Trends and Developments

Contributed by:
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Market Overview and Introduction
In a world where the words of the day are “inflation”, “recession” or “deacceleration”, and where several industries and productive sectors across the globe are starting to feel the blows of the economic climate – brought on by political crises, armed conflicts, rising interest rates, and others – it has yet to be seen whether the Mexican Financial Technology or “fintech” sector will continue to blossom. The Mexican fintech market already had a superb year in 2021, and 2022 was even more record breaking.

This is illustrated by the fact that as of 26 January 2023 there were 650 companies participating in the sector, which represents a 26% increase with respect to 2022 (source: Finnovista Fintech Radar Mexico 2023). Also, Mexico’s market share in fintech-related companies in Latin America is approximately 20.6%, exceeded only by Brazil (source: Business Insider Mexico). Finally, Mexico has become one of the top countries with the most access to venture capital. For example, more than USD3.82 billion were invested in Mexican “start-ups” and “scale-ups” in 2021 (source: Crunchbase).

So, what is the recipe for this achievement, and, more importantly, will it continue? Experts have attributed Mexico’s success in the fintech world to several factors, but a few stand out.

To begin with, Mexico is an extremely underbanked country. Over 60% of the population does not have access to formal banking or financial services and cash continues “to be king” in the country (source: PYMNTS). What does this mean in terms of numbers? Well, Mexico has one of the largest populations in the world… tenth to be precise, and second in Latin America. Moreover, more than 83% of the population is urban, and the median age is 29.2 (source: Worldometer). Naturally, this provides for an eager and robust client base.

Likewise, in the context of the COVID-19 pandemic banks reduced exposure and limited access to credit (source: Konfront). This resulted in the credit market being up-for-grabs and open to new and dynamic players in the form of fintech companies.

Pair the above with the reality that over 75% of Mexico population has access to a mobile phone (source: International Trade Administration) and the stage is set perfectly to allow fintechs to create an efficient business model based on remote digital access.

Other Trends to Watch
As the Mexican fintech market continues to grow, there are a couple of trends that are worth keeping in mind in the upcoming years to see how they play out.

First, is the fact that Mexico’s Central Bank – Banxico – is in the process of developing Mexico’s Central Bank Digital Currency (CBCD), which is estimated to be rolled out by 2025. The idea behind the CBCD is to increase financial inclusion and create a payment alternative to cash.

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Second, in the hunt for providing alternative financial solutions, other business models have come into play. For example, "Buy Now Pay Later" companies allow consumers simplicity and convenience when paying for everyday products, and can be seamlessly integrated with all sorts of retail companies.

Regulatory Framework Summary

The Mexican Congress enacted the Law to Regulate Financial Technology Institutions (*Ley para Regular las Instituciones de Tecnología Financiera*) back in 2018. This law has come to be known informally as the "Fintech Law".

Generally speaking, the Fintech Law regulates these activities:

- "crowdfunding";
- electronic wallets or "e-wallets";
- cryptocurrencies;
- open banking; and
- regulatory sandbox.

That said, the secondary regulations have been rolling out progressively with most being published in 2018 and 2019.

Finally, Banxico published the first regulations in the field of "open banking" in 2020, which only apply to credit information entities and other regulated institutions.

What is or is not a fintech company?

Generally speaking, "fintech" companies do precisely what their name entails: provide financial services/products through technology or technological platforms. That said, the Fintech Law has expressly provided that only certain kinds of authorised entities – known as Financial Technology Institutions (*Instituciones de Tecnología Financiera* or ITFs) – may provide the actual services and products provided by the Fintech Law. The Fintech Law even goes as far as providing that any entities that use, among others, the words "financial technology institution", or analogous in any language, may be subject to a monetary fine.

Financial Technology Institutions (ITFs)

The Fintech Law considers two types of ITFs: Collective Financing Institutions (*Instituciones de Financiamiento Colectivo* or IFCs) and Electronic Payment Funds Institutions (*Instituciones de Fondos de Pago Electrónico* or IFPEs).

Authorisation process

A licence granted under the Fintech Law is required for ITFs to operate as such. Licences are granted by the Mexican Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores)* – CNBV – with the prior favourable opinion of an inter-institutional committee integrated by members of the CNBV, the Mexican Ministry of Finance and Public Credit (*Secretaría de Hacienda y Crédito Público*) and Banxico. In a nutshell, companies that want to operate under the umbrella of the Fintech Law must submit an application before the CNBV. Such application must include, among others, its operation/business model, business plan, shareholder structure and information, prospective board of directors' integration and information, financial viability, and policies and manuals regarding anti-money laundering (AML). Finally, companies authorised as ITFs will be required to comply with minimum capitalisation requirements depending on the specific activities they carry out.

Collective Financing Institutions

IFCs are authorised to conduct "crowdfunding", which is defined by the Fintech Law as activities with the purpose of facilitating contact between the general public – as investing and requesting parties – in order for such individuals to grant financing to each other through information applications or other digital interfaces.

The transactions that may be carried out by the general public through IFCs are:

- collective debt financing – where the investing parties grant loans to the requesting parties;
- collective equity financing – where the investing parties acquire stock of the entities acting as requesting parties; and
- co-title or royalty collective financing – where the investing and requesting parties enter into participation arrangements in which the investing party will acquire part of the assets, income, profits or royalties of a project or activity carried out by the requesting party.

IFCs can only connect the demand and supply of debt or equity as per the above activities; they are expressly precluded from acting as counterparties (ie, a requesting or investing party).

Among other things, IFCs must:

- disclose the selection criteria of the requesting parties, the projects to be financed, and the information and documentation analysed for such purpose;
- analyse and inform the potential investing parties of the overall risk of the requesting parties and the related projects, including general performance and payment indicators; and
- report to credit information companies.

The Fintech Law sets limits to the transactions that may be carried out by IFCs, including the maximum amount of resources that may be requested by the receiving parties and the amounts that may be invested by a single investing party.

Agreements entered into by IFCs with their users, both investing and receiving parties, must comply with financial consumer protection laws aimed at providing transparency and certainty to all parties involved. As of November 2022, Mexican financial authorities had authorised 14 IFCs.

Electronic Payment Funds Institutions

IFPEs may issue, manage, redeem and transmit electronic payment funds through information applications or digital interfaces. In particular, IFPEs may, among others:

- open and maintain electronic payment fund accounts for their clients (e-wallets) where deposits in electronic payment funds may be made in exchange for a corresponding amount in money or other virtual assets;
- carry out transfers of electronic payment funds between clients; and
- facilitate the withdrawal of amounts in cash or other virtual assets by debiting electronic payment funds.

The Fintech Law defines "electronic payment funds" as funds that are accounted for in an electronic registry maintained by an IFPE and which:

- refer to an amount in money (either in Mexican or foreign currency) or in virtual assets;
- correspond to a payment obligation by their issuer;
- are issued upon receipt of the corresponding amounts in money or virtual assets; and
- are accepted by a third party as due receipt of such amounts in money or virtual assets.

Also, IFPEs are authorised to handle virtual assets (eg, cryptocurrencies) and to facilitate their transfer between members of the general public. As of November 2022, Mexican financial authorities had authorised 28 IFPEs.

Cryptocurrencies or virtual assets

"Virtual assets" are defined in the Fintech Law as a representation of value registered electronically used as a payment method, and which may only be transferred by electronic means. Banxico is in charge of issuing secondary regulations on virtual assets. The binding virtual assets rules issued by Banxico in September 2020 are very restrictive and are intended to limit the use of virtual assets by regulated financial institutions, which are only able to use virtual assets in internal operations (keeping clients remote from any related risks).

Through its non-binding opinions, Banxico has expressed that, notwithstanding the limitations included in the rules, "the regulations do not limit the services related to virtual assets that commercial companies can offer". Additional rules are expected in the upcoming years.

The existing framework has a limited scope. Assets such as stablecoins, tokenisations, coin offerings and non-fungible tokens (NFTs) are not specifically included in the current regulation and are only addressed by Banxico in unofficial communications.

Regulatory sandbox

The Fintech Law provides for an authorisation process under a "sandbox model" for companies seeking to engage in new and innovative technological activities or otherwise rendering services that differ from the ones that are already regulated. In particular, the Fintech Law defines an "innovative model" as a model which uses tools or technological means to provide financial services and which has different modalities to those of others in the existing market.

In this context, Mexican companies – unlike ITFs or other financial or regulated entities – may request temporary authorisation to carry out, through an innovative model, an activity otherwise requiring fully fledged authorisation under the Fintech Law. This works as an exemption that allows companies to test out new models and alternatives to provide financial services in a controlled environment.

Open finance

The Fintech Law sets forth specific rules under which any party that is compliant with certain API technical requirements may request any financial entity in Mexico to provide information on their products and services, as well as aggregated statistical information or client transactional data. At present, the regulator has only defined the characteristics such APIs must have to allow a third party to receive "open financial data" – defined as data that contains no personal information, such as details of products, branch locations, etc. Specific rules for transactional data are expected, which will provide an independent and integrated offer of products and services to consumers (as opposed to the current information exchange which is privately negotiated).

Conclusions

In conclusion, Mexico's fintech sector continues to be a beacon of chance and reference in the world. The market is ripe for opportunities as the time and place are just right when it comes to fintech in Mexico. Certainly, there are challenges up ahead in the context of global economic turmoil, but the Mexican fintech market is expected to continue to grow as more and more companies begin to participate and provide digital financial solutions.

Both the players in the industry and the authorities must continue to promote investment by venture capital and private equity funds to bolster growth. Likewise, authorities must be mindful of becoming too protectionist of the sector, so as not to become a significant entry barrier. That said, they must be just when it comes to applying the law, while also seeking for the market to be efficient and innovative.

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Gonzalez Calvillo has been at the forefront of the legal market in Mexico for over 35 years, operating as a full-service leading law firm thanks to its transactional core and expertise in a wide range of practice areas. The firm is recognised for its ability to build cross-disciplinary teams for the most complex legal challenges and long track record of successfully providing ground-breaking legal, business and regulatory advice to high-profile domestic and international companies. Often described as a pioneer of the Mexican legal services industry, the firm is known for its commitment to doing things differently, finding bespoke solutions, and creating transformational legal changes that enable clients to achieve their objectives. For more information, please visit www.gcsc.com.mx

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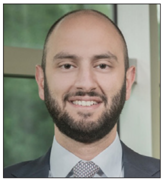

Daniel Guaida Azar has over 14 years of professional experience and has focused his practice on domestic and cross-border project finance, M&A and structuring publicly traded private equity funds, representing clients from a wide range of industries. He has developed expertise in the fintech space advising start-ups venturing into newly authorised banking and financial activities in Mexico and in regulatory authorisations to operate as fintechs. Daniel's experience also includes advising technology start-ups in their initial structuring, funding at different stages and buyouts. He holds a masters from the Instituto Superior de Derecho y Economia in Madrid and obtained his law degree (JD equivalent) from the Universidad Iberoamericana in Mexico City.

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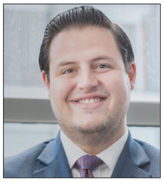

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