ORIGINAL SPANISH VERSION . . .

Bank Foreclosure Law Reform and the development of Mexico

***Comercio Exterior* (“Foreign Trade” magazine),**
Vol. 55, Number 1, January 2005
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Current political and economic environment in Mexico

The lack of results of the current Mexican administration has given rise to a generalized sentiment of frustration and disappointment in society. Great debate has occurred in all arenas regarding the causes for economic stagnation. Some blame the legislative power and its reluctance to pas the executive-proposed reforms to the energy sector, the fiscal regime, the social security and the telecommunications laws, just to mention a few. Others, mainly the parties opposite to the one currently in office, hold the executive branch of the federal government accountable for the *impasse*, wielding the argument that such proposals are harming to the country, lessen Mexico’s sovereignty and, generally, represent a setback to certain social “conquests”, since they do not attend to the social needs of the country. To be sure, the majority of the population only have a vague idea about the content and the intent of such reforms, thus becoming easily influenced by the disqualifying arguments brought forth by the various opposing groups.

Under the present circumstances, the reform initiative for the Bank Foreclosure Law can be presented as a viable alternative for a quick approval, firstly, because of its positive effect it would have upon the economy and upon the standard of living of the population, and secondly because it may confront less political pressures in light of the lower number of groups who have expressed opposition to it.

Comparison between Mexican foreclosure law and those found in other countries

The underlying principle upon which a bank loan is borne in all developed countries is that if the debtor misses her debt obligations, the lender takes fairly immediate control of the asset representing the loan’s collateral. Once in possession of such guarantee, it is presupposed that the lender can easily liquidate it in order to recoup the loan outstanding amount. In this line of reasoning there is, then, the implicit assumption that the debtor is fully aware of the risk she is about to undertake by assuming a loan under her full free arbiter.

The current Mexican laws addressing foreclosure, in stark contrast with those prevailing in many foreign countries, do not easily enable lenders to recoup their losses whenever the borrowers do not meet their financial obligations. The *legal-shelter* recourse (or *abeas corpus*, in Latin) available in Mexican Constitutional law, has been frequently resorted to by morose debtors over the last decades, with the ensuing decision on the part of the courts to initiate a lengthy court proceeding in which the validity of the lender's rights to take possession of the collateral is questioned. Even when such court proceedings eventually end up in a ruling in favor of the lender, they take a long time which translates into high costs for the lender. For example: Who assumes the risk that results from the aging of the collateral asset? Not only is the lender confronted with the risk of interest and principal non-payment on the part of the debtor, but it also faces the possibility that the guarantee itself might be insufficient to cover the amount owed due to deterioration. As a result of this unfortunate chain of events, the lending risk is increased for the lenders, and along with it the rates of interest. Even with a more vigorous competition[1] among the bank and special-purpose non-bank banks ("*Sofoles*", in Spanish) now in place in the country, lenders are reluctant to lend, and this is reflected in the *risk premium* that is evidenced by the current interest rates. The foreclosure law reform would address the fundamentals of such issue.

Proposed Reform

On the basis of the above, it is herein proposed that the Mexican Foreclosure Law be reformed with the inclusion of the following basic statement:

> "Lenders shall make the transfer of ownership of the collateral assets pledged by the borrowers effective without the possibility for the borrowers to resort to legal shelter (*abeas corpus*) and without the need for judicial order, as soon as borrower has incurred nonpayment on the due loan's interest for over sixty (60) calendar days as long as the lender has duly informed the borrower, in writing and with acknowledgment of receipt, at least thirty (30) calendar days before making such ownership transfer effective in favor of the lender."

It is worth highlighting here that the reformed law would become effective on the date of its approval by the legislative power, and would thus not be applied retroactively to the preexisting loans, in order to minimize the political opposition which this reform might

[1] The Herfindahl Index is calculated as the sum of the squares of the market shares of each participant in the market for a given industrial sector. This index measures the monopoly or oligopoly power exerted in the market. In general, a Herfindahl Index over 0.1800 indicates the market is unduly concentrated. A limiting value of 1 for the index implies the presence of a monopolist in the sector. The value of this index for the Mexican banking sector has been calculated as 0.1609 (see Exhibit 1), which reveals that, in the best of cases, there is limited competition which might insinuate collusion among the bank participants in the market. This last risk, however, may be resolved thanks to the evolution and diversification of the Mexican non-bank-banks ("*Sofoles*", or "limited object financial entities") and with the arrival of new banking entrants in the sector, as will be described soon in the paper.

stir. As the new Mexican politician breed would put it: "The direction would be corrected, although the problem with what is already loaned would not change".

Economic and social effects of the proposed Reform

In "The Force of Finance", Reuven Brenner identifies the grave obstacle the absence of a liquid, competitive and accessible credit market represents for economic development in countries like Mexico[2]. Following Brenner's line of thought, it may be worthwhile to cite many practically immediate benefits which could be expected from such a reform to Mexican Foreclosure Law:

a) *Economic Growth*. By reducing the risk of nonpayment, the reform should induce a reduction in interest rates. Such effect would enable a large number of individuals to undertake a loan to acquire real estate or a durable good with the ensuing lower monthly payments. The productive activity of the country would be thus increased through the demand of durable and capital goods. This interrelationship becomes manifest in the following example:

   Currently an affordable house at the bottom of the pyramid costs approximately 150,000 *pesos*[3] an the effective interest rate for 30-year mortgage loans stands at approximately 14% p.a. or, equivalently, to about 1.1% per month, which translates into an approximate monthly payment of 1,680 pesos (*please, see Table 1*). If one considers that the portion of income a low income prototypical family may allocate to housing is in the order of 40%, this would mean that a family entering into such mortgage would have to have a monthly income of about 4,200 pesos. Upon the proposed reform's entering into effect, it could be expected to see a drop in mortgage interest rates to about 10.3% p.a., or about 0.83% per month[4].

   As a result of this drop in the interest rate, the hypothetical monthly payment for such a mortgage would drop to about 1,299 pesos, a 22.7% reduction in monthly cost. The threshold family income required to entered in such a mortgage would then be 3,247 pesos per month, which represents an increase in the number of qualified buyers, or potential housing demand for such homes of 2.4 million houses[5]. Other productive sectors for consumer durable goods and the rest of the real estate market would a similar increase in their demand. Such sectors, by increasing their production, would reactivate production of intermediate goods, with the

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[2] Reuven Brenner, The Force of Finance, Texere LLC, 2001, pp. 33-58
[3] Based on average prices for affordable housing as established by INFONAVIT, the Institute for National Promotion of the Workers' Housing, a federal lending agency for affordable housing
[4] See the calculation in Exhibit 2 of this paper.
[5] Calculated on the basis of data from the INEGI National Survey of Income and Expenditure for the third quarter of 2002, see Table 2

ensuing surge in hiring. The materialization of the demand for 2.4 additional affordable homes would create at least 2.3 million direct jobs[6].

TABLE 1: LOW INCOME HOUSES PRICES
(figures in thousands of Mexican pesos)

STATE	AUTHORIZED PRICE	SALE PRICE, FINAL	BUILT AREA (m^2)
	AVERAGE	AVERAGE	AVERAGE
AGUASCALIENTES	155,330.00	217,623	56.10
BAJA CALIFORNIA	264,665.36	221,930	45.90
BAJA CALIFORNIA SUR	199,081.60	187,156	49.73
CAMPECHE	202,500.00	154,279	44.70
CHIAPAS	202,916.74	185,688	53.49
CHIHUAHUA	210,186.20	213,455	48.98
COAHUILA	209,683.36	201,632	54.28
COLIMA	185,150.00	212,148	55.61
DISTRITO FEDERAL	393,593.21	380,716	58.24
DURANGO	180,792.00	179,252	48.94
GUANAJUATO	300,134.19	231,309	60.41
GUERRERO	189,995.00	301,545	67.86
HIDALGO	215,000.00	226,151	57.51
JALISCO	253,923.48	256,002	55.24
MEXICO	312,174.92	251,320	54.35
MICHOACAN	235,000.00	227,585	52.64
MORELOS	306,454.55	222,723	61.91
NAYARIT	217,400.00	256,280	50.85
NUEVO LEON	302,150.52	256,006	58.98
OAXACA	281,750.00	217,474	50.45
PUEBLA	225,017.65	231,836	63.45
QUERETARO	246,275.00	240,823	57.26
QUINTANA ROO	247,160.00	235,712	53.92
SAN LUIS POTOSI	252,142.34	208,305	57.44
SINALOA	161,773.33	180,961	45.74
SONORA	215,452.13	210,783	54.01
TABASCO	0.00	219,945	54.21
TAMAULIPAS	228,526.83	197,400	49.44
TLAXCALA	0.00	188,211	57.32
VERACRUZ	0.00	206,311	52.87
YUCATAN	154,032.00	271,625	89.57
ZACATECAS	0.00	206,816	54.03
NATIONAL AVERAGE	204,633.14	224,969	55.48

[6] Corporación Geo, one of the leading construction companies in affordable housing, shows 3,400 jobs on its payroll and 25,000 temporary jobs on construction sites and has the capacity to develop 30,000 houses in the year 2004. If this ratio is extended sector-wide, in gross measure, it implies that in order to build 2.4 million houses a contingent of 2.3 million jobs would be required.

TABLE 2: HOUSEHOLDS AND THEIR MONETARY INCOME

MONETARY INCOME	
	NATIONAL TOTAL
Decile	Monthly Average of the Monetary Income per Household (mexican pesos)
Total	
I	790
II	1,676
III	2,423
IV	3,116
V	3,923
VI	4,881
VII	6,110
VIII	7,906
IX	11,181
X	24,795

Source: Encuesta Nacional de Ingresos y Gastos de los Hogares

This would indeed reduce joblessness, because giving more acquisitive power to a greater proportion of the population increases consumption and creates a multiplier effect. In this sense, the country GDP could show additional significant growth in the short term[7].

b) *Stimulus to innovation and an increase in competition across all the economic sectors of the nation*. There are many talented poor Mexicans who, without access to loans, cannot implement their ideas, many of which could represent powerful innovations to compete with the incumbent oligopolies of the country. (translator's note)

c) *Increase in the formality and the spirit to fulfill their obligations on the part of the Mexican workers and corporate owners.* The signing of a loan contract is an act that every lender practices in an entirely voluntary fashion. Every potential borrower exerts absolute freedom as to whether to engage in the loan contract, fully cognizant of all the terms and obligations

[7] It would be expected that the increase in both consumption and investment would create a multiplier effect on the GDP. At the same time, it may be expected that this increase in the aggregate level of expenditure would not generate inflationary pressure on the economy, since the current existence of unemployment makes it possible to increase the aggregate supply without exerting major pressure on prices. Although the estimation of this effect is beyond the goals of this paper, it is worthwhile to mention the study of Aaron and Muellbauer (*op.cit.*) who, in their analysis of South Africa (an economy very similar to the Mexican one in terms of the housing sector since in the nineties) conclude that the effect of a change in the real prime rate of one percentage point upon the rate of growth of an economy's GDP is about -0.318. In other words, a five percentage point reduction in the real rate of interest, for example from 15% to 10% *per annum*, would stimulate additional real growth of the GDP by one point six percent approximately (see Exhibit 2 of this paper)

established in the accord. Among them is the fact that collateral and loan guarantees could be foreclosed upon by the lender in the framework of the proposed reform. Since the borrower could lose the asset which represented the loan guarantee in the case of payment noncompliance, he/she has a great incentive to work hard and achieve a personal income or increase the available revenue of his/her corporation in order to be able to pay the acquired financial obligation. In economic terms, the moral hazard is reduced whenever the borrower has good reason to meet the conditions contracted by virtue of the loan, lest he/she lose the asset constituting the loan collateral or guarantee.

d) Brenner documents how societies with a developed lending market show a greater sense of responsibility before their social obligations to work and those contracted in the course of business in general[8]. It could even be inferred that the incurrence of loans by the majority of the population could change the pattern of expenditure and savings among the Mexicansa, favoring the latter with its ensuing benefits to the economy. Are Mexicans living in a culture of non-payment or, rather, are they responding to the scarce incentives triggered by the poor legal framework?

e) *Reinforcement of democracy*. Due to the lack of lending market, the majority of the population resorts to alternative financing sources, chiefly public funds, subsidies or special industry supports. This seriously restricts the agents' freedom of action by creating obligations unto them towards the agencies providing them the financing. Other institutions have also set themselves up to become alternative financing sources, such as religious groups and non-governmental organizations which, through their control of financial resources increase their area of influence. One such recurring example is the construction of hospitals, clinics and schools by religious groups in the less developed regions of the country, forcing the local dwellers to adhere to the ideology professed by the financing organization. These practices would be reduced by the existence of a vigorous credit market. Following the line of reasoning of Amartya Sen, Nobel prize in Economics, the power emanating from certain organizations (be it federal or local governments, or any other financing entity with a political agenda) hinders the election ability of the individual in the realms of the economy and politics, becoming long term an obstacle to a nation's development through a sub-efficient allocation of productive resources[9].

f) *Less propensity of the federal government to incur deficit*. The displacement of private expenditure by government deficit is a well known

[8] Reuven Brenner, *op. cit.*

[9] Amartya Sen posits economic freedom as the capacity of the nation's citizens to perform commerce freely, both as consumers and as producers. Every centrally planned economy or operating under a pseudo capitalist regime managed by monopolists inhibits the individual's freedom to choose who to buy from in the most competitive conditions, limits the possibilities of the markets, makes economic exchange costly and reduces the economic well being of society. Amartya Sen, *Development as Freedom,* Alfred A. Knopf, 1999, pp 13-35.

phenomenon. As the public sector shows a greater demand for funds, with a lesser risk for non-payment of its obligations, it prompts the financial intermediaries to channels less resources to the private sector. Not only does this represent unfair competition over limited financing funds, but it also tends to maintain relatively high rates of interest. At the same time, the persistent public deficits may inhibit private expenditures as a result of the higher rates of interest, as a result of a greater supply of government debt.

With the proposed reform, the financing entities would have reason to channel more funds to other productive sectors, given the drastic ensuing reduction in the risk of their loan portfolio. Simultaneously with this, the expected increase in the number of lending institutions would further contribute to a reduction, in a gradual fashion, of the interest rate. This, in turn, would also stimulate the adjustment of the risk premium for each loan to the loan recipient's sector and loan term. The public sector would seek budget equilibration, given its reduced financing possibilities vis-á-vis the relative increase in the yield of private projects to lenders, given the lessened risk of non-payment. The scale would tilt in favor or ever lesser fiscal indiscipline.

g) *More competition in the banking sector.* The absence of enforceable loan guarantees disavows the entry of new participants in the banking sector. In Mexico, banks obtain a great part of their earnings through the fees charged for services not related to the lending of money and, to a great extent, through federal government funding and the receipts on the IOU's of the 1990's banking bailout. Nonetheless, these sources of earnings seem, in the long term, unsustainable, since there is a real limit to the amount of earnings achievable via fees and government funding in an economy without significant growth. The bank's basic function is to hoard resources to make them available to productive, profitable and productive investment projects. The paradox of the banks' profitability without lending to the private sector is due, to a large extent, to the fact that the private banking sector is *included* in the public budget, thus rendering it profitable. The vicious cycle is as follows: on one hand the government assumes as debt the bank's capitalization and, on the other hand, the government must reduce the private sector borrowing possibilities to render the public budget sustainable. The lack of a clear and definitive law on foreclosure procedures may even favor the exit of some of the current participants of the banking sector[10]. The passing of the Bank Foreclosure Law Reform would send a clear signal to all participants. Besides the anticipated large increase in lending in Mexico, the resulting state of law

[10] According to a statement communicated to one of the authors by the director of one U.S. largest banks worldwide, such institution has greatly reduced its presence in Mexico. According to the information provided, the lack of adequate legislation concerning foreclosure and the ensuing lack of growth in the retail lending business in the country render the banking activity in an unstable, unattractive position.

would be enhanced, thus reducing country risk, which should translate into greater direct foreign investment as well.

h) *Increase in taxation through the integration of the informal sector income to the country's taxable base.* Due to the nature of their activities, those in the informal economy do not pay taxes nor have a way to demonstrate income. This fact, in addition to the excessive number of steps and length of time required to get a bank loan, are propitious factors pushing the informal economy sector to seek financing also in the informal sector, who normally charge usury rates. If the formal sector interest rates dropped to levels near or below one digit figures and the access to loans were facilitated by means of the proposed reform, at least part of the informal sector would confront an economic trade-off: Remain in the informal economy without paying taxes, but paying exorbitant loan rates, or enter the formal economy sector paying taxes, but having access to credit at reasonable rates. If the marginal taxation rates over personal income are low, the decision over this trade-off may be favorable to the nation's treasury. Russia, for example, has been very successful with its policy of lowering the marginal income tax rate to 13% for low income individuals, while banks have opened their doors to consumers looking for credit at the same time. This has resulted in millions of Russians asking their employers to report on their full incomes, in order to show the banks proof of cash flow to access mortgages, credit cards and car loans[11].

Groups opposing banking reform

It should be obvious that members of all the political parties realize the urgency of reforming the bank foreclosure law. Nonetheless, the votes in Congress continue to be adverse to the reform. This can be explained by the following two main reasons:

a) The defense of partisan interests in the short and medium term. The possibility of the reform's originating a quick and notable improvement in the quality of life of the majority of the population encourages the political parties opposing the one in office to reject the reform in both houses (H. of Representatives or Deputies and the Senate). They uphold the premise that the citizenry would adjudicate to the current federal administration the resulting economic success product of the reform, making such opposing parties lose ground to the party currently in office. This dilemma is difficult to resolve in a two-house regime and therefore many experts have recommended to change to a parliamentary system[12]. Given its mere

[11] Business Week, June 7, 2004, pp. 54-58. In concurring fashion to the Russian banking reform, the prime minister of the country, Vladimir Putin, has also succeeded in getting the reform on land ownership passed, a key issue linked to the development of a lending market with effective foreclosure abilities for banks, as stated later in this paper. As a result of these measures, the annual GDP growth rate of Russia has been a compounded 6.8% for the years 200-2003.

[12] This regime consists of the popular election of members of a parliament, equivalent to the houses that currently conform the legislative power in Mexico. Parliament then chooses, by majority of vote, the prime minister; in this way the legislative process of law reforming is facilitated because, by counting on the support of the majority of the

nature, the latter system eases the approval process for all initiatives emanating from the executive power.

b) The argument of defense of the exposed lower classes:

1)Some parties point out to the Bank Foreclosure Law as helping the banks, “belonging to unscrupulous individuals who achieve riches through usury, predating on the scarce material goods that belong to the working class’.

In this regard, there are proofs that today, without a reform to the current bank foreclosure law, the working class undergoes predation upon their patrimony by the hands of informal credit institutions who charge exorbitant interest rates, despite the fact that it is precisely such informal sources that the working class can turn to for financing, given the difficult conditions established by the formal banks to grant a loan. On the other hand, it is important to consider that, once the reform is passed, each individual, in full awareness of the possible consequences, shall decide whether to undertake a loan or not confronting the potential loss of the asset acquired through the loan, with the upside potential of being able to rapidly increase his/her patrimony while paying lower interest rates than today. This is why the concept of making the reform non-retroactive is key to this proposal. In fact, this risk-return trade-off, in the form of the ‘possibility of asset loss versus fast material growth for the individual, constitutes the very basis of capitalism.

2) Another argument is that “there is no assurance that the banks would reduce the active rates of interest”. This is to say, despite the fact that the reform would decrease the risk of loans, “banks could take advantage of their prevailing oligopoly position to preserve interest rates high to continue benefiting from wide spreads”.

In order to analyze this argument, it is necessary to start from a fundamental economic principle. A factor that contributes to high prices in a goods market is the presence of monopolies or oligopolies in a productive sector of the economy. In the financial sector, the good that is supplied and demanded is loan-able funds, and its price is the rate of interest. Foreclosure law reform would reduce the lending risk and, in consequence, would diminish the corresponding premium charged in the interest rate. The above would increase the volume of loans in the Mexican economy, which would stimulate the entry by international institutions in the Mexican banking sector. Greater competition would

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members of parliament, the prime minister can have certainty about counting on the majority to pass his/her initiatives. An alternative to the parliamentary system would be the possibility to re-elect the representatives and the senators of the country. In this way, they would be directly affected by their decision in the medium and long term, since they might still be in active legislature in those times, and would thus be incentivized to make decisions beneficial to the country in the long term.

make it costly for the incumbents to preserve high prices, so they would have difficulty to maintain the current margins.

EVOLUTION OF THE REFORM

There were intense efforts on the part of the executive power to obtain legislative approval of the reform in the first half of 2003. Nevertheless, due to the conflicts of interest mentioned above, in particular coming from some members of the legislature, the approved "*reform*" finally did not achieve its key goal of granting complete control of the collateral or guarantee to the lender.

It may be worth mentioning that there were some benefits from the passing of the mild initiative, such as the obligation financial entities now have to disclose with clarity information on the loan terms to potential borrowers, through ample publishing of the terms of a loan before the borrower signs a loan agreement (similar to the Truth in Lending Act of the US – note of the translator).

In a situation in which the lenders do not get control of the collateral asset or guarantee, lenders may anticipate, justifiably, that borrowers have an institutional sphere of opportunity to default on their loans; in consequence, lenders will try to avoid such risk and will be induced to lend less. Although the credit ranking bureau reduces the risk of choosing bad borrowers, the institutional framework invites borrowers (including the good ones) to commit *moral hazard*[13].

ALTERNATIVES TO PROMOTE THE PASSING OF THE REFORM

A determining factor of the failure to pass the reform through the Congress of the Union was the scant and ineffective social communication applied to it. The first step to get the law reform passed is to publicize it amply to gain the backing of the population and to exert pressure over Congress about it. In order to achieve a favorable perception of the reform it is important to analyze the functioning of political rhetoric, so as to see how the proposal would adapt to such rhetoric.

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[13] Financial markets are replete with information problems. Financial intermediaries exist, in fact, only because lenders and borrowers cannot directly perform a direct transaction among themselves, due both to lack of information as well as to the transaction costs they would incur to achieve the corresponding flow of funds. All banking legislation shall aid to resolve the two main problems derived from the *asymmetry* of information problem: 1) the moral hazard, which is the risk that one of the parties (the agent), upon signing of the agreement, may incur activities which hurt the interests of the other party (the principal), and 2) adverse selection, which is the risk that the principal (who issues the contract) chooses the wrong agent (adverse counterparty) from among a set of unrecognizable, mixed, good and bad candidates. Akerlof was the first economist who studied how the markets may not function efficiently due to informational problems. His famous example refers to the problem of adverse selection in the used car market, wherein the sellers do not reveal all necessary information, and in which the buyers are not willing to pay the stipulated prices, mainly because the latter cannot distinguish between a 'good' car (a *peach*) and a 'junker' (a *lemon*). In anticipation of the fact that the car they may acquire could be a lemon, the market does not adequately function: a scarcity of peaches and an overabundance of lemons ensues. This reduces welfare because the prices will not adequately reflect the value of the cars and leave the sellers of peaches unsatisfied since they cannot easily sell their cars at the 'right' price, but it also leaves the buyers of lemons unsatisfied, since sooner or later the y discover that the auto they have acquired is not worth what they paid for it. George Akerlof, "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism", *Quarterly Journal of Economics*, number 84, 1970, pp. 488-500.

In general, all approaches formulated in the political arena appeal to *common sense*, but almost never appeal to their economic viability. Nobody questions the benefit of "providing everyone with adequate supply of water" or ensuring that "all have a dignified and secure job". Political rhetoric concentrates upon the first level of conclusion in the logical thinking process[14]. *Non-linear analysis*, in contrast, is the mechanism that affords the conclusion that not granting effective guarantees for loan recovery to the lenders is equivalent to asking lenders to provide the funds with a willingness to lose the wealth entrusted to them by savers. To provide the necessary guarantees to the lender constitutes a mechanism which protects the borrower, since it widens the fan of credit options at competitive interest rates. In return, nonetheless, the borrower must assume the risk of losing control of the collateral asset or guarantee for the loan whenever non-payment occurs. The *non-linearity* of this reasoning makes it difficult for the general population to have a favorable perception of the reform.

In order to *popularize* this type of analysis, an effective, intense social communication program is needed, constituted by a set of simple concepts of the premise-conclusion type. The main objective would be to eliminate the notion that "the reformed law would defend the banks" and the corresponding need to 'dulcify' it.

Repetition, simplicity and a stimulus to the majority of the population to reach the right, favorable conclusions are the key points of this communications campaign, which in no case would obviate the need for lobbying of the various legislative groups, who in due moment shall be pressed by the citizenry, by then already convinced of the virtues of the proposed reform.

COMPLEMENTARY ASPECTS TO THE PROPOSED REFORM

The proposed reform is reinforced through:

a) The recognition, and as a consequence the adjustment of the corresponding pertinent Mexican legal codes, that the transfer of ownership of assets adjudicated to the lenders shall be prompt and unquestioned. This aspect must be included, in terms of current contract law, in the lending agreement as a contingent cession of ownership at the moment the borrower engages in the loan agreement. The public notary sector of the country and the judicial authorities shall, therefore, participate in the specific wording on the proposed reform to achieve such contractual functionality.

b) A nationwide deeding campaign. Hernando de Soto postulates as the secret to economic development of the nations the granting of public deeds of ownership to each citizen over the land that he occupies, in special when it concerns the irregular settlements around the cities of developing countries[15].

De Soto further states that capital formation occurs when the citizenry in its

[14] Thomas Sowell, *Applied Economics*, Basic Books, 2004, pp. 4-7
[15] Hernando de Soto, *The Mystery of Capital*, Basic Books, 2000, pp. 39-67

entirety enters the formal economy of a country by the recognition of the basic right of ownership of the land occupied by each individual, the former statement not counter to the possibility that the federal government may effect a price (even nominally) over the cession of the land rights to the formerly squatting citizen. This is applicable even in the cases of eviction of squatters from private property with subsequent relocation of such individuals to federal land specifically designated for such purpose, payable possibly in installments, perhaps at symbolic prices. The virtuous and explosive formation of capital is due to the fact that the authenticated property right over the land achieved through deeding to the majority of the population is a predetermining factor for the granting of credit in Mexico, since the ownership of real estate constitutes one of the best collaterals for loans.

CONCLUSIONS

Contrary to what might be thought, Bank Foreclosure reform would result in a significant improvement in the quality of life of the general population, not only being of benefit to the owners of the banking institutions, since the reform would stimulate the agents, both lenders and borrowers, to reach a Nash equilibrium[16] in which a true, efficient, credit market develops reaching the entire population.

In order to obtain the benefits cited in this work it is determining to have a social communication campaign which encourages legislators (through the pressure of public opinion) and opposing groups to seek the benefits that the correct implementation of such a reform would bring about.

It is clear that the foreclosure law reform has been a theme temporarily forgotten in the State renovation agenda and in current Mexican economics. It is important to highlight the significance of this reform as a key element in economic development, and the adverse politicking activity such reform proposal has suffered.

It will be to a great extent through the construction of solid institutional mechanisms, credible and permanent ones, what will enable the economic agents to build their most effective exchange dynamics. It is not surprising then, that voids in the legal and institutional framework inducing undesirable behavior are the causes of scarcity, hikes in prices, lack of quality, violation of each other’s rights and the consequent reduction in the quality of life of the general population. It is, then, urgent for Mexico to attend to these pressing issues with reforms such as the one herein proposed to assure the country’s economic future.

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[16] In a Nash equilibrium there is the confluence of a collectivity of agents with possibly divergent interests, without anyone such agent having incentive to leaving said equilibrium. In this case, the equilibrium between debtors and creditors is Nash, because they will not have any incentive to revert the Loan Foreclosure Law to the current *status quo*.

ANNEX 1

Calculation of the Herfindahl Index for the Mexican banking sector.

The Herfindahl Index has been calculated based on the total asset value of all the banks chartered in Mexico with operations in the period 1997-2003, as shown in Table A1.

IH = Summation of all market shares squared= Sum(Si^{2})

Where: Si = percent of market share for company 'i'

The results show a market concentration in the sector which has increased in the last years, in which the number of participants has been reduced either through mergers and acquisitions (Citibank-Banamex, Santander-Serfin, HSCB-Bital), or by the complete disappearance of a company in Mexico (Banpaís, Fuji Bank, Nations Bank, Societé Genérale).

Table A1

Mexico: Market share of the banking institutions operating in the country, 1997-2003 (in millions of Mexican pesos)

BANKING INSTITUTION	1997		1998		1999	
	Total Portfolio		Total Portfolio		Total Portfolio	
	Balance	%	Balance	%	Balance	%
TOTAL	745,551.89	100%	880,559.95	100%	823,496.86	100%
BBVA BANCOMER	216,483.63	29.04%	244,306.60	27.74%	241,240.47	29.29%
BANAMEX	152,196.66	20.41%	186,244.74	21.15%	178,968.85	21.73%
SERFIN	104,905.24	14.07%	115,679.70	13.14%	140,633.69	17.08%
BITAL	54,812.11	7.35%	56,897.36	6.46%	59,844.68	7.27%
SANTANDER MEXICANO	46,493.49	6.24%	49,618.28	5.63%	50,092.98	6.08%
BANORTE	20,847.05	2.80%	25,003.05	2.84%	26,821.68	3.26%
SCOTIABANK INVERLAT	NA	n.a.	NA	n.a.	NA	n.a.
INBURSA	12,425.65	1.67%	21,999.15	2.50%	20,437.19	2.48%
J.P. MORGAN	2,456.86	0.33%	1,336.90	0.15%	556.55	0.07%
BANKBOSTON	556.90	0.07%	518.14	0.06%	792.55	0.10%
ING BANK	483.15	0.06%	1,460.39	0.17%	2,222.71	0.27%
DEUTSCHE BANK	NA	n.a.	NA	n.a.	NA	n.a.
BANK OF AMERICA	570.95	0.08%	989.39	0.11%	755.43	0.09%
INTERACCIONES	5,997.13	0.80%	3,145.26	0.36%	3,727.56	0.45%
IXE	1,689.15	0.23%	2,481.53	0.28%	3,425.87	0.42%
DEL BAJIO	1,937.44	0.26%	2,912.39	0.33%	2,194.70	0.27%
AFIRME	3,264.16	0.44%	4,991.34	0.57%	3,937.77	0.48%
CENTRO	21,275.87	2.85%	21,304.84	2.42%	19,397.29	2.36%
INVEX	1,114.52	0.15%	1,702.20	0.19%	2,165.34	0.26%
MIFEL	1,381.33	0.19%	2,201.95	0.25%	2,868.97	0.35%
HSBC	497.20	0.07%	604.88	0.07%	935.89	0.11%
BANREGIO	1,173.12	0.16%	1,358.13	0.15%	1,835.54	0.22%
COMERICA BANK	352.57	0.05%	2,409.58	0.27%	2,002.40	0.24%
TOKIO MITSUBISHI	618.63	0.08%	907.47	0.10%	938.21	0.11%
DRESDNER BANK	1,265.56	0.17%	2,413.84	0.27%	2,041. 74	0.25%
GE CAPITAL BANK	218.17	0.03%	1,005.07	0.11%	980.56	0.12%
BANSI	410.95	0.06%	662.72	0.08%	814.79	0.10%
A. EXPRESS	205.09	0.03%	391.25	0.04%	466.36	0.06%
ABN AMRO BANK	246.13	0.03%	536.94	0.06%	279.39	0.03%
BANK ONE	86.23	0.01%	65.76	0.01%	208.03	0.03%
CREDIT SUISSE	NA	n.a.	NA	n.a.	NA	n.a.
BANCO AZTECA	NA	n.a.	NA	n.a.	NA	n.a.
QUADRUM	1,229.34	0.16%	1,411.40	0.16%	NA	n.a.
BNP MEXICO	429.10	0.06%	1,001.91	0.11%	NA	n.a.
BANPAIS	20,098.34	2.70%	27,132.33	3.08%	NA	n.a.
FUJI BANK	684.44	0.09%	830.67	0.09%	NA	n.a.
NATIONS BANK	151.83	0.02%	63.72	0.01%	NA	n.a.
SOCIETE GENERALE	378.22	0.05%	444.54	0.05%	NA	n.a.
CITIBANK	10,755.22	1.44%	24,975.01	2.84%	NA	n.a.
OTHER	57,860.46	7.76%	71,551.52	8.13%	52,909.67	6.42%

Source: "*Comisión Nacional Bancaria y de Valores*", the Mexican National Banking and Securities Commission .

As the index shows, from 1997 to 2003, on average, 80% of the banking market has remained in the hands of 16% of the bank participants, and in this period there have not been significant changes in the particular institutions which concentrate the Mexican banking assets.

With regard to the *Sofoles*, the Mexican non-bank banks with a special object (chiefly, housing credit), the corresponding market is found to be concentrated given the nature of the financings offered by these organizations (please, see Table A3).

If the *Sofoles* expanded their scope of lending and had the possibility to offer financing for investment of any type and in any industry, the degree of concentration of their market would be diminished to a considerable degree. This same diversification would simultaneously reduce the risk of their lending portfolio, to the benefit of the whole industry. The calculation of the Herfindahl Index for both *Sofoles* and banks taken together for the years 2001 and 2002 show that, while the number of market participants is increased on average by 116%, the degree of concentration of market power only gets reduced by 20%, which reinforce the notion that the *Sofoles* only have minimal share in the lending market.

Table A1 (Continued)

BANKING INSTITUTION	2000		2001		2002		2003	
	Total Portfolio		Total Portfolio		Total Portfolio		Total Portfolio	
	Balance	%	Balance	%	Balance	%	Balance	%
TOTAL	941,170.33	100%	917,026.01	100%	986,671.33	100%	964,566.47	100%
BBVA BANCOMER	264,341.45	28.09%	251,613.25	27.44%	247,466.39	25.08%	247,674.34	25.68%
BANAMEX	210,094.54	22.32%	206,202.97	22.49%	189,822.29	19.24%	183,321.03	19.01%
SERFIN	83,145.48	8.83%	73,235.56	7.99%	64,788.43	6.57%	120,617.99	12.50%
BITAL	60,913.17	6.47%	64,403.34	7.02%	120,876.78	12.25%	111,707.64	11.58%
SANTANDER MEXICANO	56,546.20	6.01%	59,473.73	6.49%	67,606.58	6.85%	NA	n.a.
BANORTE	79,684.61	8.47%	81,558.07	8.89%	152,559.76	15.46%	150,210.34	15.57%
SCOTIABANK INVERLAT	43,785.27	4.65%	54,829.99	5.98%	53,918.27	5.46%	59,037.66	6.12%
INBURSA	27,702.30	2.94%	29,672.92	3.24%	43,296.10	4.39%	37,963.02	3.94%
J.P. MORGAN	615.06	0.07%	97.63	0.01%	0.00	0.00%	0.00	0.00%
BANKBOSTON	1,658.77	0.18%	1,928.21	0.21%	1,735.10	0.18%	2,485.43	0.26%
ING BANK	1,302.02	0.14%	1,507.46	0.16%	3,847.46	0.39%	2,626.41	0.27%
DEUTSCHE BANK	0.00	0.00%	29.15	0.00%	0.00	0.00%	0.00	0.00%
BANK OF AMERICA	679.98	0.07%	975.87	0.11%	395.51	0.04%	166.56	0.02%
INTERACCIONES	1,744.47	0.19%	4,074.49	0.44%	2,717.49	0.28%	2,944.43	0.31%
IXE	1,585.70	0.17%	2,836.90	0.31%	3,037.83	0.31%	3,536.90	0.37%
DEL BAJIO	2,922.69	0.31%	4,565.88	0.50%	5,968.98	0.60%	8,622.81	0.89%
AFIRME	3,855.10	0.41%	3,365.31	0.37%	3,395.84	0.34%	4,340.34	0.45%
CENTRO	565.40	0.06%	980.34	0.11%	920.43	0.09%	1,099.75	0.11%
INVEX	2,763.61	0.29%	3,363.29	0.37%	4,394.79	0.45%	4,084.87	0.42%
MIFEL	3,514.46	0.37%	3,356.98	0.37%	3,437.76	0.35%	2,865.74	0.30%
HSBC	1,059.19	0.11%	1,262.67	0.14%	798.90	0.08%	NA	n.a.
BANREGIO	2,976.45	0.32%	2,952.81	0.32%	3,736.67	0.38%	4,329.10	0.45%
COMERICA BANK	2,006.67	0.21%	2,068.50	0.23%	2,458.73	0.25%	2,881.79	0.30%
TOKIO MITSUBISHI	1,304.64	0.14%	1,391.09	0.15%	1,895.33	0.19%	1,552.08	0.16%
DRESDNER BANK	1,089.34	0.12%	1,725.15	0.19%	138.54	0.01%	0.00	0.00%
GE CAPITAL BANK	1,027.56	0.11%	1,708.12	0.19%	3,448.58	0.35%	4,211.17	0.44%
BANSI	1,134.61	0.12%	1,157.76	0.13%	1,012.93	0.10%	1,402.63	0.15%
A. EXPRESS	664.36	0.07%	1,035.38	0.11%	1,722.81	0.17%	2,196.29	0.23%
ABN AMRO BANK	114.23	0.01%	6.76	0.00%	9.96	0.00%	97.54	0.01%
BANK ONE	118.64	0.01%	147.00	0.02%	168.11	0.02%	225.45	0.02%
CREDIT SUISSE	NA	n.a.	NA	n.a.	0.00	0.00%	0.00	0.00%
BANCO AZTECA	NA	n.a.	NA	n.a.	1,094.96	0.11%	4,365.19	0.45%
QUADRUM	2,556.20	0.27%	NA	n.a.	NA	n.a.	NA	n.a.
BNP MEXICO	95.23	0.01%	NA	n.a.	NA	n.a.	NA	n.a.
BANPAIS	NA	n.a.	NA	n.a.	NA	n.a.	NA	n.a.
FUJI BANK	NA	n.a.	NA	n.a.	NA	n.a.	NA	n.a.
NATIONS BANK	NA	n.a.	NA	n.a.	NA	n.a.	NA	n.a.
SOCIETE GENERALE	NA	n.a.	NA	n.a.	NA	n.a.	NA	n.a.
CITIBANK	24,713.94	2.63%	NA	n.a.	NA	n.a.	NA	n.a.
OTHER	54,888.99	5.83%	55,499.43	6.05%				

Table A2 Herfindahl Index for the Mexican banking sector, 1997-2003

	1997	1998	1999	2000	2001	2002	2003
Value of the Herfindahl Index	0.1580	0.1502	0.1735	0.1553	0.1540	0.1529	0.1609
Number of Banking Institutions	35	35	28	33	30	32	30

Table A3 Market share of *Sofoles* in Mexico (balances in thousands of MX pesos)

SOFOLES	2002 Total Portfolio Balance		2003 Total Portfolio Balance	%
Total	**114,713,889**	**100.00**	**124,724,210**	100.00%
Ford Credit de México	27,534,082	24.00%	19,861,607	15.92%
Hipotecaria Nacional	16,920,706	14.75%	22,100,027	17.72%
GMAC Mexicana	17,258,448	15.04%	17,400,742	13.95%
Hipotecaria Su Casita	12,578,707	10.97%	14,125,840	11.33%
Hipotecaria Crédito y Casa	9,764,958	8.51%	11,312,376	9.07%
Crédito Inmobiliario	4,279,367	3.73%	5,254,236	4.21%
General Hipotecaria	3,538,114	3.08%	3,629,240	2.91%
Metrofinanciera	3,252,272	2.84%	4,823,937	3.87%
Patrimonio	2,494,822	2.17%	3,854,197	3.09%
Servicios Financieros Navistar	2,162,089	1.88%	1,997,252	1.60%
Terras Hipotecaria	1,678,505	1.46%	2,027,098	1.63%
Fincasa Hipotecaria	1,628,943	1.42%	2,318,602	1.86%
Hipotecaria México	1,462,122	1.27%	2,019,232	1.62%
Hipotecaria Comercial América	1,493,550	1.30%	2,350,863	1.88%
Servicios de Crédito Associates	1,066,300	0.93%	2,331,180	1.87%
Caterpillar Crédito	1,417,327	1.24%	1,198,857	0.96%
Sociedad Financiera Associates	1,054,697	0.92%	833,526	0.67%
GMAC Financiera	920,663	0.80%	1,803,694	1.45%
Crédito Familiar	759,525	0.66%	0	0.00%
Hipotecaria Vanguardia	657,379	0.57%	1,383,282	1.11%
Financiera Independencia	531,193	0.46%	763,375	0.61%
GMAC Hipotecaria	562,627	0.49%	833,055	0.67%
Financiera Compartamos	445,856	0.39%	592,030	0.47%
Sociedad de Fomento a la Educación Superior	334,336	0.29%	581,785	0.47%
Operaciones Hipotecarias de México	345,412	0.30%	375,260	0.30%
Cemex Capital	203,954	0.18%	276,854	0.22%
Hipotecaria Casa Mexicana	124,895	0.11%	376,026	0.30%
Ficen	118,144	0.10%	84,005	0.07%
Fomento Hipotecario	90,097	0.08%	100,102	0.08%
Corporación Financiera América del Norte	34,520	0.03%	62,419	0.05%
Hipotecaria Associates	280	0.00%	176	0.00%
De Lage Landen Agricredi (Financiera de tecnología e Informática)	0	0.00%	20,060	0.02%
Prime Capital	n. d.	n.d.	21,580	0.02%
Financiera Alcanza			5,511	0.00%
Finamex			0	0.00%
Crédito Progreso			6,186	0.00%

Source: Mexican national Banking and Securities Commission, *Comisión Nacional Bancaria y de Valores*.

Table A4 Herfindahl Index for the Mexican *Sofoles* sector

	2002	2003
Value of the Herfindahl Index	0.1265	0.1048
Number of SOFOLES operating in Mexico	32	36

Table A5 Herfindahl Index for the Mexican banking and *Sofoles* sectors, combined, 2002-2003

	2002		2003	
	Value of the Herfindahl Index	Number of Institutions	Value of the Herfindahl Index	Number of Institutions
Banking Institutions Only	0.1529	32	0.1609	30
Banking Institutions and SOFOLES	0.1241	68	0.1275	66

Annex 2 Calculation of the nominal interes rate expected for Mexican loans

The risk-free interest rate for Mexico, that one given by the *Cetes* (or Mexican treasury bonds), is calculated considering the real cost of money for countries without political risk, plus the political risk premium, plus the expected annual inflation.

Taking the foregoing as a basis, the nominal interest rate is calculated as follows:

$i = r + PI + rp$

where:

i = nominal interest rate
r = real interest rate
PI = expected inflation
rp = political country risk premium

The political country risk premium, measured through the EMBI indicator (Emerging Markets Bond Index), calculated by JP Morgan, has been reduced from approximately 4% (400 basis points) in 2000 to approximately 180 basis points in April 2004, as a result of the institutionalization of democracy in Mexico. The goal for Mexican inflation for this year as informed by the Bank of Mexico is 4%. On the other hand, the measured

United States inflation currently stands at 1.8% annually[1], and the reference rate or fixed mortgage rate for 30 year loans is 6.30% per annum.

The nominal interest rate which could be expected for Mexican mortgages this year, once the loan foreclosure law reform were implemented, would then be:

$i_h = PI + rp + p_h$

where:

i_{he} = nominal interest rate expected for a Mexican mortgage loan

PI = expected inflation

rp = political country risk premium

p_h = real interest rate in the United States, plus the mortgage-specific risk premium in that country

It is therefore necessary to calculate the real interest rate plus the mortgage sector risk premium:

$p_h \sim i_{US\ mortgages} - PI_{US}$
$p_h \sim 6.3\% - 1.8\%$

$p_h \sim 4.5\%$

Then:

$i_{he} \sim 4.5\% + 4.0\% + 1.8\% \sim 10.3\%$ (per annum)

It is clear that, as the Mexican political country risk premium is reduced after the implementation of other legal reforms, included the judicial one, tax reform, and energy reform, the expectation for the nominal rate for mortgage loans should be progressively lower, until a potential 8.5% rate could be reached as the political country risk premium disappeared.

It may also be worth commenting that, should the elasticity of the GDP growth to decreases in the interest rates that Aron and Mueelbauer[2] report were applied to Mexico's gradual decrease in interest rates as a result of the proposed reform, a lowering of interest rates to consumers from 14% to 10.3% per annum in the mortgage market, which is equivalent to a drop in rates of 3.7%, would induce an additional 1.17% growth in GDP during the three years immediately following the lowering of the interest rates as a result

[1] Business Week, May 31, 2004, p. 25
[2] Janine Aron and John Muellbauer, *Interest Rate Effects on Output: Evidence from a GDP Forecasting Model for South Africa*, Center for Economic Policy Research, umber 3595, 2002.

of the implementation of the reform. Considering that the GDP growth rate for Mexico in 2004 was forecast in June 2004 to be 4% annually[3], the implementation of the proposed reform would have a favorable effect on growth of 29% over growth rates currently recorded in the Mexican economy.

[3] "*Prevé SHCP mejor año*" ("SHCP, the Mexican Ministry of the Treasury, forecasts a better year"), *Reforma* newspaper, June 24, 2004.