixed assets that could be pledged as collateral. Following are some of the products and services that are developing in the region at various degrees of success.

Mortgage lending. Mortgage lending is the oldest and most developed type of retail credit in the region. However, access to housing finance remains relatively underdeveloped, and no country exceeds 13 percent mortgage debt as a percentage of GDP, except for **Chile**, where it is about 16 percent. Penetration into the lower-income sectors is even thinner, stalled by income inequality, deficient property rights that do not allow the poor to register self-built homes, weak legal infrastructures to support creditors' rights, and the lack of information on individuals operating in the informal economy. Financial liberalization and the stabilization of inflation and exchange rates have brought significant changes to the region's housing finance systems. For example, mortgage financing in dollars was developed in **Argentina** and **Perú** to reduce interest rate risk. Moreover, mortgages denominated in indexed units linked to the general price index or workers' salaries in **Brazil, Chile, Colombia, and Mexico**, have helped reduce the risk of default.

In **Argentina**, mortgage lending as a percentage of GDP grew from less than 2 percent in 1991 to 6 percent in 2000, with banks, mostly foreign-owned, supplying 70 percent of all mortgage loans. Unfortunately, the crisis that followed brought Argentina's success story to a halt and by December 2005, mortgage lending had dropped to 1.7 percent of GDP. Chances of a rebound in the sector are currently hampered by the inability of the lower and middle classes to afford the cost of housing, as wage adjustments have lagged behind housing cost.[10] Additionally, government interference has further discouraged creditors by blocking mortgage foreclosures for periods ranging from 4 to 6 months at a time.[11]

In **Brazil**, mortgage lending took off in 2002 after 20 years of virtually no growth and despite high average interest rates. The boom was ignited by the central bank's gradual reduction of deposit requirements in other sectors of the economy while pressuring banks to increase their participation in home financing. Accordingly, mortgage lending rose by 60 percent to $2.1 billion in 2005 supported by improved price and employment stability, and the establishment of a new mortgage guaranty, which facilitates loan recovery in case of default. To finance the mortgage guaranty and this new guaranty, the government has earmarked approximately $1 billion from the 2006 budget to finance and guarantee housing loans for low-income families, with some of

[9] In April 2005, Experian signed an agreement with Colombian credit bureau Central de Informacíon Financiera to develop and implement a new credit scoring system designed to improve lenders' control over credit risk.

[10] Speculative investors (foreign and upper class locals) acquired much of the real estate during the crisis and sparked a building boom bringing housing prices beyond the reach of the typical home mortgage borrower.

[11] Financial System Review. FRB-NY. December 2005.

the funds coming from a workers' severance pay fund called FAT.[12] The government has also reduced taxes on building material to encourage the house construction business.

In **Chile**, residential mortgage loans represent the strongest credit relationship with middle and upper income customers. Residential mortgage loans are denominated in Unidades de Fomento (inflation indexed units), bear interest at a fixed rate, and have maturities between five and 30 years, with a weighted average life of approximately 19 years. A significant proportion of residential mortgage loans are funded through the issue of UF-denominated Mortgage Finance Bonds, which enable banks and consumers to limit their exposure to interest rate fluctuations and inflation. In the past year, Chilean banks have made financing opportunities for the lower-middle segment of the population more available as banks see their penetration into the sector threatened by the more creative efforts of local non-bank entities such as commercial department stores and insurance companies.

In **Colombia**, private mortgage lending reported a strong come back in 2005 after remaining stagnant since 1999, when past due mortgages ballooned as a result of the local recession, high unemployment, and a structural problem with adjustable rates that resulted in negative amortization. In late 1999, a new law changed the adjustable mortgage rate index known as UPAC (a formula tied to the 90-day deposit rate index plus an inflation index) to a simpler UVR index tied only to inflation. However, not until recently have banks and consumers returned to the mortgage market encouraged by improved economic conditions and tax incentives to banks that cleaned up their past due mortgage portfolios. However, despite the renewed interest from banks, mortgage lending remains geared mainly towards the middle and high-income classes.

In **Mexico**, banks stopped issuing mortgages after the 1994 Tequila crisis while recovering from heavy credit losses. However, even before the crisis, mortgage lending in Mexico was mostly focused on residential mortgages for the middle and upper classes, the house financing for the low-income sector to specialized non-bank institutions, known as Sofoles. Recently, banks have returned to mortgage lending as historically low interest rates and a local construction boom have made this activity more profitable. Additionally, the government has encouraged the development of new public and private partnerships to increase homeownership among the low-income segment of the population. One of these partnerships pair banks with government owned mortgage institutions such as Infonavit and Sociedad Hipotecaria Federal to participate in low-income housing programs. Additionally, four private banks in Mexico have expressed an interest in buying Sofoles. The banks will benefit from the Sofoles' experience in the low-income sector and of cross-selling opportunities, while the acquired Sofoles will overcome one of their main challenges, the lack of low-cost funding.[13]

Another creative option that has been developed to boost homeownership is the rent-to-own program offered by mortgage company, Hipotecaria Su Casita. The product targets individuals with annual income of just under $18,000 who would otherwise be unable to obtain a mortgage loan because of the lack of a down payment. The efforts to increase access to homeownership in Mexico have resulted in a 53 percent increase in bank-issued mortgages to $9.3 billion as of September 2005.

In **Perú**, mortgage lending as a percentage of GDP rose from zero in the early 1990s to more than three percent in 2002 following the country's privatization of banks and the entry of foreign entities. Mortgage lending remains a driver for private credit demand thanks to better bank offerings and higher demand generated by the government's low-income housing Mivivienda program. The Mivivienda program is very important because through government subsidies, many lower and middle class families are purchasing new homes. Some banks are also offering an increasing amount of remittance products that apply the cash inflow from family members directly to the payment of a mortgage or a savings for the future purchase of a home.

Financial cards. The financial cards market includes credit, debit, electronic accounts, and e-purse cards. The credit card instrument is considered an important element of the changing consumer credit landscape because it provides a wide range of choices, from starter cards with minimum credit lines to gold cards for well-established consumers. Credit cards allow lenders to extend offerings to consumers with potentially riskier profiles and provide great flexibility and autonomy to customers over their purchasing and borrowing decisions.

Despite these qualities, credit card penetration in the region has not been uniform. For instance,

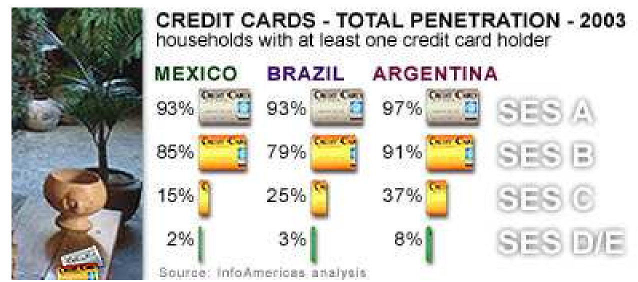
[12] "Brazil Lending Jumps in March on Lula's Mortgage Plan" Bloomberg.com. April 25, 2006.

[13] Inter-American Dialogue's Latin America Banking Advisor. January 2005.

Brazil's credit card business, the largest in Latin America and the seventh biggest in the world, has seen credit card transactions soar from 200 million in 1994 to 1.7 billion in 2005, reaching a 30 percent penetration. However, credit card use is mostly limited to the middle- and upper-income households, while over half of the population has access to debit cards. Also, ATM services in Brazil are very sophisticated, allowing customers to pay their utility bills at ATM stations.

Although banking penetration is high in **Chile** compared with most other countries in the region, there are still large sections of the population that do not have access to bank-issued credit cards. Local department stores and supermarkets recognized this gap and in the past three years have issued over 8 million credit cards compared with 4.6 million credit cards issued by banks, Visa, MasterCard, and Diners combined. Falabella, the largest department store in the country, has over 3 million users of its CMR credit card, which is accepted by several local merchants for purchases of products and services.[14] According to analysts, Falabella's is able to offer its credit cards to customers from all socioeconomic segments at low interest rates and easy payment plans because it has developed a good understanding of its customer base and has developed a risk management model that appropriately factors the risk. Studies show that individuals grouped in the ABC1 category (average monthly earnings of $3,500) have the most access to bank credit and therefore only 12 percent hold credit cards from retail stores. In contrast, in the C2 group (individuals with monthly salaries of $1,340 to $2,512), 24 percent has retail store credit cards and 68 percent in the C3 group (monthly salaries of $670 to $1,170).

In **Colombia**, the financial cards market includes credit, debit, and e-purse cards. Credit cards are issued by all major companies, such as MasterCard, Visa, and Diners, with Bancolombia holding the exclusive distribution of American Express in Colombia. However, credit card penetration is low with only 1.6 million cards circulating in a population of 44 million citizens. To promote the use of credit cards, congress approved a tax incentive that refunds two percent of the sales taxes on purchases made with personal debit or credit cards. Other positive developments include



**SES = Socio-Economic Status groups*

Chilean Falabella's plans to introduce its CMR credit card in the market.

Foreign-owned banks in **Mexico**, such as Citibank, Santander Serfin, and Scotiabank Inverlat, offer credit card users an increasingly sophisticated range of products and reward programs as competition heats up in the credit card market boosted by historical low interest rates, a growing economy, and the improved condition of the financial sector. Efforts to increase consumer lending has stepped up, with reports indicating that the number of telemarketers contracted by banks to push new credit cards has increased five-fold in the past two years, reaching consumers who would not have received such offers before. However, most "moving down market" campaigns focus on the middle class or small business sectors and not on the lower-income population. As a result, even though consumer lending has been growing by 40 percent annually over each of the past three years, Mexico is one of the countries with the lowest consumer bank credit to GDP ratio in the world at 2.8 percent.[15] Current figures released by the banking association reflect that only 31 percent of the employed population has access to a credit card, while 53 percent holds debit cards. These figures are expected to improve with the entrance of more than 10 non-bank lenders, which have requested authorization from the Mexican Finance Minister to begin issuing credit cards in the Mexican market.

In **Perú**, the number of credit cards administered by banks and other financial institutions surpassed 3.7 million as of September 2005. Nonetheless, credit card use in Perú is still under-represented in private consumption, and there is much room to increase their acceptance. While credit card use is growing, debit card usage is growing at a more rapid pace. For example, Visa has issued some 2.7 million debit cards in the country compared with 900,000 credit cards.

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[14] Falabella's CMR credit card is accepted by local supermarkets, drugstores, home improvement material suppliers, McDonald's, cell phone companies, Blockbuster, and cable TV services. Falabella is also present in Argentina and Perú, where it has a distributed 450,000 and over a million CMR cards, respectively.

[15] Mexico Financial System Overview. FRB-Dallas. January 2005.

Payroll loans. In **Brazil**, measures enacted by the Lula administration in 2003, allow consumers to repay certain bank loans through payroll deductions from private or public salaries, creating a new lending product known as *Cartão Consignação em Folha* or consignment loans. The law was extended in September 2004 to include deductions from social security beneficiaries. These loans, known as payroll loans, have attracted the attention of banks given the growth opportunities they present at a reduced risk. The bank establishes a line of credit for an individual in an amount not greater than 30 percent of the worker's disposable income, with monthly installment payments deducted directly from the borrower's paycheck or pension benefits, therefore creating a better collateralized, lower-cost loan available to all workers and retirees, without a significant deterioration in asset quality trends.[16]

Interest rates on these loans are roughly half the cost of more traditional personal loans. Payroll loans more than doubled in 2004 and expanded another 67 percent in 2005 to approximately $16 billion, representing about 18 percent of all consumer credit. However, it is estimated that more than 60 percent of payroll loan borrowers use the loan to refinance existing debts, thereby reducing its effect on overall consumer credit growth.[17]

Technology driven consumer products. New technologies and e-banking have helped further banking penetration because they permit the banks to create products and services for the unbanked sectors at both lower cost and risk. In its November 2005 issue, LatinFinance reports that banks in the region have invested over $270 million between 2003 and 2006 in card technology ranging from customer profiling to new terminals. One new technology with the most potential for the region is the EMV cards (Europay MasterCard and Visa cards) because these cards can store customers' photographs and biometric data, such as fingerprints. EMVs were initially introduced in markets that needed to reduce and prevent fraud; however, their promulgation has been slow in the region. Banks in **Mexico** have used them since 2002 to collect information on the unbanked population to measure and manage the risk of issuing credit to segments of the population previously considered unbankable either because of their income level, informal employment, or lack of official forms of identification.

In **Chile**, the increased use of Internet banking in the past five years has lowered banks' costs, which in turn has allowed banks to provide mass product and services to segments of the population previously neglected. In 2005, Chile's state-owned BancoEstado announced the introduction of an electronic payment system that allows its customers to pay taxes and other merchants. This development is significant because BancoEstado provides banking products to the lower-income segments of the population in areas where no other banking facility is accessible. BancoEstado is also leading a project that will operate Transantiago, a new electronic purse that allows individuals to pay for small charges such as public transportation. These electronic purses, use EMV technology and are expected to bring the unbanked segments of the population into the banking system by allowing the participating banks to track spending information on the cardholders to create a credit profile for the individual.

New consumer divisions. Banks in **Chile** have recognized the great potential in the lower-income segments of the population and have pursued this business over the past three years, first with the entry of several new consumer-oriented banks, some affiliated with Chile's largest department stores and then by all the major banks establishing consumer divisions. New niche banks owned by retail stores, such as Falabella, Ripley, and París, capitalize on their customer databases and cater specifically to the middle- and lower-income segments of the population. New consumer divisions opened by Banco Santander, Banco de Chile, Banco de Crédito e Inversiones, Corpbanca, Citibank, and BBVA, also aim at meeting the increasing demand for consumer loans and services from the lower-middle income segment by using marketing strategies that appeal to the everyday individual, such as offices with a more relaxed look and personnel trained to provide personalized attention. In March 2005, the general managers of these consumer divisions organized a new Bancarization Committee, whose main goal is to increase banking penetration in the country.

Other attempts to increase bancarization include BancoEstado's plans to offer services in Chile's more remote towns by carrying out banking operations using only a telephone line and point of sale terminals instead of physical branches.

[16] From a credit risk perspective, loans relying on repayment from a pension plan carry a risk equivalent to a government bond, which is lower than that of an average consumer loan.

[17] "Brazilian Consumer Loans – Payroll Deductible Loans in Structured Finance." FitchRatings. Latin America Quarterly.

Protecting the consumer and the banking system. Bank regulators and the central banks are responsible for creating a financial safety net and rules of prudent behavior to protect depositors against loss and abuse and for enforcing these rules and regulations to promote a stable financial system. In Latin America, consumer laws, deposit insurance, and prudential regulations are slowly surfacing in response to a more consumer-oriented mentality among businesses and the financial community.

Prudential norms and regulation. Banking crises have vast social consequences by disrupting the supply of credit, upsetting the payments network, and eroding the value of savings. Following the crises of the 1990s, many banking systems in the region have been restructured and prudential frameworks reformed. Central banks have seen their powers increased, and supervisory authorities have strengthened regulations especially in the areas of liquidity and capital requirements, legal powers and obligations for members of banks' boards, regulatory powers to monitor the financial condition of financial institutions, and regulators powers of intervention in case of bank deterioration and failures. Without prudent supervision, the benefits of financial deepening may be constrained.

Deposit insurance programs. Most contemporary financial systems have a deposit insurance program to prevent speculative bank runs when solvency concerns arise and to protect depositors in the event of bank failures. In this sense, the ideal deposit insurance program is explicit, and coverage is kept low and restricted to certain types of deposits. While a well-defined deposit insurance scheme can contribute to financial stability, a deficient one can increase the likelihood of a banking crisis by discouraging customers from seeking well-managed financial institutions and the banks' managers and owners from implementing prudent practices. For instance, in Latin America, depositors were not included in the explicit safety net until deposit insurance schemes were established in the 1980s and 1990s following banking crises. Worse yet, depositors in the region have been used in some cases to shore up failing banks by freezing deposits (Argentina and Brazil in the 1980s) and reducing their real value because of ensuing high inflation.[18] Today, most deposit insurance schemes in the region are explicit and generally similar, although some significant differences exist in terms of coverage, sources of funding, administration of the funds, and public expectations.

In **Brazil**, the private deposit insurance fund was created in response to bank failures of the mid-1990s. The insurance fund is owned by participating banks, who contribute a premium of 0.25 percent of total deposits calculated on a monthly basis. All banks in the system can participate, including foreign, private, and public banks. The fund guarantees up to the equivalent of $7,000 per depositor.

Chile is the only country in the group with a clearly publicly funded deposit insurance program. In the event of a bank's liquidation, the institution's technical reserves are first used to pay depositors before the government's guarantee comes into effect. At this point, the government, through the central bank, covers up to 100 percent of demand and savings deposits, with a maturity of less than 10 days and 90 percent of a customer's aggregated amount of longer-term deposits, up to a maximum of 108 UF per person (the equivalent of about $3,000). Chile has the lowest ratio of coverage to GDP per capital in the region.[19]

In **Colombia**, the *Fondo de Garantía de Instituciones Financieras* (FOGAFIN) was created in the early 1980s also in response to a banking crisis. Participating banks pay an annual premium of 0.5 percent of total demand, savings, and time deposits plus bonds. FOGAFIN is administered by the government and has traditionally provided capital support to troubled financial institutions by creating a temporary emergency guarantee capital, and more recently by extending assistance loans to shareholders. The deposit insurance covers 75 percent of a single depositor's aggregate deposits in a bank, with a maximum pay out of 15 million pesos (the equivalent of $6,500).

In **Ecuador**, the *Agencia de Garantia de Depósitos* (AGD) was established in 1998 following the country's banking crisis of 1998-1999, which resulted in the government's intervention and closing of several banks. AGD is responsible for providing deposit guarantees and for the intervention and closing of insolvent banks. AGD is publicly funded and administered. More recently, there have been talks of closing this agency and replacing it with a new program that would be funded by a one-time capitalization from the central bank and supported by contributions from the banking system, based on a

[18] "Financial Safety Nets: Lessons from Chile". The World Bank Research Observer, vol. 15. February 2000.

[19] UF is a unit of account whose value changes daily in accordance with the previous month's consumer price increase.

percentage of their deposits. Management of the program would be in the hands of either a private company or the central bank. Either plan would require new legislation.

In **Mexico**, *Instituto para la Protección del Ahorro Bancario* (IPAB) was created as part of the financial reforms of 1998. The IPAB was given four main functions: deposit insurance, liability management, asset sales and management, and liquidation/sale of intervened banks. The last three mandates stem from the Tequila Crisis, while the administration of the country's deposit insurance program will be IPAB's ongoing concern. As of January 2005, the maximum deposit guaranteed was capped at 400,000 UDIs (inflation-indexed units) per person per bank or approximately the equivalent of $130,000 at current exchange rates, making it the largest coverage to GDP per capita in the region.

Perú's deposit insurance fund, *Fondo de Seguro de Depósitos* (FSD), was created in 1991. The fund is supported by annual premiums paid by the banking system and covers up to the equivalent of $22,100 per depositor per financial institution (adjusted for inflation on a quarterly basis).

In **Venezuela**, the deposit insurance agency, *Fondo de Garantia de Depósitos* (FOGADE), was established in 1995. FOGADE is funded by participating banks through premiums based on 0.5 percent of total assets (a gradual increase to 2 percent of total assets is under consideration). Currently, the program guarantees up to the equivalent of $5,000 per account holder (with a proposed gradual increase to the equivalent of $13,000 per account holder).

Consumer protection regulations. Generally, countries with small banking sectors tend to have high average interest spreads as is the case in **Brazil** and **Venezuela** where the median interest spread stands at about 18 percent compared with 4 percent in countries with well-developed financial sectors, such as **Panamá** and **Chile**, and 3.5 percent in the U.S.

Some countries in the region have established interest rate caps on retail loans in an attempt to protect the consumer from unfair banking practices, which can include significant interest rates without proper disclosure or lack of recourse when consumers have complaints about unfair treatment. The problem with interest rate caps is that they can potentially distort the relationship between cost and risk, resulting in financial institutions incurring losses or avoiding the riskier consumer sector altogether. Conversely, some financial institutions have found ways to circumvent the interest rate caps by hiding fees and commissions in consumer loans. This counter strategy has prompted countries to enhance the disclosure requirements on consumer loans to fully reflect the full cost of a loan, including commissions, transaction fees, and the effective rate of interest. Consumer education either at the point-of-issue of credit or through non-profit organizations is another initiative observed in the region, as well as modifications to laws to encourage competition from other non-bank institutions, such as insurance companies, and cooperatives.

In **Argentina**, a reporting disclosure in effect since December 2004 requires financial institutions to publish all information related to costs and rates on savings accounts, credit cards, consumer and mortgage loans, and bank transfers.

In **Chile**, reforms to the Consumer Protection Law were introduced in 2004. The legislation aims to reduce the high interest rates charged on credit cards and to increase competition by requiring all issuers of consumer credit to disclose all costs to facilitate consumers' educated decisions. The reform created a standard reporting system for all entities for the disclosure of credit costs, shortened the court process for consumer grievances, and strengthened the powers of the consumer protection agency, SERNAC, which now can charge entities up to the equivalent of $35,000 for violations.

In **Colombia**, the Superintendency of Banks elevated the importance of consumer protection regulations by including them in the 2003 Financial Institutions Law. The higher level of importance was driven by banks' increased focus on consumer loan growth as well as ongoing consumer complaints regarding lending discrimination. The modifications require all financial institutions regulated by the Superintendency of Banks to establish the internal position of the Consumer Defender (*Defensor del Cliente*) responsible for reviewing and resolving consumer complaints against the financial institution at no cost. The Defender reports directly to the bank's shareholders. Furthermore, the law requires that financial institutions provide fair cost information to customers to make an informed decision.

In **Ecuador**, the Consumer Rights Law requires banks to post the interest rates issued by the central bank and to publish the cost of financial services including fees and commissions. Banks are also required to create customer service centers to address clients' complaints. More recently, the Superintendency of Banks issued a ruling prohibiting financial institutions from charging a maintenance fee on savings accounts. Although this ruling has been called illegal and unconstitutional by the country's private banking association, it demonstrates an

increased awareness of the need to protect the consumer. Profits for Ecuador's private banks totaled were up 25 percent for the first five months of 2005 compared with the same period in 2004 driven by higher loan revenues and fee income.

In **Mexico**, the central bank adopted measures to encourage banks to reduce service fees and interest rates charged to consumers in an effort to make credit more accessible and affordable to all income levels. Among the measures, bank profits from converting currencies in credit-card transactions were capped and banks are required to disclose all service fees charged to consumers in their credit cards ads. This last measure aims to fuel competition among banks and bring interest rates and credit card fees, which ranged from 25 percent to 40 percent. Additionally, in 2005, the central bank required Citigroup and BBVA, two of the largest credit-card issuers in the country, to open their payments systems to smaller competitors, thus removing a barrier to balance transfers for cards issued by other banks.

In **Perú**, the Superintendent of Banking approved new guidelines in November 2004 that improve the disclosure of interest rates, commissions, and other fees by financial institutions. The new regulations also require that financial institutions notify all customers of any modifications of interest rates, commissions, or other fees at least 30 days prior to the change and to clearly post all interest rates and fees for products and services in all of their offices as well as websites.

In **Venezuela**, a new Consumer and User Protection Law enacted in April 2004 entitles consumers to be informed beforehand of the amount of interest charged on a loan and the applicable interest rate. The new law is very specific as to the repayment terms of consumer loans and the various ways a consumer can reduce their interest and principal obligations. Another highly controversial law being considered by Venezuela's congress proposes new regulations on interest rates for credit and debit cards, eliminating fees on ATM usage, putting the burden on banks to prove card fraud, and establishing preferential interest rates on purchases of food and medical items and services.

REGULATORY COMPLIANCE IN THE U.S.

Due to the limitations of the Foreign Bank Supervision Enhancement Act (FBSEA) places on foreign organizations (FBOs), many regulations that apply to domestic banks with retail operations do not apply to FBOs in the U.S. because these entities do not typically accept retail deposits. However, examiners evaluate FBOs every 36 months to verify whether the FBO conducts any activities that would subject it to consumer laws and regulations. Depending on the nature and size of consumer activities, FBOs may be subject to more frequent consumer examinations

Applicable regulations in the U.S. In the U.S., virtually all financial transactions involving consumers are covered by consumer-protection laws, including deposit accounts, ATMs, charge and credit cards from financial institutions and retail establishments, auto loans and leases, and mortgage loans. The implementation of some of these regulations and laws in Latin America, customized to fit each country's own economic situation, would seem appropriate as these emerging economies work to expand financial services to the various segments of the population, specifically to the under-banked, lower-income segments.

CONCLUSIONS

A look at the evolution of consumer finance markets in Latin America shows that the financial services sectors in the region have not always been as competitive, innovative, and resilient as they are at the present time. Yet, the availability of private credit and banking services in Latin America remains lower than in similar emerging economies in other parts of the world. The overall small size of the credit markets in Latin America is the result of macroeconomic weaknesses and institutional shortcomings.

Institutional shortcomings are factors that obstruct banks' risk management process and include imperfect creditor rights protection, weak borrower screening models, and insufficient credit information on borrowers, all factors that make credit scarce and expensive. These constraints are likely to remain in the region in the immediate future, although at various degrees. For example, progress has been made in **Brazil**, **Chile**, **Colombia**, **Perú**, and **Mexico** where the trend in consumer lending, including mortgage loans, has been positive in the past year. This progress, albeit small, reflects the financial institutions' favorable response to the removal of institutional barriers and their willingness to create innovative ways to reach a large segment that holds profits for the banks in the short run, but also the key to sustainable economic success for their emerging economies. However, for **Argentina** and **Venezuela** the outlook for financial development is bleak due mainly to a very vague regulatory and institutional environment.

For most small, open economies, a desirable level of financial activity would be impossible without a safety net that includes clearly defined and enforced prudential

regulations, an independent central bank and regulatory entities, and government guarantees to depositors and banks. This last factor is very important, because while several countries in the region have issued consumer protection laws, protection for creditors in the form of more effective property registries and personal bankruptcy legislation is important for the deepening of the private credit markets.

Finally, the U.S. experience in the development of a more expansive consumer credit and banking environment could provide an excellent framework for countries in Latin America to create the right conditions for greater access to credit for all consumers and the extension of credit and financial services to traditionally underserved segments.

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EXHIBIT I

COMPARATIVE CHART								
CATEGORY	ARGENTINA	BRAZIL	CHILE	COLOMBIA	ECUADOR	MEXICO	PERU	VENEZUELA
GDP per capita [20] Nominal GDP	$4,570 $179 billion	$4,272 $775 billion	$7,100 $110.3 billion	$2,732 $125.8 billion	$2,479 $32.8 billion	$7,060 $750 billion	$2,802 $78.3 billion	$5,260 $139.2 billion
Population below poverty line	44.3%	22%	20.6%	55%	45%	40%	54%	48.5%
Recorded Unemployment	11.8%	9.9%	8.5%	11.8%	11.1% + 47% underemployment	3.6% + 25% underemployment	9.6% + widespread underemployment	12.6%
Bancarization (private credit/GDP)	45%	55%	70%	23%	22.6%	26%	17%	10.5%
Private Credit Bureau Foreign Participation Public Credit Registry	Yes - 1957 > 50% (Equifax) Yes – 1991	Yes - 1968 No Yes – 1997	Yes - 1979 Equifax Yes – 1977	Yes - 1970 No No	No N/A Yes - 1997	Yes - 1996 < 50% (TrasnUnion) Yes - 1964	Yes – 1995 > 50% (Equifax) Yes - 1983	No N/A Yes – 1975
Consumer Protection Regulations	Yes – 2004		Yes – 2003	Yes - 2004	Yes	Yes	Yes - 2004	Yes – 2004
Deposit Insurance [21] (explicit & mandatory)	1995 $10,300 Private	1995 $5,700 Private	1986 $2,800 Public	1985 $6,900 Public	1999 $8,000 Public	1999 Approx. $130,000 Public	1992 $19,500 Mixed	1995 $7,100 Private

[20] Source for GDP, GDP per capita, and unemployment: EIU Country Risk Service October 2005 (projected). Source for population below poverty line: CIA Fact Book 2005.

[21] Source: World Bank 2003.