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Banks and the government have mounted a major effort to extend financial services to those without them.

Reaching Mexico's Unbanked

by Edward C. Skelton

A well-developed financial system works as both a powerful antidote to poverty and a gateway to prosperity. By improving economic efficiency, boosting consumers' purchasing power and helping citizens realize economic opportunity, broader access to financial services helps raise living standards. Low-income families that take advantage of financial services enjoy increased security and reduced costs—in both paying for goods and services and seeking to build wealth. Better access to credit helps small businesses fulfill their potential.

In the United States, the benefits of financial services are largely taken for granted. More than 90 percent of U.S. households have bank accounts, according to the Federal Reserve's Survey of Consumer Finances. Nevertheless, both the private and public sectors devote considerable time and resources to extending banking services to the relatively small number of households that lack them.



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The situation is very different south of the border. Less than 25 percent of Mexicans possess even the most basic financial convenience: a simple checking account.¹ Those without access to financial services encounter higher costs for cashing checks, paying bills and starting businesses.

Bringing the benefits of financial services to more people is an important goal in Mexico. To achieve it, financial institutions and the government have mounted major efforts aimed at the vast number of citizens outside the formal financial system.

Recent signs point to success with using a variety of innovative channels to reach Mexico's unbanked and underbanked. Interestingly, among the foremost is a strategy banned in the United States—a bank and retail operation under common ownership.

Plight of the Unbanked

Lack of access to financial services imposes significant costs on Mexico's unbanked—both individuals and

small businesses. Cashing paychecks requires up to 10 percent of income.² Paying bills in cash takes more time, carries risks to personal security and entails transportation costs. For startup entrepreneurs, relying on the informal financial system can boost costs by 15 percent.³

A large, unbanked population burdens the financial system itself. The Banco de México, the country's central bank, reports that cash transactions cost the system up to five times more to process than checks, which are, in turn, more expensive than electronic payments.⁴

In lieu of formal financial services, unbanked households resort to such options as the proverbial cash under the mattress and community savings clubs. What people really want are deposit accounts, even those that don't pay interest, the World Bank reports.

What stops individuals and small businesses from establishing a banking relationship? In a recent World Bank survey, 70 percent of Mexico's unbanked cited high fees and minimum balance requirements as the principal reasons for not accessing the formal financial system.

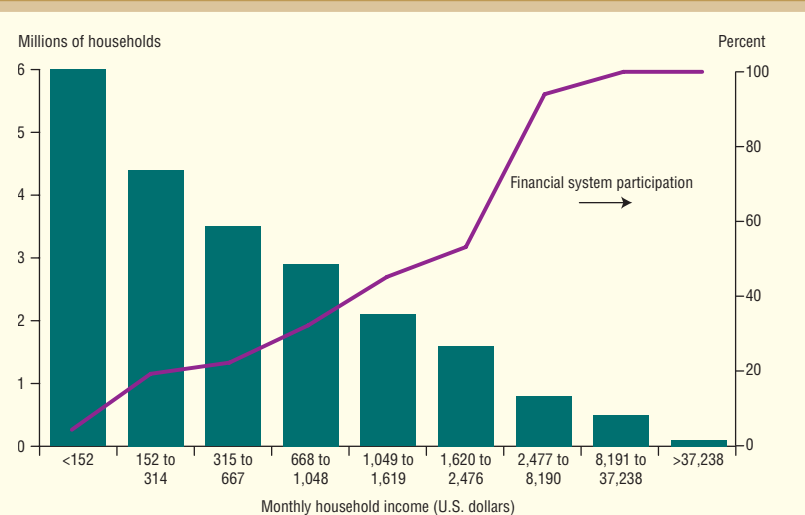
Because money is a primary obstacle, the poor are more likely to be unbanked. If we define participation as the ownership of at least one financial product, Mexican households with lower monthly incomes have lower rates of participation in the formal system (*Chart 1*).

Even small reductions in bank fees, balance requirements and other barriers might encourage many to open an account. An estimated 90 percent of Mexicans are homeowners, a high rate that suggests a capacity for saving among the unbanked despite low income levels. Possession of a deposit account could spur additional saving.

Geography is another barrier to banking relationships. Private commercial banks have a presence in only 465 of the country's 2,439 municipalities. A government-owned development

Chart 1

Financial System Participation Low Among Poorer Households



SOURCE: Sigma Mercados y Libro Mercadológico BIMSA, 2007.



bank and a number of small financial intermediaries cover an additional 525 municipalities, leaving 1,449 municipalities and their total population of almost 14 million with little if any access to formal financial services.

Market Responses

Mexico's financial sector has changed considerably over the past 10 years as its institutional, technological and regulatory environments have in many respects become world class.⁵

This newly energized financial system is looking beyond its traditional customer base. Entrants to the banking sector, including retailers, are targeting the unbanked and underbanked. They've been joined by some large banks, both domestic and foreign. These developments are beginning to attract more households to the formal financial system.

New-bank strategies. Fourteen new banks have been chartered since May 2006, adding to a base of 28 institutions. The new banks are pursuing widely divergent approaches. Five are focusing on private banking, trading and other high-end activities. The nine others are targeting the unbanked or underbanked—usually low- and middle-income customers with monthly incomes of US\$200–\$3,600.

The growth in specialized banks should continue because they can now take advantage of a charter that enables them to target specific markets. The niche bank charter, introduced in 2007, is likely to be an attractive vehicle for market entry because it entails lower startup and regulatory compliance costs.

The charter presents an especially appealing opportunity for unregulated finance companies, known by the acronym *sofomes*, which stands for Sociedades Financiera de Objeto Múltiple. *Sofomes*, a relatively new type of finance company, can't accept deposits and aren't subject to regulation by the national banking commission, Comisión Nacional Bancaria y de Valores (CNBV).⁶

Mexico has about 400 *sofomes*, with the majority focused on the agricultural industry. The remainder mostly offer credit to micro to medium-sized businesses.

Some *sofomes* have indicated an interest in becoming niche banks, which would allow them to accept deposits. A direct source of funds would lower costs, but the institutions would be subject to regulation.

Most of the new banks targeting the unbanked or underbanked work through an existing retail business or, in one case, a microfinance business. The strategy of targeting the low-income end of the market can be traced to the emergence of Banco Azteca, the first bank owned by a retailer.

Retailers and the unbanked.

Azteca was established in 2002 by Grupo Elektra, a retailer specializing in sales to low-income consumers. Before opening its bank, Grupo Elektra gained extensive lending experience by extending store credit to customers. With its new venture, the retailer can also offer basic banking products.

Before obtaining a bank charter, Grupo Elektra extended credit through its financing subsidiary, which didn't have access to deposits as a source of funds. Instead, the subsidiary obtained funding by securitizing accounts receivable, issuing debt or borrowing money. The banking business provides Grupo Elektra with a relatively low-cost source of funds, an additional business line and a potential source of profits.

Retailer-owned banks offer basic financial products, such as small personal loans and a savings account with a debit card and minimum initial balance of 50 pesos—about \$4.90.⁷ Moreover, retailer-owned banks tend to offer interest rates 1 to 2 percentage points higher than traditional banks.

The retailers also offer an appealing client base because an estimated 80 percent of the customers of Mexico's large retail stores have never had bank accounts.⁸ Combined with

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the capacity to purchase relatively big-ticket items, this suggests the need for financial services.

For customers, bank credit adds flexibility because store credit was obviously limited to purchasing goods sold by Grupo Elektra. Deposit accounts provide an additional option for customers, and access to the formal financial sector can reduce households' cost of making and receiving payments.

The retailer-owned bank strategy seems to be paying off. In less than five years, Azteca has grown into Mexico's eighth-largest bank by deposits and 10th largest by assets. The bank has exported its business model to six other Latin American countries.⁹

Retailers have advantages over traditional banks in attracting deposits from the unbanked. First, the unbanked frequent stores, have some



Expanding geographic reach through a brick and mortar network is expensive, but banks have other options.

level of allegiance to them and already use stores as their primary source of credit (*Table 1*).

Second, retailers' existing storefronts allow them to open bank branches quickly and cheaply. Banco Azteca's branch network and number of accounts are on a par with many of Mexico's largest banks (*Table 2*). In terms of asset size, though, Azteca is much smaller, reflecting its low average account balance.

The ability to establish new branches quickly at low cost is important because a physical presence is a key driver of financial services use. Not surprisingly, states with a large number of bank branches report higher financial system participation, as measured by the number of demand deposit accounts per capita (*Chart 2*).¹⁰

The CNBV has imposed specific conditions on retailers in the commercial banking business. One of the most publicized cases involves U.S.-based Wal-Mart, whose especially detailed restrictions may be a bellwether. The conditions center on transparency and maintaining a clear separation between the retail entity and bank.¹¹

This retailer-owned bank strategy—so popular in Mexico—is prohibited in the United States. Generally, U.S. retailers may lease space to a bank but not own one. Objections

to mixing banking and commerce in the United States include issues with deposit insurance and the concentration of economic power.¹²

Large-bank strategy. Large banks aren't well positioned to serve the unbanked because their branch networks still reflect the historical focus on relatively high-income households. The ratio of bank branches to population tends to be higher in states with high per capita levels of economic activity, whereas the unbanked are more likely to live in low-income, sparsely populated areas (*Chart 3*).

Expanding geographic reach through a brick and mortar network is expensive, but banks have other options. Some large banks have recognized the potential in forming a relationship with retailers and created joint ventures to launch *sofomes* that operate inside the stores.

The new entities largely target store customers who have had little or no interaction with a bank by offering small loans without requiring a credit history. Because people in even the smallest towns and poorest pockets of big cities visit stores, the strategy should allow banks to reach customers missed by traditional branching.

Larger banks find these joint ventures attractive. First, the *sofomes* aren't subject to regulation by the CNBV,

Table 1

Where Do the Unbanked Get Credit?

	Percent
Department store	48.6
Friend/relative	8.6
Government	5.7
Savings bank	4.3
Finance company	2.9
Savings and loan	1.4
Credit union	1.4
Nongovernmental organization	1.4
Other	25.7

SOURCE: World Bank.

Table 2

Retailer-Owned Bank Attracts Small Accounts

Bank	Number of branches	Number of accounts	Assets (millions of pesos)	Deposits (millions of pesos)
Azteca	1,121	6,254,981	53,183	44,956
Bancomer	1,862	12,579,085	741,276	466,224
Banamex	1,618	7,285,045	589,720	320,846
Santander	983	9,694,405	427,598	236,210
HSBC-Bital	1,360	4,600,241	355,526	263,856
Banorte	1,062	6,182,950	273,049	182,351

NOTE: Data are as of March 31, 2008.

SOURCE: Comisión Nacional Bancaria y de Valores.



effectively lowering the cost of operations and compliance.

Second, partnering with a retailer promises a way around low-income households' perception of banks as intimidating, overly formal and inconvenient. By contrast, retailers are often viewed as sympathetic, familiar and customer-oriented. Banks could use the *sofomes* as stepping stones to providing households with full banking services.

Microfinance lending. At year-end 2006, 44 microfinance institutions in Mexico reported data to the Inter-American Development Bank, up from 39 a year earlier.¹³ They included finance companies, a bank and non-governmental organizations, such as those set up by the World Bank and the International Monetary Fund.¹⁴

These lenders offered business loans ranging from 100 to 30,000 pesos—or \$9.78 to \$2,933. Microloans averaged 4,500 pesos (\$440), with monthly interest of 4.5 percent.

Mexican microfinance lenders build extensive networks of small, sometimes home-based, branches. Over the past six years, private-sector microfinance institutions have funded more than 4.8 million loans. Still, a first quarter 2008 Banco de México study found that 70 percent of small businesses fulfilled their financing needs through trade credit—loans provided directly by the suppliers of goods and services.

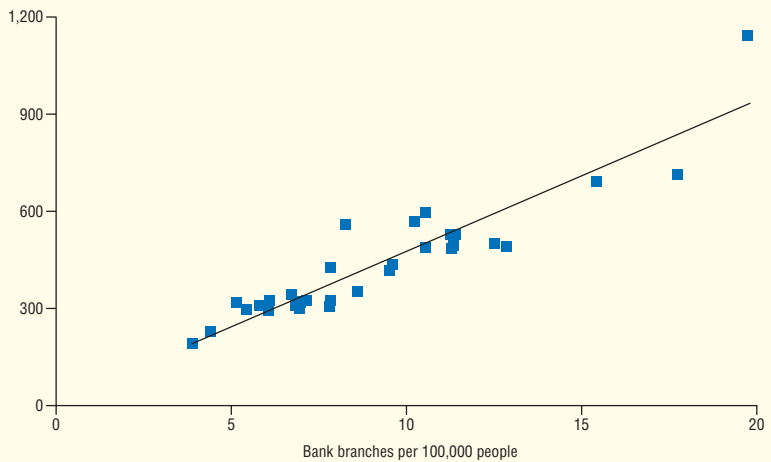
The growth potential in this sector continues to be significant. According to the International Finance Corp. (IFC), approximately 20 percent of Mexico's businesses, and a mere 11 percent of microbusinesses, have accessed the formal financial system.

The World Bank has found that small businesses gaining access to capital tend to generate large increases in profitability, with an estimated return of 20 to 33 percent on the funding received.¹⁵ Moreover, the more constrained access to capital had been, the greater the return once the obstacles were removed.

Chart 2

Deposit Accounts More Common in States with Abundant Branches

Demand deposit accounts per 1,000 people



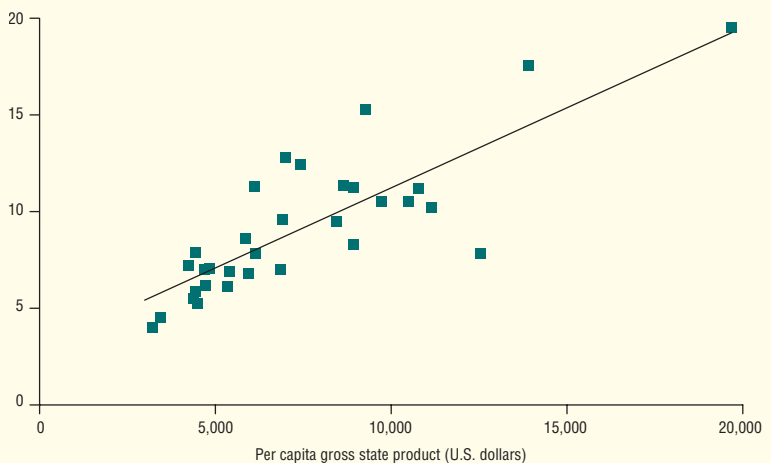
NOTES: Each point represents one of the 31 states plus the Federal District. Census data are for 2005; bank data are as of March 31, 2008.

SOURCES: Comisión Nacional Bancaria y de Valores; Instituto Nacional de Estadística y Geografía; author's calculations.

Chart 3

Bank Branches More Often Seen in High-Income States

Branches per 100,000 people



NOTES: Each point represents one of the 31 states plus the Federal District. Census and gross state product data are for 2005; bank data are as of March 31, 2008.

SOURCES: Comisión Nacional Bancaria y de Valores; Instituto Nacional de Estadística y Geografía; author's calculations.



Mexico's banks have become more aggressive in lending to micro to medium-sized businesses. For instance, Banco Compartamos, a finance company before obtaining a bank charter in 2006, offers working-capital loans to microbusinesses.

Over the past five years, the institution has grown at a compound annual rate of 46 percent in terms of clients and 60 percent in loans outstanding. As of Dec. 31, 2007, Compartamos had more than 800,000 clients and 4.1 billion pesos (\$401 million) in performing loans, spread over 252 locations in 29 of Mexico's 32 states.

Grupo Financiero Ixe, a holding company for a small bank that had focused on middle- and upper-income households and on corporations, is using a \$70 million capital injection from the IFC—the World Bank's private-sector arm—to enter the realm of microfinance.

As a group, commercial bank lending to micro to medium-sized businesses is growing rapidly (*Table 3*).¹⁶ Last year, lending to microbusinesses alone more than tripled. As these tiny enterprises' access to credit continues to improve, the overall Mexican economy should benefit.

Government Responses

Some studies have found that the prices banks in Mexico charge for financial services exceed international

standards.¹⁷ Indeed, the Banco de México has criticized the cost of banking, focusing on what it considers a lack of competition in a system where the top six banks control about 85 percent of loans and deposits.

For their part, banks cite excessive regulatory burden as an impediment to providing lower cost services, a contention backed by studies that find Mexico's compliance costs higher than those in many other countries.¹⁸

The government has developed a variety of initiatives designed to address several of these issues.

Increasing competition. While the recent surge in new banks is encouraging, regulators have taken additional measures to spur entry into the market. These include lowering capital requirements and streamlining the application process for niche charter banks.

Making entry into the industry less expensive and easier should enhance competition. So should the improved availability and standardization of information that can help households shop for the best deal on financial services.

The Banco de México posts fees, interest rates on deposits and the cost of credit on its website. In April 2007, Congress passed legislation that also improves transparency, promotes competition and increases consumer protection. Among other things, it requires financial institutions to provide clearer information about the cost of credit in terms of both fees and interest rates.

The reform also requires that the banking industry develop basic, no-fee deposit accounts for households lacking access to the formal financial system. In addition, the law prohibits fees charged for banking services from being high relative to a customer's income, particularly for checking accounts linked to automatic payroll deposits and credit cards. Banks are prohibited from charging undisclosed fees. Lastly, service providers must notify the Banco de México at least 30 days before changing fees.

Reducing regulatory burden.

In addition to its consumer protections, the 2007 legislation clarified regulators' role, gave banks more responsibility for policing themselves and eased restrictions on financial institutions, including allowing banks to outsource various operations and services. The new law also strengthened external auditors' role.

Previous reforms allowed banks to develop their own credit rating and provisioning methodologies. For example, a 2006 law standardized regulations across the different types of financial institutions. Regulators continue to work to harmonize accounting standards across financial institutions to achieve a consolidated, less burdensome supervisory approach.

A public institution. Banco del Ahorro Nacional y Servicios Financieros (Bansefi) is a government-owned development bank formed in 2001 with a mandate to expand households' access to affordable, formal financial services. The institution both serves the unbanked directly and works with small institutions that target this group.

Bansefi has approximately 5 million savings accounts and opens an average of 28,000 accounts a month. The bank offers no-fee, interest-bearing savings accounts with an initial deposit as low as 50 pesos, about \$4.90.

Bansefi's 550 branches tend to be located in rural areas (*Chart 4A*). The positive correlation between a large urban population and the availability of a commercial bank branch highlights the development bank's role as a rural provider of financial services and complement to commercial banks (*Chart 4B*).

In addition to offering savings and deposit accounts directly to households, Bansefi operates as a second-tier bank for savings and credit entities. In this role, it provides support to over 600 privately or collectively held small financial intermediaries that serve the unbanked.

Table 3

Bank Credit Up Sharply

(Millions of pesos)

	2006	2007
Microbusinesses	3,070	10,296
Small businesses	23,385	35,646
Subtotal	26,455	45,942
Medium-sized businesses	12,544	16,513
Total	38,999	62,455

SOURCE: Mexican Bankers' Association.



The support includes training and technical assistance, access to Bansefi's operational infrastructure and automation services, and the development of a broader range of financial products. Bansefi has developed a technological platform that offers small financial intermediaries access to common back-office operations, thereby increasing economies of scale and efficiency.

A large proportion of Mexico's population remains unbanked, but recent trends suggest private and public sector efforts are helping the country make important strides toward reaping the benefits of greater financial system participation.

Many new banks are targeting the unbanked, and their alliances with retailers give them leverage to achieve that goal. Large established banks, too, are undertaking new initiatives—again, often in partnership with retailers—to reach the unbanked. These efforts, combined with government programs reducing regulatory burden and promoting competition, offer the promise of bringing low-income consumers the benefits of access to the financial system.

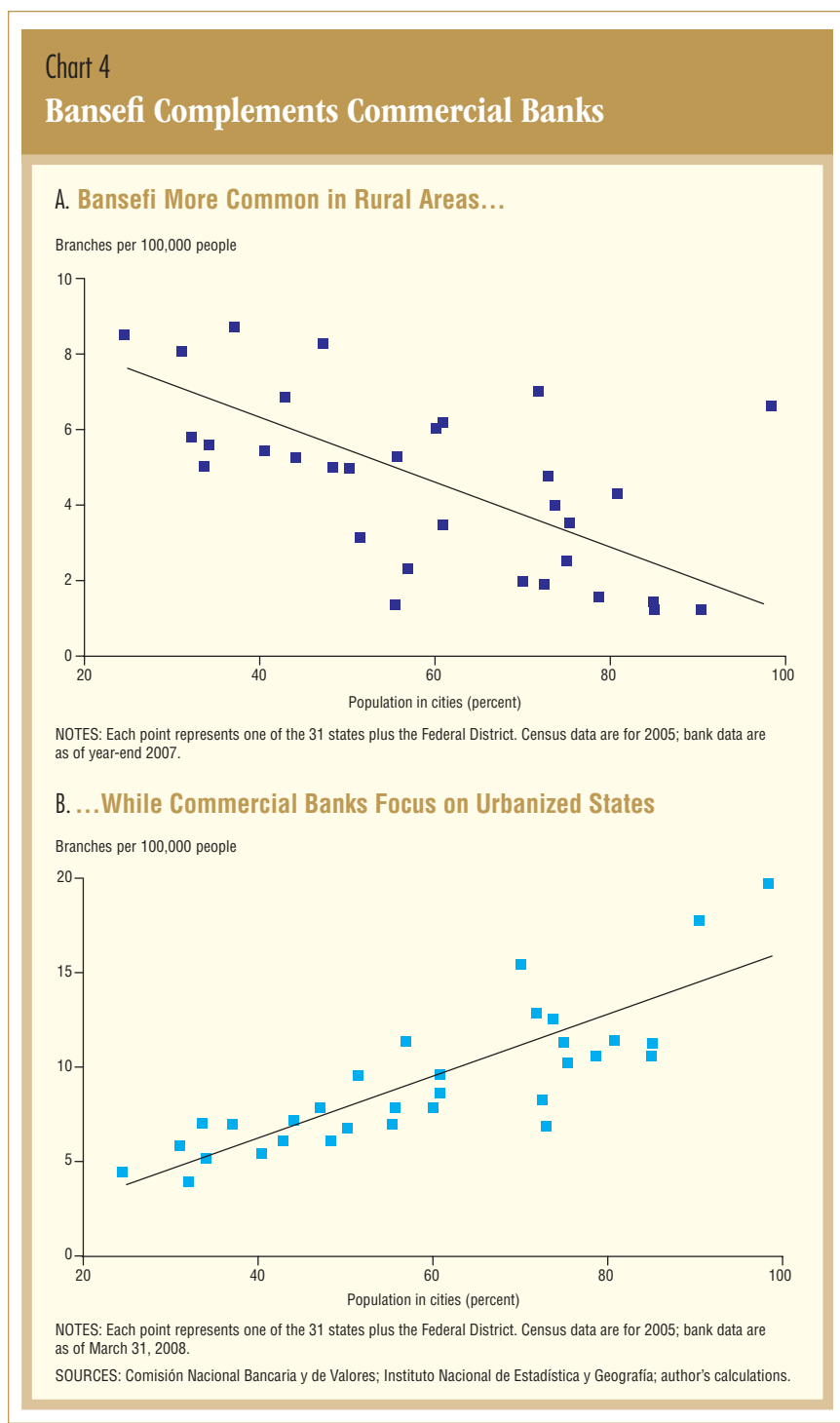
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Notes

¹ Estimates of the financial penetration rate in Mexico vary. The World Bank's 2006 "Mexico: Country-Level Savings Assessment" reports that other studies have found 15–25 percent of the urban population and 6 percent of the rural population had access to the financial system. World Bank estimates, which divide the number of people with banking accounts in Mexico by the population, yield a financial penetration rate of 23.8 percent.

² Data in this section are drawn from "The Urban Unbanked in Mexico and the United States," by John P. Caskey, Clemente Ruiz Durán and Tova Maria Solo, World Bank Policy Research Working Paper no. 3835, February 2006.

³ In Mexico, informal providers of financial services include moneylenders, family members, and rotary savings and credit associations, as



well as many bill paying, money exchange and check cashing services. In this article, informal institutions are generally those whose transactions are not captured directly by national accounts data and do not pay taxes. Formal financial institutions include commercial banks, savings and loans, and finance companies.

⁴ Banco de México information, as reported in "The High Cost of Being Unbanked," *AccessFinance*, February 2005.

⁵ See "Mexico Emerges from 10-Year Credit Slump," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, May/June 2005, and

"Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert V. Bubel and Edward C. Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2002.

⁶ Before 2007, finance companies existed solely as *sofoles*, or Sociedades Financiera de Objeto Limitado. *Sofoles* not converting to a *sofomes* charter continue to be regulated by the CNBV.

⁷ At the time this was written, the peso-dollar exchange rate was 10.23.

⁸ "Éxito de Azteca, Bancarizar a Estratos de Ingresos Bajos," by Alicia Salgado, *El Financiero*, Nov. 3, 2005.

⁹ The countries are Brazil, Honduras, Peru, Guatemala, Panama and El Salvador. The retailer already had operations in four of the six countries and could use existing retail locations to offer banking services. In the other two countries, Brazil and El Salvador, Elektra is entering both the local retail and local banking market.

¹⁰ The Federal District has a ratio of deposit accounts to people greater than 1. This probably reflects people who work and bank in the Federal District but live in a suburb.

¹¹ See *Diario Oficial de la Federación*, "Resolución por la que se autoriza la organización y operación de una institución de banca múltiple denominada Banco Wal-Mart de México Adelante, S.A.," Dec. 9, 2006. Although this resolution is more detailed than that for other retailers with banking subsidiaries, the requirements are similar.

¹² The separation of banking from commerce in the U.S. has a long and complex history. The National Bank Act of 1863 prohibited national banks from owning equity securities and enumerated the activities in which these banks could engage. The Bank Holding Company Act of 1956 prohibited banks from engaging in activities not closely related to banking. However, although industrial loan companies, or ILCs, are similar to banks, those meeting certain conditions may be owned by commercial entities.

For more on ILCs, see "Industrial Loan Companies: A Growing Industry Sparks a Public Policy Debate," by Kenneth Spong and Eric Robbins, Federal Reserve Bank of Kansas City *Economic Review*, Fourth Quarter 2007. For insight into the debate about retailer-owned banks, see "The Mixing of Banking and Commerce: A Conference Summary," by Nisreen H. Darwish and Douglas D. Evanoff, *Chicago Fed Letter*, November 2007.

¹³ The 2005 data are from "Microfinance in Latin America and the Caribbean: How Large Is the Market?" by Sergio Navajas and Luis Tejerina, Inter-American Development Bank, November 2006. The 2006 data are from an April 2008 update of this survey.

¹⁴ Microfinance is often defined as the provision of a broad range of financial services to low-income households and their microenterprises. This definition has been liberally expanded in Mexico to include unbanked small- and medium-sized enterprises. Unregulated microfinance institutions in Mexico generally offer only credit products to their customers.

¹⁵ See "Experimental Evidence on Returns to Capital and Access to Finance in Mexico," by Robert Cull, David McKenzie and Christopher Woodruff, World Bank, Feb. 12, 2007.

¹⁶ In Mexico, development bank Nacional Financiera defines business size by the number of permanent employees. The definitions are different for manufacturing, commerce and service industries.

¹⁷ For example, see "Banking Services for Everyone? Barriers to Bank Access and Use Around the World," by Thorsten Beck, Asli Demirguc-Kunt and Maria Soledad Martinez Peria, World Bank Policy Research Working Paper no. 4079, December 2006. Of the 193 banks in 53 countries covered by the study, Mexican banks performed below the median on most measures of access and affordability, including those for fees on checking accounts, minimum balances for checking and savings accounts, the number of documents needed to open checking accounts, the cost of consumer and small business credit, the days needed to process credit applications and ATM fees.

¹⁸ For example, the May 2007 IMF Country Report for Mexico finds that although financial system regulation is improving at an impressive rate, the regulatory and supervisory system continues to be complex and compartmentalized, leading to high compliance costs.

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