



# Financial Innovation and the Mexican Experience

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# Innovation is both a response and a contribution to a continuously evolving economic environment

- Financial innovation is anything that reduces transaction costs, offsets financial risks or improves products or channels, among other impacts
- It provides a way to exploit business opportunities, compete and make profits
- As in other industries, financial innovation is an engine of productivity and progress<sup>1</sup>

1/ For a review of the literature on financial innovation, see Tufano, P. (2003), "Financial Innovation." In Constantinides, G., et al. (eds.), *Handbook of Economics of Finance*, volume 1, Part A, chapter 6, pp. 307-335. Amsterdam: Elsevier North Holland

## Higher efficiency and better financial products and services improve welfare and facilitate economic activity

- The road for improvement is not smooth
  - ✓ Not every innovation can be successful
  - ✓ Some innovations can introduce complexity and exacerbate asymmetric information problems, as witnessed by the big financial crisis
- But financial debacles have occurred with and without innovation
- Furthermore, the assessment of innovation should be disentangled from public policies that may have provided inadequate incentives leading to past bouts of financial disarray

# New technologies, financial instability and regulation may be among the triggers for innovation

- Financial innovations have a long history
- The first known financial innovation, in the form of a medium of exchange, dates back to 9000 B.C.
- Some notable changes in recent decades
  - ✓ Automatic Teller Machines
  - ✓ Debit and credit cards
  - ✓ Venture capital and leveraged buyouts
  - ✓ On-line payment systems
  - ✓ Virtual currencies<sup>1</sup>

1/ For a summary of major financial innovations throughout history, see World Economic Forum and O. Wyman (2012), *Rethinking Financial Innovation: Reducing Negative Outcomes while Retaining the Benefits*. Geneva: World Economic Forum

# Adoption of innovations in developing countries has reflected their individual needs

- They tend to be followers in mainstream financial innovations
  - ✓ Their limited development of sophisticated products shielded them in the big financial crisis
- However, large segments of low-income populations push for specific channels and products
  - ✓ Rotating savings and loan associations
  - ✓ Group-based credit products
  - ✓ Retail banking correspondents
  - ✓ Mobile banking

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## In Mexico, stronger macroeconomic fundamentals in recent years have facilitated financial innovation

- Price stability
- Healthy public finances
- Pension system privatization
- Flexible exchange rate regime
  - ✓ Buffer in turbulent times
  - ✓ Discipline for authorities and market participants
  - ✓ Less pass-through to inflation
- Improved framework for financial regulation and supervision



## In a better environment, deep markets and new products have emerged

- Largest FX market traded volume among emerging economies<sup>1</sup>
- Government yield curve in pesos up to 30 years
- Foreign issuer participation in Mexican bond market
- FX and credit derivatives
- Securitization
- REITs and private equity certificates
- Mortgage products, including at fixed nominal interest rates
- Payroll lending

1/Bank for International Settlements (2013), *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2013*. April

## Also, innovative delivery channels have been leading bank infrastructure growth

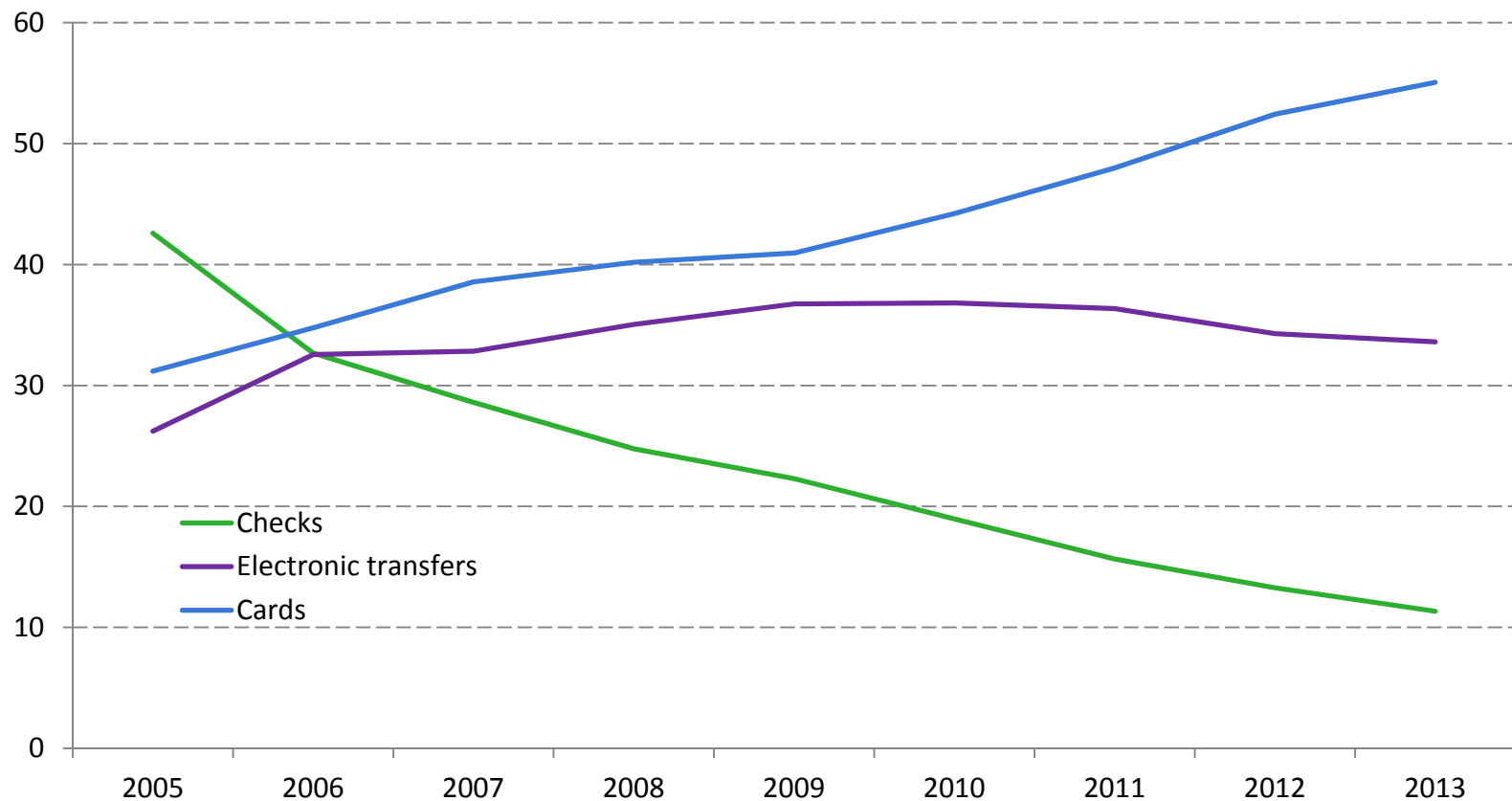
### Mexico: Bank infrastructure % average annual growth

	2003-2010	2011-2013
Traditional branches	6.2	3.7
Retail banking correspondents	--	41.0
Automatic Teller Machines	9.8	3.8
Point of Sale terminals	17.8	12.2

Source: Banco de México and the Comisión Nacional Bancaria y de Valores (CNBV)

## ... and electronic payment methods have been gradually displacing less efficient means

Mexico: Use of payment methods other than cash  
Percentage of total<sup>1</sup>



1/ Total includes checks, electronic transfers and cards

Source: Banco de México

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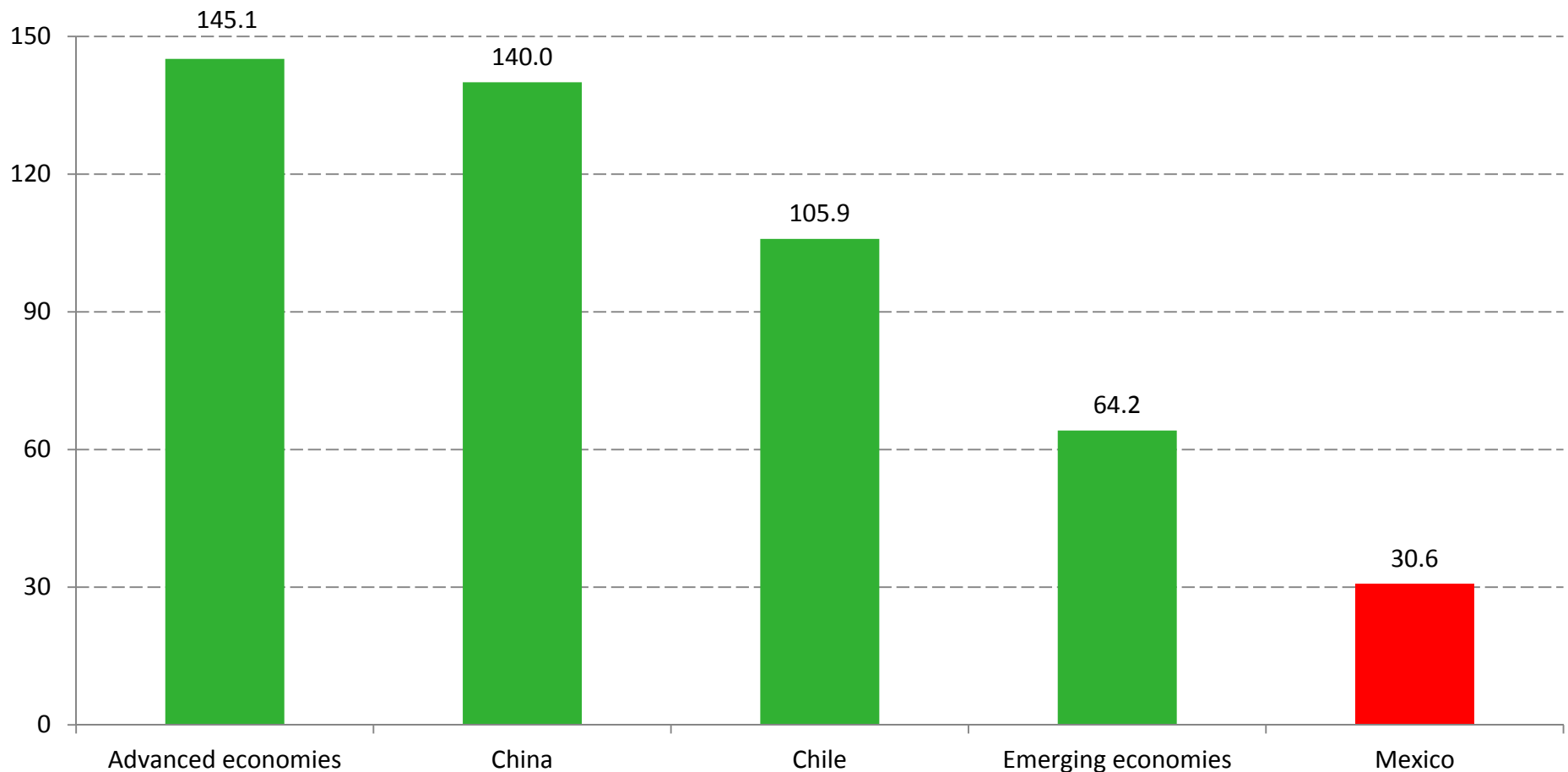
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# Yet, opportunities still abound in Mexico, as reflected in low financial penetration by international standards

Total financing to the nonfinancial private sector in 2013<sup>1</sup>  
% of GDP



1/ Advanced economies include 27 countries, and emerging economies, 30

Source: Own calculations with World Development Indicators, World Bank

## Resulting low financial inclusion has largely affected low-income families and SMEs

- Deposit accounts, transactions through the banking system, and loans per inhabitant and business remain low
- There is an inverse relationship between the lack of access to banking services and household income or company size

# Mexico is in the process of tackling the root causes of low financial deepening and inclusion

- Underlying problems
  - ✓ A weak rule of law
  - ✓ Widespread informality
    - Small transaction size, deficient business information, and lack of credit history
  - ✓ High telecommunication costs and limited transport infrastructure
- Recent major policies
  - ✓ Financial reform
    - More effective property-rights protection
    - Promotion of competition
    - Improved regulation
  - ✓ Other structural reforms: labor, education, competition, telecommunications and energy

## Macro foundations and reforms set the stage for further innovations to multiply in financial markets

- Debt trading through electronic platforms
- Attractive schemes for foreign investors to hold peso-denominated corporate bonds
- Term repos
- Extending the electronic payments system to a 24 x 7 basis



## ... and better align products and services for consumers and small businesses needs

- Use of alternative information to evaluate creditworthiness
  - ✓ Big data: bank activity, payments history and social networks
- Massive supply of standardized credit products
- Mobile banking
- Promotion of POS cell phone terminals by retail store suppliers
- Incipient peer-to-peer lending

## Finally, the role of the financial authorities is essential for innovation to be sustainable

- Possible dangers from innovation
  - ✓ Excessive risk taking
  - ✓ Fraud
- Tasks for the financial authorities
  - ✓ Fortify economic fundamentals and regulation and supervision
    - Seek the right balance: excessive regulation could make innovation too costly
  - ✓ Promote competition among intermediaries
  - ✓ Enhance information availability and the interconnectivity of service providers

## Concluding remarks

- Worldwide benefits from innovation have outweighed costs throughout history
- Significant advances in Mexico relate to the development of financial markets and new retail products and channels
- Mexico is in the process of tackling the root causes of low financial deepening and inclusion
- Macro foundations and reforms set the stage for further innovations to multiply
- Innovation requires the authorities to watch risks and strengthen the financial framework



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