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Deregulation of non-banking intermediation sector in Mexico: credit, leasing and factoring

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Background

The importance of regulated non-banking financial intermediaries (limited purpose financial entities [SOFOLES], financial leasing and factoring entities) as part of the Mexican financial system has grown considerably.

SOFOLES have focused on lower end segments that were not served or no longer served by banks after the 1995 financial crisis. Between 1995 and 2005 the participation in GDP of SOFOLES' credit portfolios (formed mostly by home loans) grew from 0.7 to 2.75%.

However, during the same period, the portfolio for financial leasing and factoring entities maintained a constant participation in the GDP of 0.2% and 0.14%, respectively. Many blame such lack of growth to regulation.

Amendments to Financial and Fiscal Laws

During the most recent legislative period, a consensus was reached by all political parties that the regulation and supervision of SOFOLES, leasing and factoring entities is imposing a costly administrative load on those entities, which inhibits competition and financial innovation. All of which translates to higher interest rates without providing clear benefits for customers.

On July 18, 2006, the Federal Executive published on the Mexican Official Gazette a

decree that amended several financial and fiscal laws ("Deregulation Decree"). The main objectives of the Deregulation Decree are:

1.- To allow anyone to conduct leasing and factoring operations without authorization nor supervision from Mexican financial authorities.

2.- To give to companies that predominately conduct credit, leasing and factoring operations, the collection and fiscal benefits enjoyed by SOFOLES, Financial Leasing and Factoring entities.

Objective 1: Leasing and factoring for all.

The first objective was accomplished by transferring the leasing and factoring provisions established on Credit Organizations and Ancillary Activities Law (LGOAAC) –a special law- to the Credit Instruments and Operations General Law (LGTOC) –the law that regulates credit operations in general.

Such objective was also accomplished by amending the Foreign Investment Law to eliminate restrictions to the participation of foreign investment in SOFOLES, financial leasing and factoring entities. Such amendment also eliminated the requirement for foreign entities to participate in credit, financial leasing and factoring operations through Mexican subsidiaries.

With such amendments, **any individual or entity, foreign or domestic, may conduct**

credit, financial leasing and factoring operations, without authorization or supervision from the Mexican financial authorities.

However, to avoid risks to the deposits of the general public, Mexican banks and Mexican financial groups are exempted from the deregulation indicated above.

Objective 2: Deregulation of non-banking financial intermediaries: The birth of SOFOMES.

The Deregulation Decree establishes the creation of a “Multiple Purpose Financial Entities” [Sociedades Financieras de Objeto Múltiple] or SOFOMES, which will be able to grant credit, as well as execute financial leasing and factoring operations without authorization nor regulation from the Mexican financial authorities.

At the end of a 7 year grace period, regulated SOFOLES, financial leasing and factoring entities will be transformed to unregulated SOFOMES or will face liquidation

There will be two types of SOFOMES:

- ▶ Regulated Entity. If the SOFOME has a patrimonial nexus to a Mexican bank or Mexican financial group, it will continue to be regulated by the financial authorities. It will be identified by the letters E.R.
- ▶ Non-Regulated Entity. If there is no such nexus with a Mexican bank or Mexican financial group, the entity will be not be regulated. It will be identified with the letters E.N.R.

In same manner as SOFOLES, leasing and factoring entities, unregulated SOFOMES will have the following advantages:

A. Collection

- ▶ Account statements will be considered enforceable and self-executing notes.
- ▶ Authorization to act as trustee and beneficiary in guarantee trust agreements to secure their credit.

B. Fiscal

- ▶ Credit portfolio will not be taken in account for the Asset Tax.
- ▶ Interest generated by transfer of credit portfolio will not generate Value Added Tax.
- ▶ Write-off for uncollectible debts.

To access the fiscal incentives described above, 70% of SOFOME assets must consist of credit-leasing-factoring portfolio or 70% of the income must come from the management of such portfolio.

Funding sources

SOFOMES may obtain its funds from private investors, financial institutions (banks, insurance and bonding companies) and public offerings of debt.

Consumer Protection

The Commission for the Protection and Defense of Financial Services Users (CONDUSEF) will be entrusted to protect and defend the right and interest of users of credit, leasing and factoring services provided by SOFOMES.

Money Laundering Prevention

To avoid money laundering SOFOMES will have to comply with money laundering prevention rules and provide regular transaction information report to the tax authorities.

Conclusion

The deregulation of the non-banking intermediation sector should considerably increase competition and reduce costs. Both aspects should eventually have a reduction of interest rates, which will benefit all sectors of the Mexican economy.

The amendments to the financial and fiscal laws described above, have opened very important opportunities for the financial intermediation sector, both foreign and domestic.

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