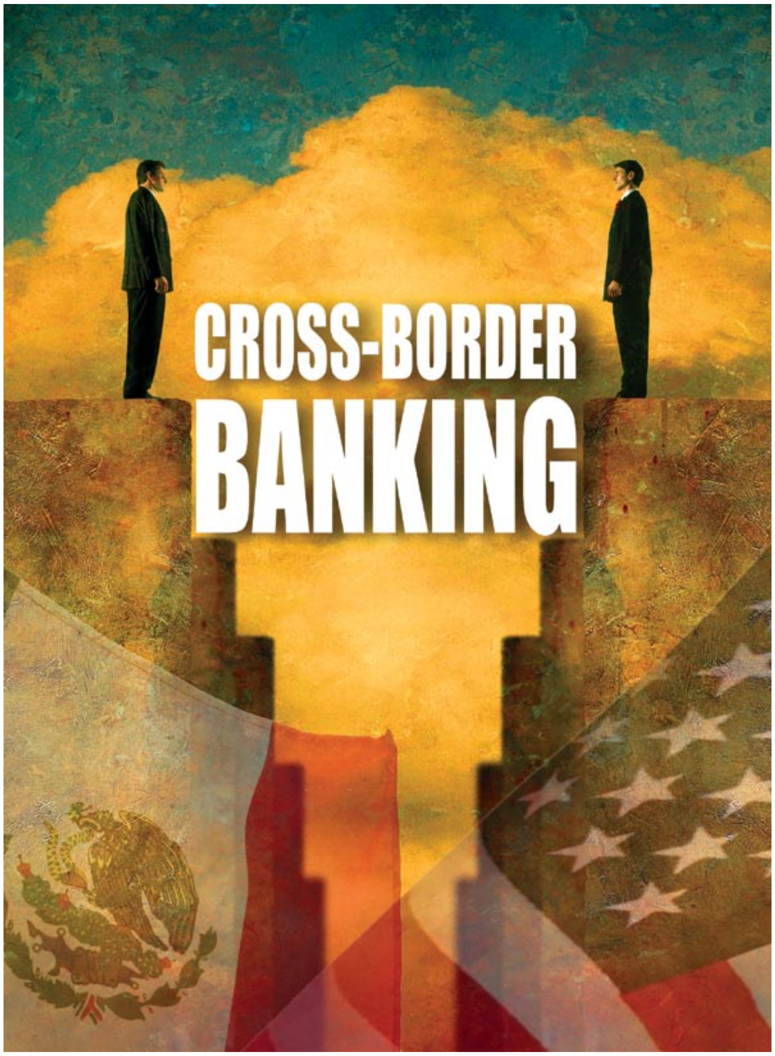
Banking Industry Evolution Along the Texas–Mexico Border

By Joaquin Lopez and Keith Phillips

For their size and income, Texas towns along the U.S.–Mexico border have a large number of big banks. They exist to serve not only local citizens but also customers from across the border. In a very real sense, these banks are an export industry that brings in outside capital and provides an important source of jobs and income.

In the new century, the border banking industry is doing business in a changing environment. Mexico has attained a degree of economic stability, and its bank sector has become more competitive. At the same time, remittances from Mexicans living in the U.S. have risen sharply.

The border banking industry's adjustment to these changes and its prospects for future growth were the focus of May's Cross-Border Banking Conference, sponsored by the San Antonio Branch of the Federal Reserve Bank of Dallas.



Bankers, analysts, academics and central bankers from Mexico and the U.S. gathered in San Antonio to discuss important cross-border banking issues, such as regulation in host countries, determinants of international bank lending, the role of remittances and cross-border market strategies.

The following presents a synopsis of the conference.

International Issues

For decades, border region banks served as an alternative to a Mexican financial sector plagued by instability and inefficiency. Though still small relative to other emerging markets, Mexico's financial sector has in recent years become very dynamic, with developments that have improved investors' ability to diversify and expand.

Edward Skelton, an international financial analyst at the Dallas Fed, pointed to the emergence of a yield curve as a sign of Mexican financial stability (*Chart 1*). After the 1994 economic crisis, Mexico couldn't issue debt with over one year to maturity. Interest rates were high. By 2000, Mexico could issue five-year bonds at lower rates. In the past year, the country has begun issuing 30-year fixed-rate bonds.

With greater stability, Mexico has been able to broaden its financial system to include securitization, the pooling of previously illiquid assets and sale of their future income streams to investors. Born of a single $178 million issuance in December 2003, Mexico's securitization market has grown explosively, increasing almost tenfold in four years. Mexico became a global player in this market virtually overnight, with its mortgage-backed securities market now ranking second only to South Korea's among emerging economies.

Securitization has given Mexican lenders access to capital and lowered their cost of funds. One side effect has been a boom in home mortgage loans, another example of an invigorated financial system. In Skelton's view, the mortgage industry's development will boost Mexico's economy by encouraging higher-quality housing, increased savings and greater wealth creation.

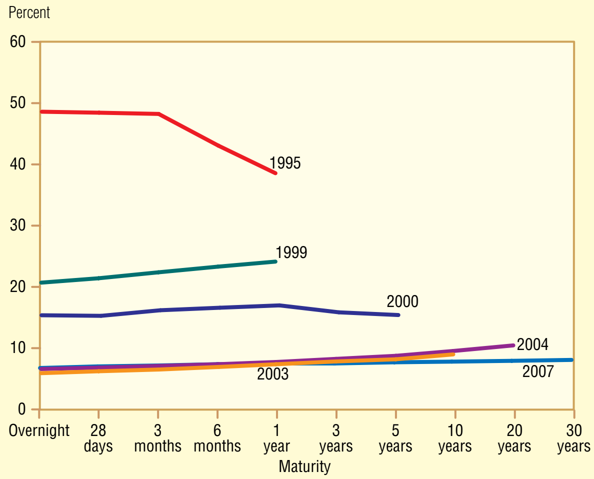
The Mexican financial system's efficiency and health are linked to foreign banks, which own more than 80 percent of the banking system. This foreign dominance not only brings greater competition and better risk management, it raises issues for Banco de México, the central bank.

Pascual O'Dogherty, the central bank's director of financial system analysis, stressed the difference between branches and subsidiaries. Branches don't have separate legal status from their parent banks, while subsidiaries are incorporated under host-country laws, making them stand-alone entities.

When a branch fails, the parent bank

Chart 1

Mexico Grows a Yield Curve



SOURCES: Banco de México; authors' calculations.

The industry is likely to continue to expand its size and customer base, and the border between U.S. and Mexican financial systems will continue to fade.

is legally bound to ensure its solvency. With subsidiaries, a parent bank's legal obligations are limited to invested capital. In practice, a foreign bank's decision to support a subsidiary is based on a balance of future profits and expenses, including legal and reputation costs. Host-country financial authorities can't rely on the assumption that foreign parent banks will always support their subsidiaries.

Parent banks may have incentives to take greater risks at subsidiaries because legal limitations and diversification across countries reduce their exposure, O'Dogherty said.

Since subsidiaries usually consolidate their financial statements with parent banks, home-country regulations ultimately prevail over host-country laws in most cases. Regulatory differences between the two nations might affect subsidiaries' operations and host-country financial markets.

Such issues result in conflicts of interest between host- and home-country authorities and misunderstandings on how to resolve failed global banks. Convergence of regulatory, legal and accounting frameworks would be the ideal solution; short of that, O'Dogherty stressed the importance of carrying out crisis-simulation exercises and communication between host and home countries' regulators.

From the early 1990s to the Asian financial crisis of 1998, most capital flows to emerging markets came in the form of international bank lending, especially short term. The past decade has seen a boom in foreign banks' presence in emerging markets.

According to Marian Micu, senior researcher at Barclays Global Investors, increased lending by international banks established in emerging economies doesn't seem to be a substitute for cross-border lending.

He mentioned that both push and pull factors play a role in international bank lending to emerging markets. Push factors in the lending country, such as real GDP and real interest rates, typically determine the size of capital flows. Pull factors in the borrowing country, such as creditworthiness, exchange rate risk and financial market performance, help determine the geographic allocation of lending.

Micu found that U.S. banks tend to have a countercyclical lending pattern to emerging markets, while European and Japanese institutions have a procyclical pattern. Furthermore, U.S. lending tends to be less risk sensitive, possibly because U.S. banks have more diversified portfolios.

Increased integration in global capital markets has reduced long-term interest rates and made them more similar across countries.

According to Harvey Rosenblum, executive vice president and director of research at the Dallas Fed, current global interest rates imply that markets perceive very little risk of recession or rising inflation. Rosenblum expressed some concern that in this new environment, risk may be difficult to ascertain. However, he warned that the likelihood has increased that any given shock could unsettle the remarkable calm in the world's financial markets.

Banks and Remittances

Remittances represent a major flow of financial resources from the U.S. to Mexico. They help reduce poverty and domestic economic risks. Researchers have analyzed remittances' determinants, economic impact and measurement.

Carlos Vargas-Silva, a postdoctoral fellow at the University of Vermont, found remittances are strongly correlated with cyclical fluctuations in U.S. output. This suggests they may be another channel by which U.S. economic trends transmit to Mexico.

Looking at remittances from the Mexican side, Vargas-Silva noted the existence of a two-way relationship. Such factors as economic hardship, exchange rates and returns to investment determine the amount of remittances. But remittances also have an impact on such variables as the real exchange rate.

As remittances grow, it becomes more important to measure them as accurately as possible. Jesús Cervantes González, director of economic measurement at Banco de México, said improvements in data recording, together with substantial increases in the number of migrants and lower transaction costs, explain the rapid growth of remittance inflows to Mexico.

Regulation has been a key to improving the remittance statistics. Since October 2002, all fund-transfer service providers have been required to register at Banco de México. Currently, the intermediaries' accounting records provide 98 percent of the data on the value of remittances and the number of transactions. The remaining 2 percent comes from direct transfers of resources in cash or kind (goods), tracked by Banco de México for many years through its Survey of International Travelers.

After Banco de México became involved in remittance reporting, financial intermediaries improved their recordkeeping. Better data allowed the industry to better understand the market's size and business opportunities.

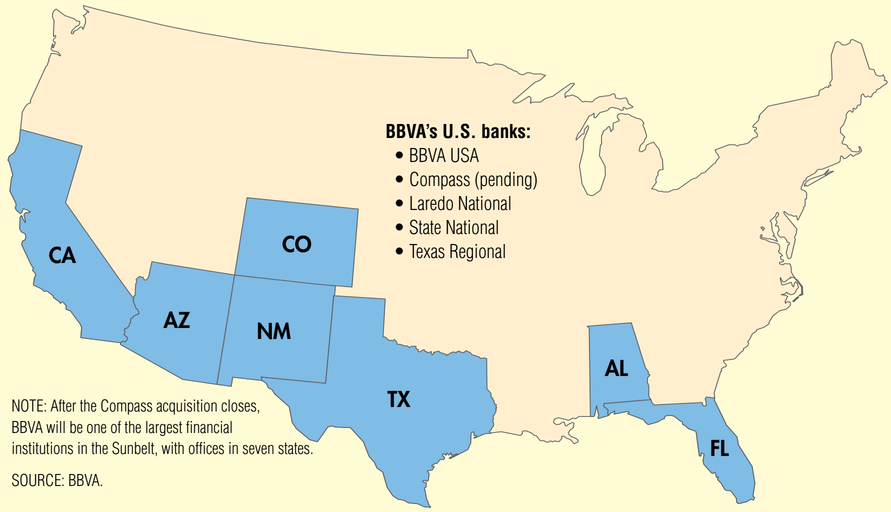
Cervantes pointed to increased use of formal channels as an important factor in remittances' growth. The trend implies that cross-border banking now plays a bigger role in these transactions.

According to Yira Mascaró, senior financial economist at the World Bank, financial institutions involved in cross-border banking still need to overcome certain challenges. Among the obstacles she singled out: competition from money transfer operators, distrust of banks, suspicion in pricing of services and limited financial sophistication among remitters and receptors.

According to Mascaró, financial training and improved services such as debit card technology and lower transaction costs are ways in which cross-border banking can gain a bigger share of this industry.

Chart 2

Banco Bilbao Vizcaya Argentaria Expanding in Southern U.S.



NOTE: After the Compass acquisition closes, BBVA will be one of the largest financial institutions in the Sunbelt, with offices in seven states.

SOURCE: BBVA.

Mexican Banks' New Role

Mexico's turbulent financial history led some citizens to hedge against swings in the peso's value by holding dollar-denominated accounts in U.S. banks. This is perhaps the simplest example of cross-border banking.

More recently, however, Mexican banks and their parent institutions have begun moving into the U.S. market. They're motivated by Mexicans' willingness to hold accounts abroad and by the large percentage of Mexicans living in the United States without banking services.

Spain's Banco Bilbao Vizcaya Argentaria (BBVA)—parent of BBVA Bancomer, Mexico's largest bank—acquired Laredo National Bancshares, Texas Regional Bancshares and State National Bancshares in recent years to become one of Texas' largest banks. In late 2006, Banorte, the only Mexican-owned bank, acquired 70 percent of McAllen-based INB Financial Corp.

Carlos Garza, president and CEO of INB, said the goal is to be a binational, bicurrency financial group delivering financial products and services in U.S. dollars and Mexican pesos.

In Garza's view, Mexican banks' U.S. participation makes them more competitive in the Mexican market. Many Mexicans hold deposits in U.S. banks, and Banorte hopes to offer them integrated services such as binational credit cards, loans and mortgages.

BBVA has expanded well beyond Texas. Indeed, its U.S. acquisitions have given it a broad presence in the southern reaches of the U.S. (*Chart 2*), according to Manuel Sanchez, president and CEO of Laredo National Bank.

Sanchez added that border banks could profitably expand their role in trade financing in Texas and the U.S., especially with China and Latin America.

Challenges and Opportunities

Susan Rico, senior vice president of Wells Fargo Bank in El Paso, said her company developed a strategy for the U.S.–Mexico border market more than 12 years ago. While a stable economy and improving country risk ratings make Mexico a more attractive loan market, significant challenges to cross-border banking remain, she said.

Political and legal actions that limit the flow of people, goods or capital across the border with Mexico can hamper cross-border banking, Rico said. In particular, the Patriot Act and related regulations have increased both the cost of doing business with Mexican companies and individuals and the risks associated with noncompliance.

Eduardo Berain, executive vice president of Frost National Bank in San Antonio, mentioned that Mexico's economic and banking stability has increased consumer confidence in the country's banking system, allowing Mexican institutions to compete more heavily for middle-market businesses.

Andrés Rivas, assistant professor at Texas A&M International University, said banking industry consolidation and the arrival of so many foreign banks have probably increased efficiency but have also raised concerns among the smaller community banks along the Texas–Mexico border.

Rico also pointed out longstanding challenges such as countries' different legal systems, accounting standards and corporate structures. One way banks can mitigate commercial and country risks is to use insurance products, including services offered by the U.S. Export–Import Bank.

Patrick Crilley, director of the Southwest regional office of the Ex–Im Bank, described how his agency levels the playing field by providing the same credit risk protection and loan guarantees that competitors in other countries can obtain from their governments. In 2006, the Ex–Im Bank's financial products facilitated more than $1.6 billion in international trade in Texas.

Vibrant Industry

Conference participants generally agreed that new opportunities for cross-border banking exist in a rapidly growing business environment. At the same time, competition is increasing both in Mexico and South Texas.

Against this backdrop, the industry is likely to continue to expand its size and customer base, and the border between U.S. and Mexican financial systems will continue to fade.

Lopez is an economic analyst and Phillips is a senior economist and policy advisor at the San Antonio Branch of the Federal Reserve Bank of Dallas.

Note

Presentations from the Cross-Border Banking Conference can be found on the Dallas Fed web site at http://dallasfed.org/news/research/2007/07crossborder.cfm.