

## Beyond the Border

# Mexico Emerges from 10-Year Credit Slump

Since the Tequila Crisis of 1994–95, one of Mexico's most persistent and striking economic contradictions has been a recovery in economic growth coupled with stagnation in bank lending. This contradiction has fueled increasing concerns about bottlenecks within Mexico's production chains and about what some analysts view as expansion rates below potential.

Lending typically declines in the wake of a financial shock, and Mexico's Tequila Crisis was no exception. Mexico's currency lost half its value in just a few months. The interbank interest rate rose some 60 percentage points, to over 90 percent, and remained above 20 percent until late 1999. Mexican banks needed most of their resources to resolve problem assets, leaving little room for new lending.

Even worse, credit extended by Mexico's banks continued to fall long after the national economy had recovered. Compared with other countries in similar circumstances, Mexico's stagnation in lending has been unusually severe and long-lasting.<sup>1</sup>

However, Mexican banks report that business loans began to grow substantially in fourth quarter 2004 and that healthy growth rates continued through the first quarter of this year, signaling a possible reversal of the credit slump of the past 10 years. We address the credit slump's possible causes, its implications and what the nascent loan upturn seems to be telling us.

### Globalization and Bank Credit

A vibrant banking system that growing businesses can turn to for credit facilitates firms' entry into previously segmented markets, enhancing competition. The availability of finance promotes economic freedom by enabling entrepreneurs to leverage resources in pursuit of business opportunities.<sup>2</sup> Similar considerations apply to consumer credit, which

can help individuals tap future income for present critical needs, such as housing and education.

Three years ago, in this same publication, we advocated financial globalization, using Mexico's banks as a case study.<sup>3</sup> We concluded that the growing prominence of foreign firms in the Mexican banking system (*Chart 1*) was not cause for alarm, but would promote world-class banking practices, enhance financial competition and result in greater financial stability. This was not to say Mexico's banking system was in particular need of foreign involvement, but rather represented our view that international competition can promote economic and financial rigor in any country. Our analysis contrasted sharply with globalization's detractors, who broadly claim foreign influences and international linkages are harmful.

Today, many of the benefits we claimed would result from the international openness of Mexico's banking system have been realized, but business lending has been slow to resume. In particular, evidence suggests that certain

small- and mid-sized Mexican businesses have lacked adequate financing, resulting in bottlenecks in the production of key goods and services and holding Mexico's economic competitiveness below its potential.<sup>4</sup>

It is in this context that the recent upsurge in business lending takes on particular importance. Consumer lending has been growing rapidly for many years now, but business lending was relatively restrained before the fourth quarter of last year, when real year-over-year growth reached 15 percent (*Chart 2*). Through the first quarter of 2005, aggregate business loans continued to grow strongly at a rate of 17 percent.

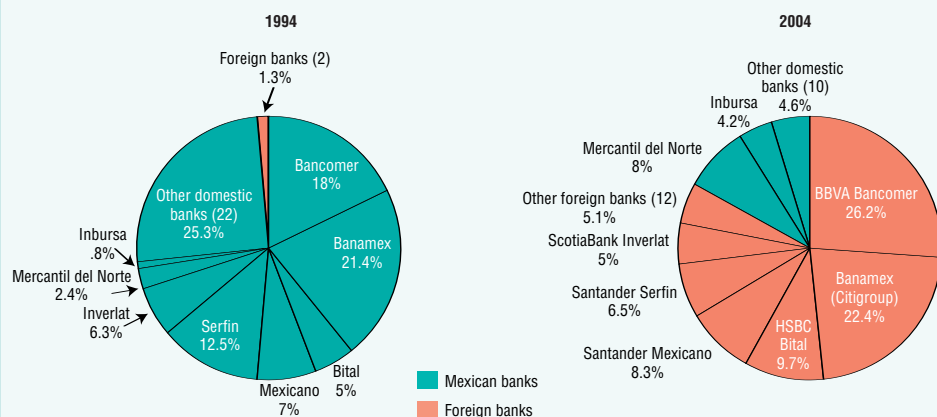
### Crisis and the Beginning of Reform

A few years prior to the Tequila Crisis, Mexico privatized its commercial banks after a decade of government ownership. During that decade, the banks had channeled most lending to the federal government. As a result, credit and market risk assessment were minimal.

Once privatized, the banks took

Chart 1

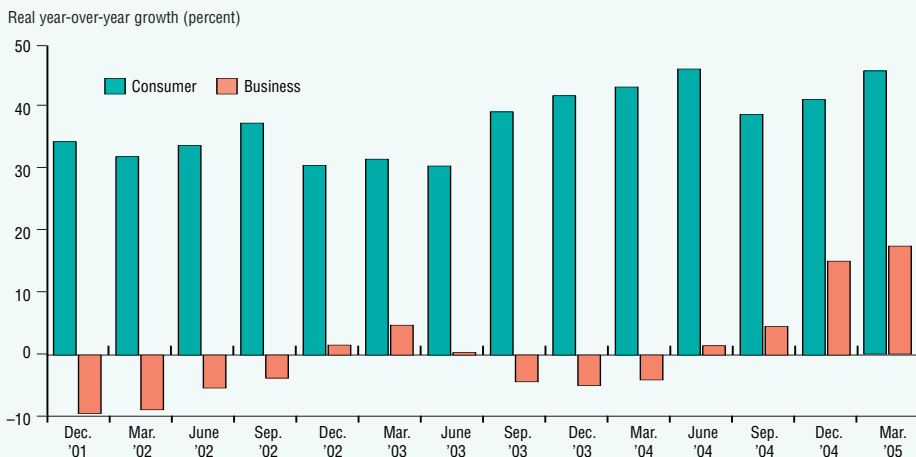
### Globalization of Mexican Banking



SOURCE: Comisión Nacional Bancaria y de Valores.

Chart 2

### Loan Growth in the Mexican Banking System



NOTES: Government interventions and loan sales preclude accurate and consistent calculations of year-over-year loan growth prior to 2001. Consumer loans do not include mortgages. As of year-end 2004, real year-over-year growth in mortgage loans was 2.4 percent, the first real increase in six years. As of March 31, 2005, mortgage loan growth was sustained, with a portfolio increase of 5.3 percent year-over-year in real terms.

SOURCE: Comisión Nacional de Bancaria y de Valores.

steps to generate high returns and justify the steep auction prices at which they had been bought. The result was high-risk lending to the private sector. Incomplete legal enforcement of financial contracts, an underdeveloped system of supervision and regulation, an implied unlimited government guarantee of bank liabilities and the banks' own inexperience in assessing the risks associated with lending to the private sector aggravated the problem. Bank lending expanded at an average annual rate of 25 percent from 1989 through 1994, resulting in a quadrupling of bank credit as a percent of GDP.

Bank credit to the private sector serves a vital economic role when properly extended, but this undisciplined explosion in lending gave rise to imbalances. At the end of 1994, Mexican banks' risky loans became more precarious with the collapse of the peso and subsequent jumps in inflation and interest rates. The Tequila Crisis devastated the ability, and in some cases the willingness, of borrowers to repay their debt. The banks' financial condition deteriorated severely.

Government programs to support the banking system took on a variety of forms. The government initiated pro-

grams to improve bank balance sheets by easing debtor burden. Discounts on loan balances and future payments were offered. Their cost was shared by the government and the banks. For the most part, the general public regarded these programs with indifference.

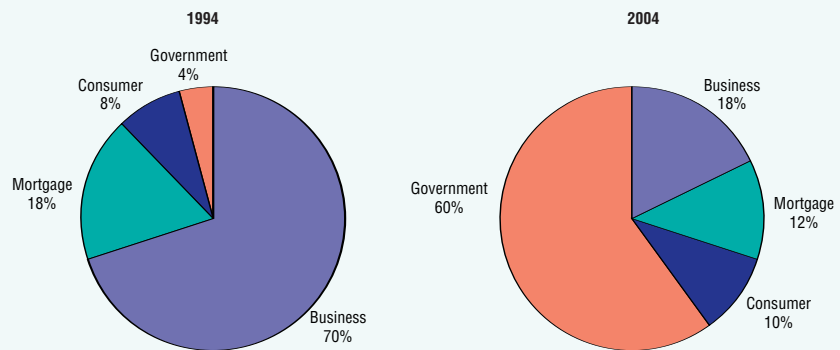
In contrast, the government's forbearance policy for the banks themselves was wildly unpopular. The public viewed it as a taxpayer bailout of bank shareholders. Under the Loan Purchase and Recapitalization Program, the government gave the banks good bonds in exchange for bad loans. Suspicions were widespread that many of the loans were granted or defaulted upon fraudulently or had been extended to insiders. These bonds helped prevent failure, but their high volume and nonnegotiable nature constrained liquidity (*Chart 3*). At the hardest hit banks, shareholder value was substantially reduced or even eliminated.

The crisis' effect on the banks led many to question their privatization. There is much evidence that the source of bank problems was not privatization itself, but the lack of regulatory, risk management and legal infrastructure. Whatever its liabilities, the Tequila Crisis highlighted these problems and motivated change.

*The Tequila Crisis devastated the ability, and in some cases the willingness, of borrowers to repay their debt. The banks' financial condition deteriorated severely.*

Chart 3

### Bank Loan Portfolios in Mexico



NOTE: The government category includes the government notes issued in resolving the banking difficulties of the mid-1990s.

SOURCE: Bank of Mexico.

*For most of the largest banks, full balance sheet recovery did not occur until foreign banks began to purchase them. These purchases, which commenced in 2000, often involved infusions of capital.*

### The Promise of Sustained Loan Growth

An examination of the primary problems inhibiting growth in lending activity over the past 10 years reveals substantial progress toward resolution, suggesting the recent widespread growth in lending will continue.

**Reparation.** The fallout from the Tequila Crisis explains banks' initial reluctance to lend. Banks had to work out problem loans, raise their low capital levels and engineer a quality-led escape from high funding costs. Other problems included generally inefficient operations and inadequate information technology. In response, the banks streamlined their operations, rationalized costs and generated increased revenue. For most of the largest banks, however, full balance sheet recovery did not occur until foreign banks began to purchase them. These purchases, which commenced in 2000, often involved infusions of capital.

One reason for the delayed business credit recovery involves the nonnegotiable notes the government gave banks in trade for their bad loans. Banks could not sell these bonds and use the proceeds to lend to businesses. Beginning in the fourth quarter of this year, the nonnegotiable notes will begin to mature and will likely be rolled over into negotiable notes. These new notes will provide banks with a fresh source of liquidity, as the notes will no longer tie down

bank funds that otherwise could be diverted to support loan growth.

**Regulatory and Risk Management Infrastructure.** The years following the Tequila Crisis have been a time of profound regulatory change. Mexican regulations now generally conform to international standards—or are even more demanding—in risk management, internal control policies and loan provisioning.

At the time of the Tequila Crisis, and for many years thereafter, credit bureaus were not fully developed and banks did not use them. However, a subsequent regulatory change requires banks to obtain, review and document a borrower's past repayment performance and current financial situation before making a loan. Consumer and mortgage loans extended without following these procedures are subject to a specific reserve requirement equal to 100 percent of the loan balance.

Though reluctant at first, bankers now embrace these procedures. Credit bureaus have grown in importance, and the public now values a good credit rating, helping to establish a positive repayment culture. With the new credit rating infrastructure, consumer lending has experienced strong, sustained growth. Spillovers of these methods and technologies, together with increased regulatory attention on all types of lending, suggest business credit is poised to expand.

**Legal Infrastructure.** Another impediment to loan growth, and secured lending in particular, has been the legal environment. Understaffing and overwork have plagued the Mexican courts. Court personnel, especially judges, tend to be poorly paid. These problems have been particularly acute at the local level. Many bankers and industry analysts feel the local courts are corrupt and susceptible to political meddling. And, until relatively recently, Mexican bankruptcy and collateral repossession laws were vague and heavily tilted in favor of the borrower. As a result, banks turning to the judicial system to collect delinquent loans often found the proceedings lengthy and unfruitful. Before the recent reforms, observers indicated court decisions on foreclosure and repossession required at least five years.

Recent years, however, have ushered in significant improvements in Mexico's legal infrastructure. In 2000, the Mexican Congress passed a law implementing new processes governing bankruptcy and the repossession of collateral. A subsequent reform in 2003 further clarified the resolution process behind bankruptcy and loan default.

Anecdotal reports suggest the laws overhauling bankruptcy proceedings and detailing collateral repossession have proven generally effective and have greatly shortened the time for a decision. Moreover, most such cases now can be resolved outside the court system. These options have also permitted financial institutions to become more adept at working directly with customers in encouraging payment.

Still, in some cases, contract enforcement may be difficult. Property rights systems involve numerous mutually reinforcing institutions. Some local authorities responsible for enforcing property rights in Mexico are still weak, reflecting the country's not too distant history of authoritarian rule. These circumstances may prove difficult to remedy, as they can involve political institutions or informal customs.<sup>5</sup>

Even so, positive financial system developments associated with improvements in the legal infrastructure are not hard to find. Mexico's burgeoning asset-backed securities market is testament to a growing faith in the enforceability of

secured lending contracts. Despite a slight rise in interest rates over the second half of the year, Mexico's securitization market almost quadrupled in 2004, making it the top such market in Latin America. Some examples of new, structured financial transactions include securitizations of truck, auto and credit card loans, as well as municipal and state government debt. Mexico's first mortgage-backed security (MBS) issuance occurred in December 2003. The MBS market increased from a single \$53 million issuance in that year to six issuances totaling \$477 million in 2004. Continued economic and political stability, emergence of new securitization products for a broader group of assets and liberalization of regulations have all worked to increase institutional demand for securitized assets. All this bodes well for continued expansion in bank lending activity.

**Bank Competition.** In their continuing struggle to regain adequate financial footing in the wake of the Tequila Crisis, banks invested in government securities, replaced high-cost time deposits and borrowings with low-cost demand deposits, cut overhead expenses through layoffs, shed unprofitable operations, and pushed up transaction volume and service fee income. Opportunities for further advances along these lines appear rather limited. Net interest margins have thinned and stabilized. With increased accuracy in credit scoring, monitoring and contract enforcement, a return to loan markets seems to be the next step in increasing profitability.

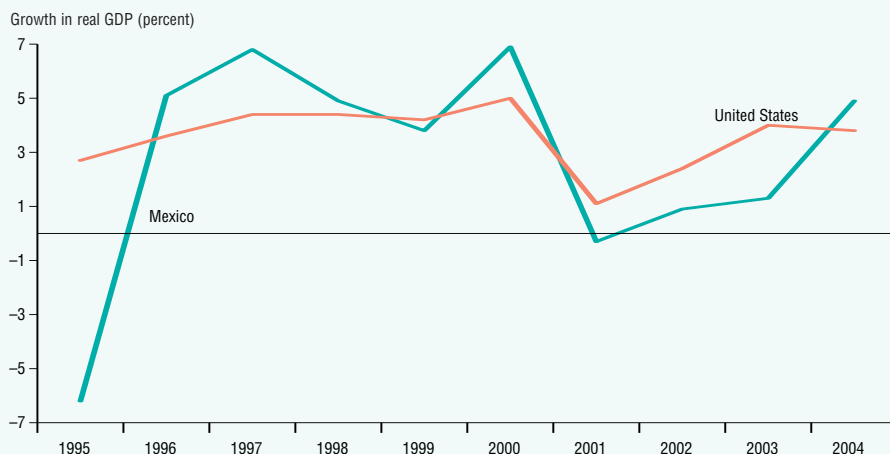
**Economic Conditions and Loan Demand.** In spite of strong economic growth, high real interest rates and price fluctuations did not moderate in Mexico until 1999–2000. By then, business lending seemed ready to grow, but the subsequent economic slowdown in the United States stalled economic growth in Mexico and ended the momentum behind the initial signs of credit expansion.

Fortunately, economic growth has resumed in both the United States and Mexico. The comovement of these two economies partly reflects the unifying effects of 1995's North American Free Trade Agreement in promoting further integration of their business and economic cycles (*Chart 4*). The increase in loan demand

*Recent years have ushered in significant improvements in Mexico's legal infrastructure.*

Chart 4

### Economic Conditions in Mexico Compared with the United States



*By rebuilding capital and improving risk management systems, Mexico's banks have positioned themselves to take advantage of the positive trends shaping business loan demand.*

associated with stronger economic activity should work along with the other factors discussed to generate lasting growth in business loans at Mexico's banks.

#### Outlook

Mexico represents a unique banking opportunity. Macroeconomic conditions are stable and improving, the country's financial infrastructure continues to develop and modernize, and business cycle convergence with the United States should help spur future growth. Slowly but surely, various impediments to the supply of, and demand for, business loans have been resolved. By rebuilding capital and improving risk management systems, Mexico's banks have positioned themselves to take advantage of the positive trends shaping business loan demand. Stable net interest margins and limited ability to raise fees and cut costs will help propel the supply of loans as banks pursue profits to boost shareholder value.

These considerations suggest Mexico's 10-year slump in business lending is over. Lending's rejuvenation is the lat-

est step in the monumental restoration of Mexico's banking system, characterized by sound loan growth and the types of achievements present in the most advanced banking systems.

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#### Notes

- <sup>1</sup> "NAFTA and Mexico's Less-Than-Stellar Performance," by Aaron Tornell, Frank Westermann and Lorenza Martinez, National Bureau of Economic Research, Working Paper No. 10289, February 2004.
- <sup>2</sup> "Financial Markets and Economic Freedom," by Luigi Zingales, in *The Legacy of Milton and Rose Friedman's Free to Choose*, Federal Reserve Bank of Dallas, 2004, pp. 175–89.
- <sup>3</sup> "Financial Globalization: Manna or Menace? The Case of Mexican Banking," by Robert Bubel and Edward Skelton, Federal Reserve Bank of Dallas *Southwest Economy*, January/February 2002.
- <sup>4</sup> Tornell, Westermann and Martinez (2004).
- <sup>5</sup> "Why Institutions Matter: Banking and Economic Growth in Mexico," by Stephen Haber, Stanford Center for International Development, Working Paper No. 234, November 2004.