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## FINANCIAL INTEGRATION IN LATIN AMERICA

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### EXECUTIVE SUMMARY

**Many Latin American economies have experienced significant reductions in growth recently, as a result of the end of the commodity super-cycle and the rebalancing of China's growth, and a number of global banks have been leaving the region.** Although Latin American countries were generally less affected by the global financial crisis (GFC) than other regions, the region continues also to suffer from the protracted sluggish growth in advanced economies. In addition, there has since 2008 been a withdrawal of global banks from the region, thus potentially worsening access to credit or reducing competition in the financial sector. More broadly, the GFC demonstrated that extreme economic volatility can originate from outside the region, rather than internally, as was the experience of the 1980s and 1990s.

**The timing may now be propitious for Latin American economies to work towards greater regional financial integration.** This would not be a substitute for wider integration in the world economy; some Latin American economies are amongst the most active in global initiatives. However, given the retrenchment by global institutions and limited agreement on global agreements at the present conjuncture, regional financial integration could be a route towards global integration. Regional financial integration could, for instance, facilitate the adoption of best practices by Latin American economies in such areas as supervision and accounting, serving as step towards wider integration at a later stage. It could also facilitate inward investment, enable markets to achieve minimum viable size, and add a dimension of diversification, such that these economies would not rely solely on domestic or global developments, but could reap benefits from the economic stability of other countries in the region.

**There are important ongoing initiatives to foster financial integration within Latin America.** Since 2011 the Presidents of Chile, Colombia, Mexico and Peru have met regularly to take forward the agenda of the Pacific Alliance (PA). Most recently, on July 2, 2015 they issued the Paracas Declaration reaffirming their commitment to foster market integration between their countries. Mercosur, a more long-standing organization, may also revive the momentum of its financial integration agenda. Private sector banks, particularly from Brazil and Colombia, are moving across the region, establishing themselves as regional institutions. Meanwhile, stock exchanges are establishing regional presence: the Integrated Latin America Market (MILA) initiative aims to foster equity and bond market integration across the PA countries. And the Brazilian stock exchange has bought 8% of the Santiago exchange.

**This paper suggests a number of measures to advance regional financial integration in Latin America.** A number of pre-conditions are identified that would enable integration to proceed safely. In addition, a number of barriers are identified that could be progressively reduced and eliminated; proceeding on a regional basis may make it more palatable for instance for a country to relax the limits to which its pension funds may invest cross-border. Opening domestic economies in this way could serve to increase competition, and favorably position Latin American countries for further global integration in the future.

Approved by  
**Alejandro Werner**

Prepared by a WHD team led by Charles Enoch<sup>1,2</sup> and including, Carlos Caceres<sup>1</sup>, Luc Eyraud<sup>2</sup>, Alla Myrvoda<sup>2</sup>, Anayochukwu Osueke, Diva Singh<sup>2</sup>, Ben Sutton<sup>2</sup>, Iulia Teodoru<sup>1</sup> (all WHD), with contributions of LEG (Jefferson Alvares, Wouter Bossu<sup>1</sup>, Barend Jansen, Laura Lorenzo<sup>1,2</sup>, MCM (Marco Pinon<sup>1,2</sup>, Mohamed Norat), and RES ((Camelia Minoiu and Paola Ganum) on the basis of work at headquarters and on missions to Brazil, Panama and Colombia (June 2015) and Mexico, Peru, Chile and Uruguay (July 2015).

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<sup>1</sup> Participated in May/June mission.

<sup>2</sup> Participated in July mission.

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## Glossary

AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ASEAN	Association of South East Asian Nations
BCBS	Basel Committee for Banking Supervision
BIS	Bank for International Settlements
BIT	Bilateral Investment Treaty
BCP	Basel Core Principles
BROU	Banco de la República Oriental del Uruguay
CCP	Central Counterparty
CDIS	Coordinated Direct Investment Survey
CPIS	Coordinated Portfolio Investment Survey
DTA	Double Taxation Agreement
DvP	Delivery versus Payment
ECB	European Central Bank
EM	Emerging Market
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FSB	Financial Stability Board
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GFC	Global Financial Crisis
IFRS	International Financial Reporting Standard
IIP	International Investment Positions
IOSCO	International Organization of Securities Commissions
LA	Latin America
LA-7	Brazil, Chile, Colombia, Mexico, Panama, Peru, Uruguay
LAC	Latin America and the Caribbean
LAMR	Local Asset Maintenance Requirement
MILA	Latin American Integrated Market
MSCI	Morgan Stanley Capital Interactions Index
MOU	Memorandum of Understanding
NAFTA	North America Free Trade Agreement
OTC	Over the Counter
PA	Pacific Alliance
PFMI	Principles for Financial Markets Infrastructures
PPP	Public Private Partnership
RES	IMF's Research Department
ROA	Return on Assets
ROE	Return on Earnings
WTO	World Trade Organization

## INTRODUCTION AND OVERVIEW

**1. Between 1982 and 2002, all major Latin American (LA) economies underwent—in many cases—repeated economic and financial crisis including the Mexican crisis of 1994 that the IMF Managing Director Camdessus called the first crisis of the 21<sup>st</sup> century.** In nearly all cases, the countries undertook IMF adjustment programs (see table 1). The current financial systems of Latin America are to a large extent legacies of the manner in which the various countries responded. In most cases, responses involved the initial nationalization of a significant part of the banking system, followed by sales, in many cases to foreign banks, particularly to those from North America and Europe. Mexico was an extreme example of this, with only one large bank remaining in domestic hands. At the same time, many countries sought to reduce their vulnerability to loss of confidence: in some cases, including Brazil and Mexico, tight limits were put on residents' holdings of foreign currencies and banks' exposures to foreign currencies.

**Table 1. IMF Lending Arrangement with A-7 Since 1982**

Country	Number of programs	Total borrowing (Bil of SDRs)
Brazil	6	41.3
Chile	3	1.4
Colombia	3	0.0
Mexico	5	17.9
Panama	7	0.4
Peru	9	1.1
Uruguay	10	2.8
All IMF programs	371	314.5

Source: International Monetary Fund.

**2. After the LA crises of the 1980s and 1990s many LA countries opened their economies to global financial institutions, reflecting a view that this strategy could bring protection from regional instability, provide much needed capital, and help import managerial and technical skills.** This strategy worked well and, together with gains from the commodity boom and improvements in macro management, growth recovered strongly in most countries; no large LA country needed financial support during the global financial crisis (GFC), despite the exposure to global banks. Indeed, foreign bank subsidiaries in Latin America in some cases provided a source of strength for global balance sheets and in some cases provided liquidity to their overseas parents. This resilience was linked also to the banks' reliance on domestic deposits. Overall, the period since 2002 has seen sustained LA growth: GDP in 2014 in the seven LA countries covered in this report (see below) is estimated to have been 52 percent higher in real terms than in 2002, compared with 25 percent for the United States and 16 percent for the countries of the European Union.

**3. Nevertheless, although Latin America was relatively less impacted by the GFC than other regions, the crisis demonstrated that extreme volatility could also originate from outside the region, and that the region too would be significantly affected.** Weakened in the GFC and facing the costs of additional regulatory demands, reduced profitability and increased funding costs, European and North American banks have been downsizing. In this process some global institutions have left countries in Latin America, and other emerging markets, or markedly reduced their exposures. No new bank from Europe or North America has established a significant presence to replace them. The withdrawal of global banks has led to increased consolidation among leading local banks, for instance in Brazil, potentially undermining the competitiveness of the banking systems and liquidity in the local markets. The pressure on global banks to withdraw may increase further as regulators



implement a range of reforms, including the systemic banks' capital surcharge requirements, the requirements of the Key Attributes of Effective Resolution Regimes of Financial Institutions, OTC reforms and ring-fencing requirements. Most recently, Deutsche Bank has announced its withdrawal from investment bank activities in ten LA countries.

**4. The nonbank financial sector is also challenged.** Volumes and liquidity in a number of exchanges are declining as US regulations for derivatives trading have increased the cost of doing business in emerging markets. For pension funds and insurance companies, regulatory restrictions constraining the bulk of their activities to their domestic markets are causing increasing friction, especially in smaller markets.

**5. There are important ongoing initiatives mirroring private sector trends to complement the strategy of openness to global institutions with increased financial integration within Latin America.** Banks particularly from Brazil and Colombia are moving across the region, regarding themselves as regional institutions with the whole region essentially as their home base. Cross-border participation in stock exchanges is also apparent, with the Brazilian stock exchange purchasing 8% of the Santiago exchange. Non financial corporates are expanding across the region, particularly including retail institutions from Chile and conglomerates from Brazil and Mexico. On the official side, since 2011 the Presidents of Chile, Colombia, Mexico and Peru have been meeting regularly to take forward the Pacific Alliance (PA). Most recently, on July 2, 2015, they issued the Paracas Declaration, reaffirming their commitment to foster market integration between their countries. Mercosur has brought together six LA economies<sup>3</sup> with the objective of integration; although the Mercosur process has stalled recently, conditions may be favorable for a revitalization of the financial integration process.

**6. Regional initiatives are not substitutes for further integration with the rest of the global economy. LA countries are deeply involved in major ongoing global initiatives.** However, the ongoing retrenchment of global institutions from the region could leave countries underfinanced, or with less competitive systems, unless they are able to attract new institutions. Moreover, global agreements, particularly as regards financial integration are not reached quickly, and substantial mileage may be achieved by going further and faster on a regional basis. Indeed, to the extent that regional integration would involve also raising financial standards across the region, it could facilitate wider integration in the future. And integration initiatives bring greater visibility to Latin American economies, and hence possibly greater investment into the region: in September 2015 the Presidents of the PA conducted a joint roadshow around major global financial markets, and the PA was invited as observer to the ASEAN meetings in the Philippines in November 2015.

**7. Currently, LA has less regionally integrated financial markets than other parts of the world.** Latin American financial markets are less integrated than a global average, after controlling for fundamentals. Various factors, including size, history of crises, and regulatory structures, may contribute to this. Integration can help foster depth, and deeper financial markets, at least up to a certain degree, have been shown to positively impact growth, so reducing the integration deficit in

<sup>3</sup> Argentina, Bolivia, Brazil, Paraguay, Uruguay, and Venezuela

Latin America could serve to stimulate growth. As prospects for growth in a number of LA countries, for instance Peru, now hinge on large infrastructure investment projects, mainly financed through public-private partnerships (PPPs), the need for deep and strong financial markets has become even more important.

**8. At least some of the lack of integration of financial markets in LA countries derives from prudential measures adopted after their economic/financial crises of the 1980s and 1990s.**

Several countries including Brazil and Mexico had adopted some restrictive measures even before the crises, many of which remain in place, including for example Brazil's regulations that restrict Brazilians from holding foreign currency domestically, permit foreign banks to enter the country only upon Presidential approval, and allow only 10% of pension fund assets to be invested abroad. The Mexican regulatory framework also provides a schedule of restriction on investment by type of instrument, limiting foreign asset holdings to 20%. In many countries, pension and insurance funds remain heavily constrained in how much they can invest outside the home country.

**9. Many LA economies are now under strain.** In part, this is conjunctural. With the end of the commodity super-cycle boom and the slowdown in China, which had been the key impetus for much of the growth experienced in most of the region, largely countries in South America, meanwhile the effect on Mexico remains limited, there is recognition of the need to find new drivers of economic growth. Amongst possible drivers, financial liberalization and regional integration may help new growth sectors emerge. At a more fundamental level, the reasons for the strain at this point are structural. For instance, restrictions are hampering synergies between the rapidly growing pensions and insurance funds in the region and countries' needs for long-term financing. Legislative and regulatory reforms in a number of LA countries, most significantly Chile, have generated rapid growth in these funds, but domestic capital markets are insufficient to provide efficient investment opportunities. Restricting funds to invest mostly domestically, and avoiding having foreign funds join them in the domestic market, means that financing large domestic initiatives would involve an over-concentration by the domestic funds, which would therefore be reluctant, or unable, to invest on a commensurate scale, putting such investments under threat.

**10. Measures to foster regional financial integration could thus be an important response to Latin America's economic challenges:**

- **Growth for most of the LA has been closely related to the expansion of the Chinese economy, which drove both higher volumes of commodity exports, and the resultant higher prices at which they were sold.** With the slowdown in China and the end of the commodity super-cycle, growth through commodity exports may no longer provide sufficiently strong export support to the region's economies. The prospect of tighter global financial conditions further complicates the economic outlook. New industries will require financing, which in turn will require strong financial markets, both in terms of banking (which still dominates the financial sectors of all LA economies) and capital markets (where pension funds in particular are growing rapidly and could potentially supply much of the financing for the emerging needs of the region).

- **The global banks that have been major players in many LA economies have been withdrawing since the GFC, both because a number were weakened in their home countries and have had to retrench, and because the global regulatory agenda in response to the GFC has increased prudential requirements.** Insofar as the departing banks are not replaced by cross-border institutions, this will imply increased concentration in domestic banking systems, with potential loss of competitive forces, which in turn could undermine the efficiency of the systems. For instance, the purchase of HSBC's retail operations in Brazil, announced in July 2015, by Bradesco, Brazil's second largest private bank, will add to the consolidation of the Brazilian banking sector. Most recently, Deutsche Bank has announced its withdrawal from investment banking activity in ten Latin American countries.
- **There are increasing links across Latin America in the non-financial sector,** not primarily through trade between LA countries but through the cross-border establishment of LA corporates, including some of the major conglomerates. Companies from Brazil, Chile and Mexico have been particularly active in this regard.
- **The intent of the international regulatory agenda has been to reduce overall risks.** At the same time, at least in its initial stages it appears to have inflicted a number of unintended consequences on emerging markets (EMs). The increasing cost of cross-border activities (for instance by requiring haircuts on cross-border collateral and centralizing business on exchanges) and of dealing in markets outside the financial centers has led to shifts in capital market activity towards exchanges in advanced economies. If global institutions and markets withdraw from LA, this may hinder the region from developing new products, which may in turn increase costs of, and reduce access to, finance particularly for second-tier institutions, in addition to potentially transferring intermediation fees outside the region.
- **Increasingly, size matters in building and maintaining financial infrastructures.** IT and legal representation costs, for instance, in order to achieve competitive parity with the major financial centers, may be prohibitive on a national scale for all but the largest LA countries. Without the integration of regional markets, prospects for maintaining active markets in some LA countries may be limited.
- **In the nonbank arena, the ongoing rapid growth of pension and insurance funds in a number of LA economies threatens to overwhelm domestic capital markets.** The limited pool of assets in these markets may be largely held by the funds to maturity, depressing liquidity, and limiting investment opportunities for smaller retail investors.
- **As a corollary, with the next phase of growth in Latin America likely to involve projects with large financing needs, for instance for infrastructure, it will be challenging to finance these solely through domestic markets.** Countries' domestic pension and insurance funds, which are generally subject to concentration limits, may provide an insufficient pool for financing on the required scale. Permitting increased cross border investments by pension funds and insurance companies will enable them to diversify their risks, and thus facilitate the financing of large

indivisible projects. Such an increase in cross-border investment would of course need to be accompanied by appropriate risk management.

- **Also, while ensuring domestic protection from potential cross-border spillovers may have been the most prudent response to the LA crises, regulatory reforms since then provide a complementary route for protection.** In addition to tighter bank capital, liquidity and disclosure requirements, regulators have increasingly recognized the need for consolidated supervision. Consolidated supervision, and conglomerate supervision, together with upgraded MOUs, and colleges of supervisors for all banks with significant cross-border activity, are designed to mitigate the risks of cross-border activity. Macroprudential measures too are increasingly being adopted and refined to address systemic risk concerns and to limit spillover risks from global market volatility.
- **Finally, differences across the region in the speed of application of the new global regulations, as well as continuing limitations on the range of permissible activities, generate their own costs, and lead to anomalies.** In an environment of consolidated supervision, each institution has to follow both home and host regulations, putting banks from countries with more advanced regulations at a competitive disadvantage. And while banks from some countries are able to make cross-border investments, their home countries may not be very accessible to inward inflows. Brazilian Bank Itaú Bank for example takes an explicitly regional perspective for its operations; however, its expansion might be more welcomed in target countries if institutions in those countries found it easier to enter and to do business in Brazil.

**11. In sum, regional integration of banking and capital markets could help counter the negative conjunctural and structural factors presently affecting the region.** Integration creates a larger internal market, thus enhancing competition and potentially fostering economies of scale. It reduces the costs of the withdrawals of the global institutions, serves to diversify the risk exposures of LA economies and makes them less vulnerable to volatility in global markets. Capital market integration would enable pension and insurance funds to diversify their investments, and enable large projects to find a wider range of potential investors. Deeper markets would likely be more liquid, reducing costs and increasing access for participants more generally. Increasing access for regional banks to operate cross-border would enhance competition and enable the spread of best practices. Some form of “passporting” broker-dealers recognized in one country would help the process of establishing a unified capital market, as long as the passported firm would be subject to full supervision in both home and host jurisdictions. Retaining financial intermediation within the region would help markets develop new products, facilitate access for second-tier companies, for whom intermediation on global markets may be difficult, and would serve to generate income from financial market activity. As a prelude, harmonizing tax, regulatory and accounting frameworks would help provide a level playing field, and would also likely stimulate investment from overseas into the region.

**12. Increasing cross-border activity without robust risk management may be considered a potential threat to financial stability, but possible risks can be mitigated.** Enhanced cross-border consolidated and conglomerate supervision across Latin America should enable supervisors to keep track of banks’ and financial conglomerates’ complex cross-border activities. Careful monitoring of intra-group transfers and ring-fencing capital should dampen spillovers from the home countries of

parent institutions. Higher quantity and quality of capital and liquidity requirements should make banks safer. Supervisory and resolution colleges together with signing MoUs should provide early warnings of problems and assist in dealing with those that occur. With this expanded toolkit, countries may be more willing to accept the benefits of regional integration, notwithstanding the initial costs of enhancing the regulatory regime to protect financial systems from systemic risks.

**13. Ongoing initiatives may provide a model for taking regional integration forward. .**

The combination of political and market enthusiasm may make the PA a more successful initiative than earlier regional attempts. The diversity between Mexico on the one hand, as a large manufacturing country, and the other three, medium-sized commodity exporters (Chile, Colombia and Peru), suggests that their integration could bring particular synergies. Among the various PA plans for integration, the Latin American Integrated Market (MILA) initiative seeks to establish a unified capital market. Initial MILA measures have been limited, and activity disappointingly minimal, with the process coming under criticism for achieving few results. Impediments are interrelated, and may require a comprehensive rather than step-by-step removal in order to have an impact. Thus, especially in light of the strong political support, it would be timely to make a strong coordinated push for financial integration amongst these countries and more widely. A coordinated approach to remove the remaining barriers, particularly if based on reciprocity across the PA countries, and more widely in the region, could enable reforms to proceed more effectively, generating significant early results, which would help sustain momentum. Meanwhile Mercosur has been a vehicle for integration across Brazil, Argentina and Uruguay for many years. While it has recently been relatively dormant, factors including the recent changes in external economic policies in Argentina, suggest that this may be a propitious moment for the revival of Mercosur too.

**14. The argument of this paper is that, in response to these ongoing developments, financial integration within LA, with appropriate management of the risks, could bring needed diversification to LA financial sectors, and set the stage for further integration into the global economy as conditions permit.** The process of regional financial integration is more likely to be successful if pursued as a consolidated package, even if gradual, rather than through a continuation of the ad hoc measures that have characterized much of the liberalization process so far. Such integration would diversify the risks to which individual LA economies are exposed. It could also serve to offset the possible loss of competitive forces as domestic financial institutions consolidate their positions in local financial markets. Finally, integration could help foster financial deepening, and potentially attract capital from outside the region. This paper provides some recommendations to facilitate this process.

**15. The aim of this paper is not to propose measures that artificially stimulate financial integration in LA if there is no underlying economic case.** Rather it seeks to identify barriers to financial integration in the region that are a legacy of the past environment, or are the unintended consequences of measures introduced for other reasons, the removal of which could pave the way for regional financial integration, and thereby support growth.

**16. Financial integration has a number of aspects: the cross-border establishment of financial institutions; cross-border investment and portfolio flows; and the integration and unification of financial markets.** The regulatory environment needs to be permissive, with a supportive financial infrastructure, but markets will ultimately determine the extent to which integration actually takes place. Other regions have included financial integration as part of their overall unification objectives, for instance the European Union (EU), and the Association of South East Asian Nations (ASEAN). There have in the past also been attempts to foster economic integration in Latin America, for instance through Mercosur and the Andean Pact, but these did not focus primarily on the financial sector. These past attempts had some successes, but also generated lessons.

**17. This study covers seven LA economies, Brazil, Chile, Colombia, Mexico, Panama, Peru and Uruguay (LA-7).** All are at a relatively similar stage of economic development, and have taken steps to liberalize in recent years. Five are amongst the biggest LA economies; the other two are much smaller, but are closely related. One, Brazil, represents almost half of the entire LA economy, and is somewhat separated from the others, partly because of geography and language but also due to its regulatory regime. Four of the others—Chile, Colombia, Mexico and Peru—are actively engaged in an integration strategy, through the PA and its capital markets component (MILA); their efforts are now at a critical stage. Finally, the two smaller countries (Panama and Uruguay), also have large financial systems, are closely related to their regional neighbors, and have economic prospects that will be greatly influenced by their regional relationships.

**18. The report first looks at possible benefits of regional integration.** It then covers the various sectors of the financial markets: banking; pension funds; insurance; and capital markets in the seven countries. The following chapters look at regulatory and legal barriers to regional integration, and finally at possible measures to contain the risks. Recommendations are provided for each section, and are summarized at the end of this section. An accompanying background paper sets out some quantitative evidence on the benefits of integration, and also looks at some of the issues country-by-country.

### Box 1. Key Recommendations to Facilitate Regional Financial Integration

- Take opportunities for regional integration, in the event of global bank withdrawal/downsizing, when identifying potential purchasers.
- Develop an explicit, open, objective and non-discriminatory statutory and regulatory framework for entry of cross-border financial institutions.
- Ensure level playing fields within countries for domestic and cross-border banks, including by ensuring all banks have access to credit bureaus and deposit insurance.
- Develop stable and transparent tax rules for domestic and cross-border financial activities, where appropriate buttressed by agreements for avoidance of double taxation.
- Harmonize accounting and regulatory frameworks, through consistent implementation of IFRS, timely adoption of a consistent capital definitions as articulated by Basel 3 and Solvency II-type regimes, and explore opportunities for mutual recognition of licensing.
- Introduce and/or enhance consolidated supervision of all banking groups; expand supervisory and resolution colleges to cover all regional banks with significant cross-border activity.
- Introduce and/or enhance conglomerate supervision, and establish regulatory limits for intra-group exposures within banking groups, and between bank and non-bank parts of conglomerates.
- Harmonize legal frameworks for bank resolution and restructuring, as well as non-bank insolvency regimes.
- Increase gradually (avoiding disruption to markets) the maximum ratio for pension funds and insurance companies to invest cross-border within the region up to 50% (or higher) when the present limit is below this. Ensure that this occurs when there are sufficient safeguards for management of risks of these investments abroad.
- Examine scope for relaxation of limits for pension funds and insurance companies to invest in regional infrastructure projects.
- Ensure infrastructure procurement bids are open to institutions from the region (if not wider).
- Explore prospects for revitalizing regional currency settlement.
- Assess the compliance of regulatory frameworks Central Counterparties (CCPs) using the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI), through peer reviews. Upon compliance, LA-7 countries may recognize each other's CCPs and/or regulatory frameworks.
- Work towards full compliance with FATF standards so as to avoid loss of correspondent banking relationships; integrate efforts, including on plans to mitigate corresponding banking issue, across the region.
- Consider, where relevant, relaxation of exchange controls in a timed and sequenced manner taking into account other macroeconomic and financial sector prudential policies. This could include permitting individuals to hold foreign exchange accounts onshore.

#### Brazil

- Permit sales of LA bonds in Brazil.
- Reduce fragmentation of Brazilian public bond market by eliminating practice of separate legislation for each issuance.

### **Box 1: Key recommendations to Facilitate Regional Financial Integration Regional (concluded)**

- Remove requirements for institutional investors to invest abroad only through Brazilian asset management vehicles.
- Encourage revitalization of financial Mercosur.
- Enhance cooperation with PA, bilaterally and through Mercosur, to examine possibilities for further integration, for instance through increasing cross-holdings of stock exchanges and harmonizing capital market practices.

#### **Pacific Alliance countries (Chile, Colombia, Mexico, Peru)**

- Establish a small secretariat in one of the countries to prepare and disseminate a comprehensive framework for integration, including timelines and sequencing to maintain integration momentum, ensure consistency, and gain the benefits of proceeding through reciprocity.
- Permit pension funds and insurance companies to count cross-border PA investment as domestic Once appropriate supervisory arrangements have been put in place.
- Replace remaining ratings-based country limitations for pension fund investments across PA countries with specific foreign exchange and corporate limitations.
- Complete MILA expansion beyond equities (primary and secondary markets) to include sovereign and corporate bonds.
- Harmonize operational procedures, including all aspects of listing requirements, for capital markets.
- Ensure all countries have signed IOSCO Multilateral MOUs.
- “Passport” broker-dealers in MILA countries, while ensuring broker-dealers are subject to regulatory oversight in both home and host countries.
- Seek to harmonize safety nets, for instance as regards bank deposit insurance and investor protection, and consider establishment of a common fund.
- Enhance contacts amongst national regulators and supervisors, including through exchanges of staff and secondments to the secretariat.
- Examine potential for expanding geographic scope.

#### **Panama, Uruguay**

- Panama to refocus its efforts to be a regional hub including by ensuring that capital, disclosure and other requirements are at least as strong as those of other countries in the region.
- Panama to examine the benefits of joining PA, and to adopt PA measures for regional integration.
- Uruguay to consider raising its pension funds foreign asset cap, and to end the restriction that purchases be entirely with securities from multilateral institutions.
- Uruguay to support revitalization of financial Mercosur, and to examine possibility of integration more broadly, including for instance to establish partnerships for the Uruguayan stock exchange.



## BENEFITS OF REGIONAL INTEGRATION

### A. Definition of Financial Integration

**19. Financial integration is the process through which the financial markets of two or more countries or regions become more connected to each other.** Financial integration can take many forms, including cross-border capital flows (e.g. firms raising funds on capital markets cross-border), foreign participation in domestic markets (e.g. a parent bank's ability to set up a subsidiary abroad), sharing of information and practices among financial institutions, or unification of market infrastructures. Financial integration can have a regional or global dimension, depending on whether a country's financial market is more closely connected to neighboring countries or to global financial centers/institutions.

**20. Financial integration is a multi-faceted concept.** There is no universally-accepted definition of financial integration. From a theoretical point of view, it may be signaled by the convergence of the prices of assets with the same characteristics (law of one price). Perfect integration exists if similar assets have the same price even if they are traded on different markets. To work with a more tractable indicator, this section defines financial integration by two main criteria:

- The first criterion is the degree of *cross-border financial activity*. In this sense, the concept of integration is very close to that "financial globalization" defined by IMF (2007) as "the extent to which countries are linked through cross-border financial holdings, and proxied by the sum of countries' gross external assets and liabilities relative to GDP." According to this criterion, any barrier to exchange or market access impedes the free movement of capital and limits integration.
- The second criterion is the degree of *convergence* and consolidation across markets. Financial openness and free access are not sufficient conditions for integration. Two markets can be perfectly open to each other and still be imperfectly integrated, because they keep very distinct market structures.<sup>4</sup> In their definition of an integrated financial market, Baele and others (2004) include the feature that market participants "face a single set of rules when they decide to deal with financial instruments and/or services." According to this second criterion, a single (common and fully harmonized) market is the ultimate form of financial integration. Moretti et al (2015) explain that in particular convergence and consolidation patterns have helped regional and global integration due to large increases in portfolio investments, syndicated loans, and M&A flows.
- Importantly, these two criteria are interconnected. The convergence of market structures facilitates and creates incentives for cross-border capital flows, while financial openness offers opportunities to import financial institutions from abroad, paving the way for greater harmonization across markets.

<sup>4</sup> For instance, the discussion on financial fragmentation in the euro area (and its implications for the transmission of the ECB monetary policy) focused at least as much on the absence of common firewalls (resolution and deposit insurance funds and supervisory mechanisms) as on the need to revive bilateral financial flows. See euro area Article IV reports.

**21. In practice, financial integration is always imperfect.** Segmentation stems from various sources, including capital flow restrictions (some of them having a prudential purpose), technical constraints hindering cross-border flows, insufficient harmonization of financial regulations, cultural barriers, and country-specific risks that deter foreign investors.

## B. Is There a Deficit of Financial Integration in Latin America?<sup>5</sup>

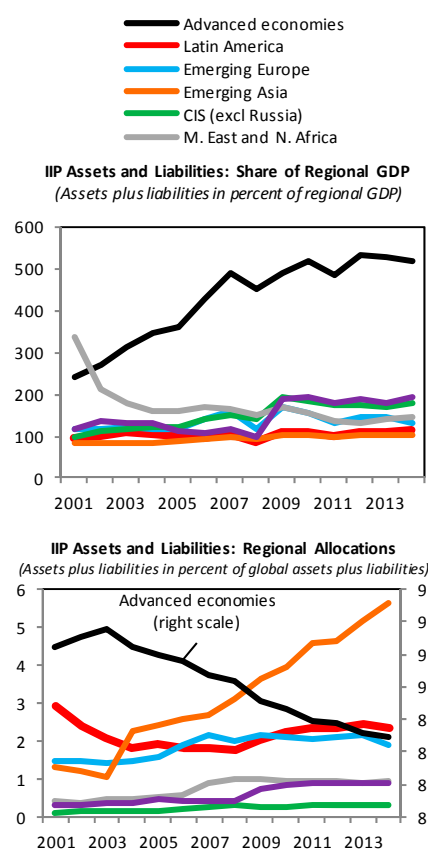
**22. Since the 1990s, most countries in Latin America have embarked on a process of financial liberalization.**

This process has been characterized by a reduction of impediments to cross-border financial transactions, increased participation of foreign banks in the local banking systems, and greater cross-border capital market activity. Today most LA countries have fewer *de jure* restrictions on capital flows than Asian economies (Galindo and others, 2010).

**23. However, *de facto* integration of LA with the rest of the world remains low.**

To assess the degree of financial integration, figures 1 and 2 use three measures of cross-border capital flows. The first, and most common, indicator is international investment positions (IIP) presented here as the sum of foreign asset and liability stocks outstanding. While the dollar value of international assets and liabilities among all LA countries has grown over the last decade, the region has not increased its international exposure (assets plus liabilities in percent of regional GDP). Nor has its relative importance as a partner in international finance improved, unlike the allocation of foreign positions vis-à-vis emerging Asia, which doubled between 2004 and 2013 (figure 1). The second measure looks at cross-border claims held by BIS banks. These data include not only traditional loans (across-borders), but also portfolio equity and debt holdings of BIS banks. Here again, the broad group of all LA countries has garnered a relatively low 3-5 percent of BIS claims over the last 10 years (figure 2, left). The third dataset is bilateral portfolio and FDI stocks outstanding reported in the IMF's Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct Investment Survey (CDIS). While technically these are components of the IIP data, their bilateral nature permits investigation of regional integration. This indicator re-iterates the relatively low (and

**Figure 1. Global Financial Integration in Latin America and the Caribbean: International Investment Positions<sup>1</sup>**

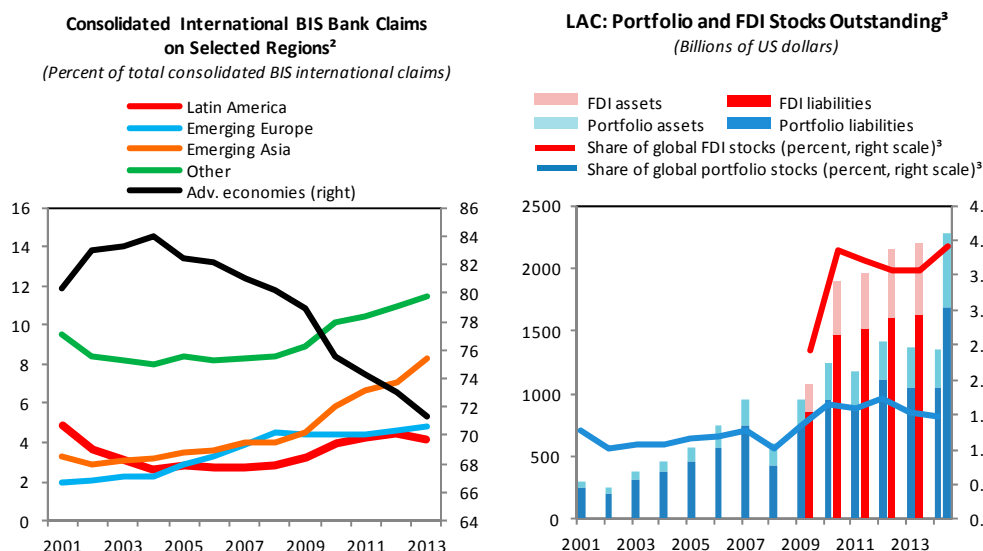


Sources: IMF, Balance of Payments Statistics.  
<sup>1</sup> Values are not consolidated for intra-regional trade.

<sup>5</sup> In principle the best measures of financial integration should be price based. However, in light of the difficulties to adequately identify homogenous assets across countries, this section relies on quantity based indicators.

potentially declining) participation of the LA region, while highlighting the importance of FDI flows over portfolio investments (figure 2, right). These results are further supported by the econometric analysis set out in the background paper, which shows that LA-7 countries are under-integrated even after controlling for macroeconomic fundamentals such as the level of development, trade openness, or the quality of the institutional framework.

**Figure 2. Global Financial Integration Latin America and the Caribbean (LAC): International Bank Claims, Portfolio, and FDI<sup>1</sup>**



Sources: IMF, Balance of Payments Statistics; BIS, Consolidated Banking Statistics; IMF, Coordinated Portfolio Investment Survey; and IMF, Coordinated Direct Investment Survey.

<sup>1</sup> Values are not consolidated for intra-regional trade.

<sup>2</sup> BIS bank lending, immediate borrower basis. Foreign claims includes cross-border lending, holdings of debt and equity securities, and local currency lending to residents.

<sup>3</sup> Aggregate assets plus liabilities of Latin America, in percent of aggregate assets plus liabilities of all reporting countries.

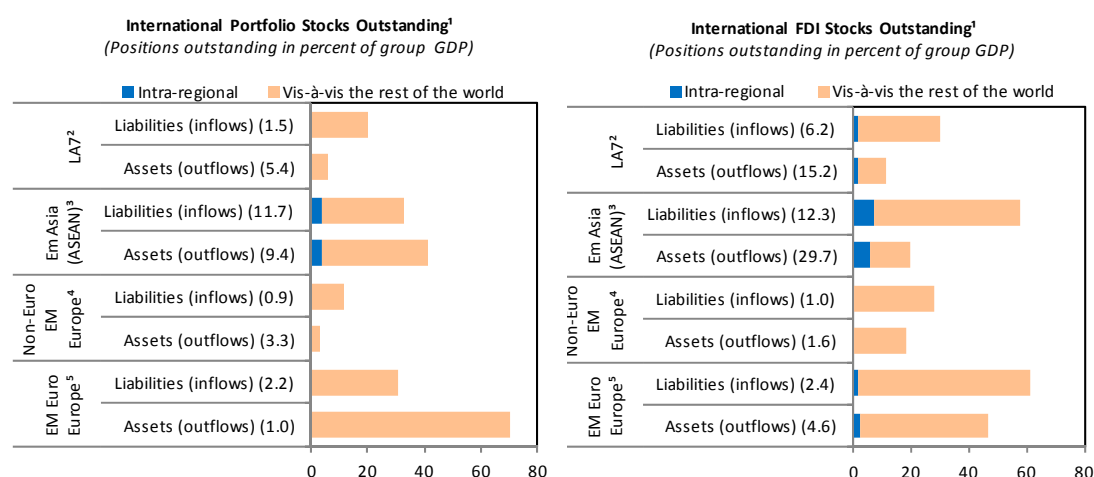
**24. Regional integration in LA seems also less advanced than in other EM regions.** Figure 3 shows that there is greater intra-regional investment, of both FDI and portfolio, amongst the ASEAN countries reflecting both the fruits of long trade and financial negotiations as well as the importance of a large, diversified trade and financial center (i.e. Singapore<sup>6</sup>). Regarding its evolution over time, the available indicators of financial regionalism depict differing trends depending on how it is measured. For portfolio assets, there is an apparent diversification away from regional assets in Latin America as the intra-regional share has fallen from over 10 to under 5 percent since 2008 (figure 4, left). For FDI, the data, only available since 2009, also suggest a declining trend. However, indicators of cross-border bank lending do point to some momentum in LA. Table 3 highlights the expanding positions that Latin

<sup>6</sup> If Singapore is excluded from emerging Asia (ASEAN), Latin and Asian intra-regional integration levels become quite comparable.

BIS banks are taking in their neighbors<sup>7</sup>. Although BIS bank lending data are only available for four LA countries, it is a striking trend that the share of claims on other LA-7 countries has risen dramatically since 2005.

**25. Cross-border mergers and acquisitions provide anecdotal evidence of global fragmentation and regional integration after the GFC crisis.** Although the trend seems less pronounced than in Emerging Europe or Emerging Asia, several global banks have withdrawn from LA to refocus on their core markets and activities, while regional or domestic banks have taken over their activities (see following section). In 2013, Grupo Aval, the largest conglomerate in Colombia, acquired BBVA activities in Panama, while the largest bank in Colombia, Bancolombia, purchased HSBC's holdings. The same year, BBVA sold its Chilean, Colombian, Mexican and Peruvian pension funds to regional and local buyers. Santander issued IPOs in Mexico and Brazil. More recently, the Ficohsa group from Panama has nearly completed the purchase of Citibank's operations in Honduras and Nicaragua, while HSBC has announced its intention to sell its Brazilian holdings to Bradesco, the second largest Brazilian private bank. Another dimension of regional integration is the gradual merger of the MILA stock exchanges (Chile, Colombia, Mexico, and Peru) that began in 2011. Once complete domestic investors will more easily be able to buy and sell equities from other MILA countries (see section V).

**Figure 3. Intra-Regional Component of Global Integration: Portfolio and FDI Investments, 2014**



Sources: IMF, Coordinated Portfolio Investment Survey (CPIS); IMF, Coordinated Direct Investment Survey (CDIS).

<sup>1</sup> Numbers in parenthesis report the share of intra-regional assets or liabilities in total assets or liabilities of the region.

<sup>2</sup> LA7 Includes: Brazil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay.

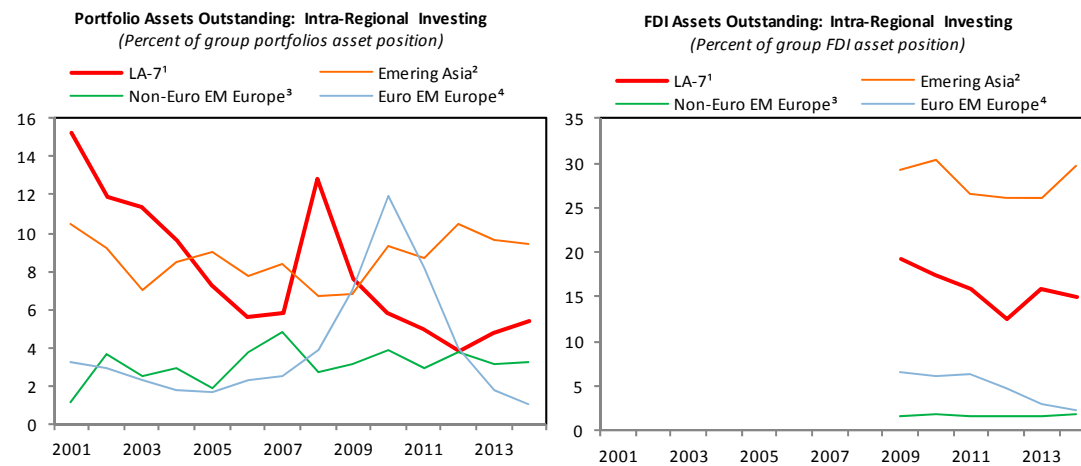
<sup>3</sup> Emerging Asia includes: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

<sup>4</sup> Non-Euro Emerging Europe includes: Bulgaria, Hungary, Poland, Romania, and Russia.

<sup>5</sup> Euro Emerging Europe includes: Cyprus, Estonia, Greece, Latvia, Malta, Slovak Republic, and Slovenia.

<sup>7</sup> Unfortunately, BIS consolidated statistics do not report international claims by banks in any of the comparator regions. Moreover, it is likely that the consolidated statistics underreport international claims as many large Latin banks are subsidiaries of larger global banks. For example any regional claims by the Mexican bank Banamex are consolidated with its parent company, Citibank, and effectively reported as claims on the region vis-à-vis the United States.

**Figure 4. Evolution of Intra-Regional Integration**  
(Stocks outstanding in percent of group GDP)



Sources: IMF, Coordinated Direct Investment Survey (CDIS).

<sup>1</sup> LA-7 Includes: Brasil, Chile, Colombia, Mexico, Panama, Peru, and Uruguay.

<sup>2</sup> Emerging Asia includes: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

<sup>3</sup> Non-Euro Emerging Europe includes: Bulgaria, Hungary, Poland, Romania, and Russia.

<sup>4</sup> Euro Emerging Europe includes: Cyprus, Estonia, Greece, Latvia, Malta, Slovak Republic, and Slovenia.

## C. Benefits of Further Integration in Latin America

**26. By expanding possible financing options and vehicles for savings in a country, financial integration can enhance financial development, which in turn has been linked to higher economic growth** (Sahay and others, 2015). First, integration may stimulate capital accumulation. There are indeed general advantages related to financial deepening in the host country. If capital is brought from outside, competition among financial institutions can be enhanced, particularly when the domestic financial sector contains few institutions, and maintains high spreads between borrowing and lending rates; and economies of scale can be exploited by pooling larger amounts of savings. The monetary transmission mechanism can also be enhanced if the banking sector becomes more competitive. All these factors are likely to lower funding costs, and stimulate investment. Second, better resource allocation and importation of technology and knowledge may create opportunities for efficiency gains and boost productivity, which is another source of growth. Third, financial integration can also promote growth indirectly by exposing policy maker decisions and corporate actions to greater financial market scrutiny. The background paper shows a quantitative assessment of the macroeconomic effects from further integration in LA-7 countries. It shows substantial gains from closing the “integration gap,” with a growth dividend estimated in the 0.25–0.75 percent range.

**27. In addition to raising the growth trend, financial integration may also foster economic resilience and reduce volatility around the trend.** Output volatility can be mitigated through two main channels. First, financial integration is likely to increase the depth of financial markets leading to greater market liquidity: possibilities to sell and buy securities will increase with the emergence of new players and new instruments. Second, financial integration offers new opportunities for risk-sharing and inter-temporal consumption smoothing through the diversification of portfolios across asset classes, sectors and countries. Overall, this stabilization effect should be particularly beneficial in LA

countries where production bases are concentrated and that depend heavily on agricultural activities or extraction of natural resources (IMF, 2015). Of course, the flip-side of this must also be acknowledged: increased integration could, in certain situations, serve to transmit shocks from one country to another.

**28. Regional integration can bring a number of additional benefits for both the home and host countries:**

- **Cross-border financial activity (bank and nonbank) both follows and can be followed by cross border trade, and thus could help foster wider regional economic integration.** A larger common market creates new growth opportunities, which may be influential in LA in a context of lower commodity prices and tighter global financial conditions. The potential for increasing intraregional trade in LA may be limited by factors such as geography and foreign exchange risk, but is aided by the heterogeneity of economic activity across the region, with for instance Mexico exporting manufactured goods, Chile copper and Uruguay food.
- **Regional banks (robustly supervised with sufficient high quality capital to support their cross border operations) and regional markets may have a better understanding of the needs of the region than global institutions.** They may be able to provide expertise particularly suited to the host country, such as improving financial inclusion. The homogeneous importance of specific commodity exports across some countries in the region may also be fertile ground for transplanting expertise in trade and industrial credit.
- **At the regional level, capital market integration creates scope for economies of scale, especially when individual markets are relatively small.** In many LA countries, the small size of national markets, in some cases due partly to domestic regulatory factors, constrains financial sector growth and efficiency, contributing to higher costs, a narrower range of financial products and the exclusion of many from formal financial services. Addressing regulatory limitations and facilitating regional integration could contribute to loosen these constraints by allowing governments, financial intermediaries, and corporations to access a regional market with greater depth and liquidity. In addition, larger inflows of foreign capital to the region may follow, as a larger and more liquid regional market may be more attractive to international investors.
- **Regional banks can fill the hole left by retrenching global banks.** Since the GFC, financial pressures together with increased regulatory oversight, have led some global institutions to reduce their cross-border activities and pull back into their core markets (IMF GFSR April 2015). Responding to the withdrawal of these banks, regional activity has been growing rapidly in a number of emerging markets, particularly in Asia and Emerging Europe (BIS, 2014). This trend has so far been less pronounced in much of LA, although global banks continue to downsize and withdraw. Regional integration could help avoid increased consolidation of domestic financial sector activity and mitigate a possible credit squeeze if North-American and European banks continue to reduce their presence in the region without onselling their business to another institution. While this could lead to the emergence of large regional banks, and bring the risk of

concentration at a regional level, it would nonetheless foster greater competition and diversification of risks within domestic markets.

- **Diversifying exposure to external financial markets through regional integration could mitigate the impact of foreign spillovers.** While regional integration may enhance risks if a region were to be hit by a common shock, the presence of regional banks could also serve to diversify the overall risks facing a country's financial sector: although the GFS showed that global banks were more-or-less all subject to similar risks, the performance of banks from regions other than the US and Europe was substantially less affected. An internationally exposed, but geographically diversified financial system could more nimbly replace borrowing and saving vehicles regardless of the origin of foreign shocks. Regional banks could thus provide a buffer against global volatility, while giving countries the possibility to develop financial capacity beyond the limitations of their national boundaries.

**29. Such advantages are not assured though unless accompanying measures are in place, including enhanced supervision.** Cross-border financial activity also brings risks, including adverse spillovers if there is insufficient official capacity to exercise necessary oversight. Critics of financial integration point to financial crises following capital account liberalizations in Mexico (1994), East Asia (1997) and Russia (1998). Work to identify positive results from financial integration often struggles to generalize results and often must narrow the findings to selected forms of integration (FDI and equity are statistically favored over debt instruments) or acknowledge necessary conditions such as high levels of economic development, institutional quality, or financial development. However, Rancière and others (2006, 2008) show that the direct effects of financial liberalization on growth outweigh the negative indirect effect of higher propensity to crisis. In their review of the benefits and costs of financial globalization, Kose and others (2006) also recognize the existence of conflicting results but conclude that the empirical literature "lends some qualified support to the view that developing countries can benefit from financial globalization, but with many nuances. On the other hand, there is little systematic evidence to support widely-cited claims that financial globalization by itself leads to deeper and more costly developing country growth crises."



## Box 2. Can Regional Financial Integration Facilitate Infrastructure Project Financing?

### The infrastructure gap in Latin America remains large and will require significant financing resources.

Infrastructure gaps exist in energy, transportation, telecommunications, and water/sanitation across Latin America. Traditionally these projects are sponsored and financed by governments. However, with shrinking fiscal space, governments are finding it more difficult to balance competing demands and still fund infrastructure on their own balance sheets. Hence many countries are making wide use of PPPs to deliver more public investments with more freedom to choose where to commit long term resources. .

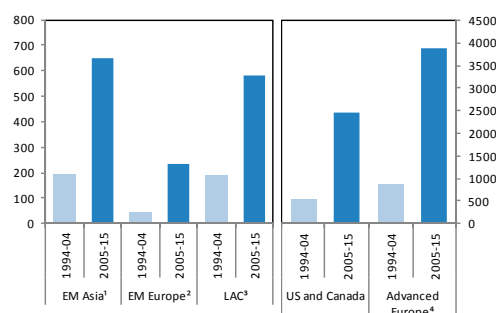
**Pension funds and insurance companies are natural investors in funding infrastructure projects, but concentration limits preclude large investments in individual projects.** As prudential caps limit their capacity to attract cross-border financing, large projects may find it hard to generate the financing they need. Pension fund and insurance companies have substantial resources to invest, and need long-term local currency assets to match their liabilities. While institutional investment managers express great interest, project risks remain high, and prudential caps<sup>1</sup> for “alternate” investments—which include infrastructure—continue to be low. Given that the alternate asset class includes many competing products like real estate, energy, and private equity, funds available for infrastructure may be limited. Moreover, when pension and insurance funds help finance projects cross-border, they have to mind both foreign currency and alternative asset caps. In such cases, flexibility on the part of project sponsors to absorb currency risk in their liabilities, or hedging as financial markets deepen, could help draw in foreign institutional financing.

### Expertise in risk assessment for regional projects can facilitate the flow of investment

#### funds; however developing such expertise is expensive.

Arranging infrastructure loans can be difficult because the projects can be expensive and subject to risks that are difficult to quantify. Syndication of bank loans has been useful in distributing the risks across multiple banks. One of the contributions of PPPs has been developing risk frameworks and project financing that looks to pair risks with participants best able to manage those risks. For example, a project may seek equity financing from participating engineering, procurement and construction firms or firms that will provide operational services after construction. These firms may have better access to capital, while the equity stake helps align incentives for timely, cost effective delivery of obligations. Collaboration among banks, equity funds, insurance companies and pension funds to jointly develop risk assessment teams among regional lenders that specialize in infrastructure projects can help them amass their intellectual capital quickly and at lower cost. And as risk mitigation strategies become more widely employed, regional sponsors will begin tailoring the financial structure of their projects to more easily attract financing.

**Private Sector Deals for Infrastructure Projects**  
(number of deals)



Source: Preqin deals database.

<sup>1</sup>Includes China, India, Indonesia, Malaysia, Myanmar, Pakistan, Philippines, and Thailand.

<sup>2</sup>Includes Czech Republic, Hungary, Poland, Russia, and Turkey.

<sup>3</sup>Includes Argentina, Brazil, Chile, Colombia, Mexico, and Peru.

<sup>4</sup>Includes Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

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<sup>1</sup>Typically 5–10% of assets under management for pension funds.

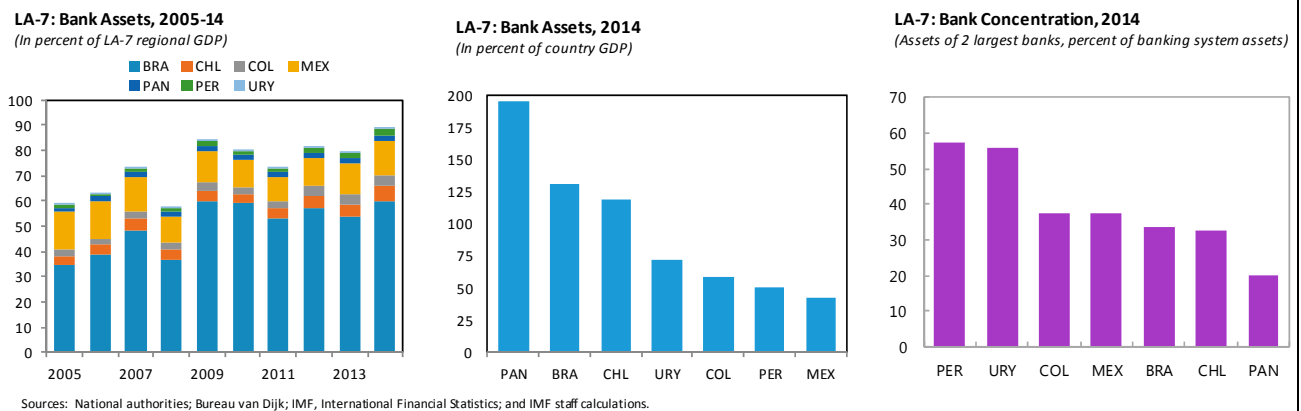


# THE FINANCIAL SECTOR IN LATIN AMERICA AND BARRIERS TO INTEGRATION

## A. Banking in the LA-7

Banking systems are the largest financial intermediaries in the LA-7, amounting to about 100 percent of LA-7 GDP. Brazil has the largest, closely followed by Chile's banking system, and only surpassed by Panama as a share of GDP. With liberalization of financial systems in the 1990s, most assets in the LA-7 are now with private banks (about 60 percent of LA-7 GDP), while assets in public banks remain high only in Brazil and Uruguay as a share of GDP; meanwhile foreign banks hold important market shares in some of the LA-7 (27 percent of LA-7 GDP). However, the integration of regional banking systems remains low. Despite liberalization, most banking systems are characterized by high concentration and in some cases by high bank interest rate spreads.

Figure 5. LA-7 Indicators of Banking Sector Growth, Size and Concentration

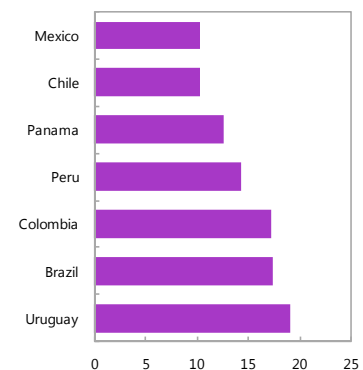


### Background - Financial Intermediation:

**30. Financial intermediation in the LA-7 remains limited compared to advanced economies and other emerging economies.** However, important heterogeneity exists. Chile has the highest credit ratio to the private sector among the LA-7, while financial deepening in Mexico, Peru and Uruguay remains relatively low. Chile's credit to the private sector more than doubled since 1995 (from 50 to over 100 percent of GDP in 2014), while it is only about 35 percent of GDP in Mexico, Peru and Uruguay, not having risen in the past two decades. Chile is the only LA country whose credit to the private sector is comparable to that of Emerging Asia and G7 economies. Even Brazil's credit to GDP ratio remains relatively low compared to

Figure 6. Credit Growth, 2010-15

(percent, annual average)



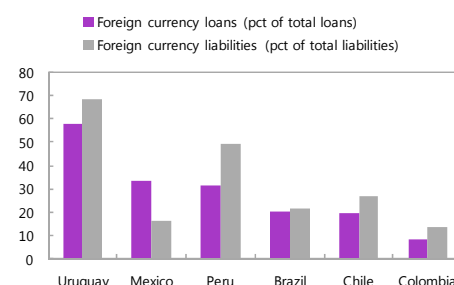
Source: IMF, International Financial Statistics.

Emerging Asia and G7. In terms of deposits, Brazil and Panama lead (with ratios of 60 percent of GDP), though even these ratios are much lower than in Emerging Asia, while Peru's ratio is the lowest. While Mexico has a low ratio, it has access to other financial funding through corporate bond issuance and capital markets. Financial access in terms of number of branches per 100,000 adults is lowest in Uruguay and Mexico.

**31. Economic growth, stable macroeconomic policies, and reforms to deepen financial markets have supported credit expansion in recent years.** Credit growth in Uruguay has been high, albeit from low levels, driven by economic growth as well as official attempts to increase financial access. Credit growth in Brazil has decelerated to 11 percent y/y in 2014 from the high rates of 30 percent y/y in 2010<sup>8</sup>, driven by a slowdown in credit expansion by public banks, while private bank credit continued to expand at a moderate pace. The slower credit growth likely also reflects lower demand, given weaker economic activity. Since 2011, credit in Peru has been slowing gradually on the back of macro prudential measures but monthly growth rates still average around 15 percent (y/y). Credit growth in Mexico moderated to below 10 percent y/y in 2014 (from 17 percent y/y in 2011), driven in part by a deceleration in construction after financial difficulties of the three largest builders surfaced. At the same time, lending by the publicly-owned development banks is growing rapidly, given a new mandate of promoting micro-finance and lending to underserved sectors. Credit growth in Colombia was also buoyant over the period, and will likely continue to outpace nominal GDP growth, in line with the government's financial inclusion policy.

**32. Dollarization in some of the LA-7 has slowed in recent years.** High dollarization was a response to past crises and hyperinflation episodes and consequent loss of purchasing power of bank deposits. Dollarization slowed—and even reversed—following policy initiatives that included adopting inflation-targeting frameworks; macroprudential measures, including differential reserve requirements on local currency versus foreign currency deposits and capital requirements on FX loans; and the development of local currency capital markets. In Peru, FX corporate loans have decelerated sharply following de-dollarization measures introduced at the end of 2014: new repos in domestic currency to support the growth of credit in local currency and to encourage the substitution of foreign currency loans with local currency loans; also, higher reserve requirements on foreign currency deposits, as well as reserve requirements for banks that do not meet certain de-dollarization targets for credits. Uruguay, on the other hand, still has a highly dollarized financial sector, possibly associated with inflation persistently above the target range, with FX loans accounting for 60 percent of total loans, and FX liabilities at close to 80 percent of total liabilities. At

**Figure 7. Foreign Currency Loans and Liabilities**



Source: IMF, Financial Soundness Indicators.

<sup>8</sup> The high credit growth rates were due to both demand (high economic growth—7 percent in 2010—and increasing financial inclusion) and supply factors such as changes in regulations for housing loans, collateral and payroll deductible loans.

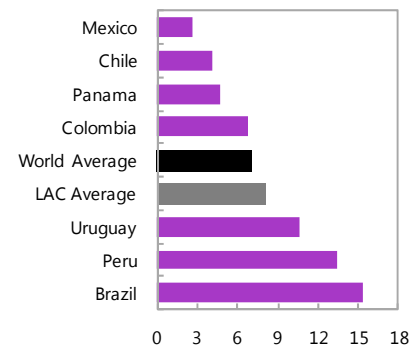
the other end of the range, Brazil, Chile, and Colombia have much lower FX lending and liabilities ratios, even though dollarization in Brazil has been increasing in the last year.

**33. Most banking systems in the LA-7 are characterized by high concentration, which may have a significant impact on loan rates and spreads** (see the panel on bank concentration below). In Peru and Uruguay, the three largest banks account for about 70 percent of banking system assets, and in Uruguay, 40 percent of banking system assets are controlled by one government-owned bank. In Brazil, Chile, Colombia and Mexico the three largest banks hold 50 percent of banking system assets, and Brazil stands out with 45 percent of banking system assets controlled by public banks, with a high degree of earmarked and subsidized lending.

**34. Bank spreads in several LA-7 are high compared to other regions.** Brazil has the highest spreads at over 15 percent,<sup>9</sup> and ROE is reported to be around 20 percent for the largest banks. At the same time, Brazilian banks exhibit high operating expenses due to entrenched inefficiencies,<sup>10</sup> especially in state-owned banks which have a high share of directed lending and social projects. In addition, high costs of doing business, as Brazil ranks poorly in terms of ease of doing business and investor protection, may increase costs for private banks. Uruguay too has high interest rate spreads and operating expenses. While Peru has high spreads, it has one of the lowest operating expenses. Spreads in Colombia, Chile, Mexico Panama, are lower than in Brazil and Peru and they have been coming down in Colombia, Mexico, and Panama, hinting at increased competition in those markets.

**Figure 8. Interest Rate Spread, 2014**

(lending minus deposit rate, percent)



Source: IMF, International Financial statistics.

<sup>9</sup> The rate for Brazil averages spreads for non-financial corporations (10 percent) and households (26 percent). Jorgenson and Apostolou, 2013, in "Brazil's Bank Spread in International Context," use the net interest margin (NIM) to measure the bank spread and derive a pure spread (or margin) that is comparable across banks in any country across time. This pure spread varies across countries and over time according to the degrees of bank competition and macroeconomic (interest-rate) volatility in each country. While their study only looks at the period 1995–2009, their measure could suggest lower spreads for Brazil in recent years too.

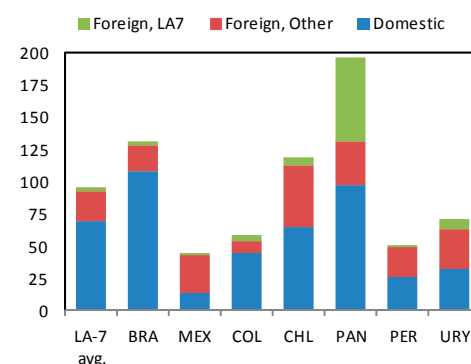
<sup>10</sup> 2011 OECD Economic Surveys and Tecles and Tabak, 2010. According to the OECD, operating costs are three times higher in Brazil than in the average OECD countries, and 40 percent above the average in Latin America (see also Beck and Demirgüç-Kunt, 2009).

### State of Play of Regional Financial Integration:

#### 35. Banking systems in the LA-7 have been liberalized since the 1990s.

This liberalization process involved deregulation, openness to foreign bank entry and privatization. While the market share of foreign banks is high in some of the LA-7, the cross-border share of regional banks remains minute. Panama is the only exception: regional banks hold 33 percent of bank assets in Panama, of which 22 percent are held by Colombian banks. Foreign ownership of banks is highest in Mexico, with most bank assets held by North American and European banks (of the 70 percent of banks assets which are foreign-owned, 18 percent are owned by U.S. banks and 37 percent by Spanish banks). At the same time, Mexican banks (i.e. Banco Azteca) have a very small cross-border regional presence. Brazil and Colombia lie at the other end of the range, where bank assets are predominantly held by domestic banks, either in large part government-owned banks in Brazil, or private banks in Colombia.

**Figure 9. Commercial Bank Ownership<sup>1</sup>**  
(bank assets in percent of GDP)



Sources: National authorities; Bureau van Dijk; and IMF staff calculations.

<sup>1</sup> Year-end 2014 or latest available.

**Table 2. Size of the Regional Market, 2014<sup>1</sup>**

	LA7	BRA	CHL	COL	MEX	PAN	PER	URY
Total bank assets, bil USD	4,058	2,737	286	191	617	90	98	39
Public bank assets, pct of GDP	36	62	18	4	9	17	1	32
Private bank assets, pct of GDP	62	69	100	55	43	178	49	39

Source: National authorities, and IMF staff calculations.

<sup>1</sup> Year-end 2014 or latest available.

**36. Foreign claims of some Latin American BIS reporting banks on the region provide some evidence of increasing regional integration since 2005.**<sup>11</sup> Foreign claims by Chilean banks on the region are 50 percent of total claims, the highest among the BIS reporting banks from Latin America,

<sup>11</sup> The Consolidated Banking Statistics of the BIS (CBS) capture the worldwide consolidated positions of internationally active banking groups headquartered in reporting countries. The data include the claims of reporting banks' foreign affiliates but exclude intragroup positions, similar to the consolidation approach followed by banking supervisors. The CBS are designed to analyze the exposure of internationally active banks of different nationalities to individual countries and sectors. Exposures can take many forms: for example, cross-border claims, local claims of banks' foreign affiliates, derivatives, guarantees, or credit commitments. Colombia, Peru, and Uruguay do not report to the BIS, and thus, total foreign claims of the LA-7 on the region are underestimated.

while Panama's are 30 percent of total claims (Table 2). Foreign claims by Brazilian banks on the other LA-7, while significantly increasing since 2005, are still only about 13 percent of total claims—US\$18 billion (of which 12 percent are on Chile), with most foreign claims being on the U.S. and the U.K. Foreign claims by Mexican banks on other LA-7 are tiny, at 3 percent of total claims.

**Table 3. Consolidated Foreign Claims on the World by BIS Banks in 4 Latin American Countries**  
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
<b>Brazil</b>	3.3	2.7	3.1	2.5	3.2	3.7	3.4	4.1	5.0
<i>of which: claims on other LA7</i>	0.0	0.1	0.1	0.1	0.4	0.5	0.5	0.7	0.8
<b>Chile</b>	2.4	2.1	2.1	1.7	1.9	1.9	2.6	5.2	4.8
<i>of which: claims on other LA7</i>	0.6	0.4	0.5	0.6	0.7	0.6	0.7	2.9	2.3
<b>Mexico</b>	0.6	0.5	0.6	0.7	0.9	0.6	0.4	0.4	0.5
<i>of which: claims on other LA7</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Panama</b>	66.2	48.1	51.7	48.3	47.0	44.5	44.9	42.0	42.7
<i>of which: claims on other LA7</i>	11.7	12.5	14.0	10.9	10.8	12.0	12.4	10.6	11.6

Source: BIS, Consolidated Banking Statistics.

**37. Mergers and acquisitions (M&A) by LA banks of international banks withdrawing from the region (see table 5) suggest a trend towards greater regional integration.** Regional banks, especially Colombian banks, acquired businesses of HSBC, Santander, BBVA and Citibank, which were withdrawing particularly from Central America, but Paraguay and Peru too. The assets of Colombian banks' subsidiaries abroad reached US\$50 billion, accounting for 24 percent of the total assets of the Colombian banking system (table 4). Colombian banks have attained a significant market position in Central America (22 percent of assets on average), with the share of Colombian bank assets in Panama reaching 23 percent (and over 50 percent in El Salvador). These regional integration trends can be a spur to enhancements to supervisory, resolution and tax system frameworks.

**Table 4. Assets of Colombian Banks in the Region**  
(Percent of parent bank's assets)

Bancolombia	29.1%
Banco de Bogota	43.0%
Davidiendia	21.6%
Occidente	9.3%
Sudameris	24.5%

Sources: National authorities and IMF staff calculations.

*Prospects for Further Regional Financial Integration:*

**38. Two Brazilian banks (of which one is an investment bank) have a regional perspective and have established a significant presence across Latin America.** Bank Itaú, based in São Paulo, has the strength and the ambition to become the major regional player. The size of the bank is close to that of the entire Mexican banking system (US\$420 billion in assets). It has expanded regionally mainly via M&A, but through a few greenfield investments in Colombia and Mexico as well. With its most recent acquisition of Chilean Corpbanca<sup>12</sup> (and merger with Corpbanca Colombia), the share of Itaú's cross-border business will now reach 13 percent, from 7 percent in 2011. Similarly, investment bank BTG Pactual, based in São Paulo, aspires to be the investment bank of the region. Investment banks are likely more able to establish operations abroad compared to retail banking, owing to the lower cost structure and initial investment involved in their operations. BTG Pactual started expanding throughout much of Latin America following the GFC when global banks were seen to be withdrawing.<sup>13</sup> However, other Brazilian banks mostly focus on their domestic market. They view the potential to expand domestically, and appear to be consolidating their positions at home

**39. Conditions in other countries too have so far precluded much regional integration.** The large presence of foreign banks from the U.S. and Spain in Mexico mean that any decisions on expansion to the region from Mexico are taken at headquarters, rather than in the Mexican subsidiaries; among domestic banks, only Bank Azteca has decided to expand regionally, having a small presence in Brazil, Guatemala, Panama and Peru among others. Also, the more important

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<sup>12</sup> Corpbanca had expanded its operations to Colombia, in part due to the very low spreads and profitability and high banking intermediation rates in Chile, but became vulnerable to takeover due to problems in the non-financial part of the conglomerate.

<sup>13</sup> Since the arrest of its CEO on corruption charges in November 2015, however, BTG Pactual has experienced bouts of market pressure. Risk emanates from its relatively heavy reliance on wholesale funding, which has translated into noticeable swings in wholesale deposits. This could potentially hinder the bank's ability to further expand its operations in the region over the near term.

**Table 5. Financial Sector Divestments Following the Global Financial Crisis**

Deal Data		Banking Operations/Assets for Sale		Selling Firm	
Year	Value (Mil USD)	Name	Country	Name	Country
<b>Latin America and the Caribbean</b>					
2009	N.R.	Credit card portfolio	Argentina	Citigroup Inc	USA
2012	N.R.	Banco Suquia SA	Argentina	Credit Agricole SA	France
2011	N.R.	JP Morgan Vastera Argentina SRL	Argentina	JPMorgan Chase & Co	USA
2011	76.8	CIBC Bank & Trust Co Cayman Ltd, CIBC Trust Co Bahamas Ltd	Bahamas	Canadian Imperial Bank of Commerce/Canada	Canada
2015	45.0	Banco Standard de Investimentos SA	Brazil	Standard Bank Group Ltd	S. Africa
2009	18.7	Credit portfolio	Chile	Banco Santander SA	Spain
2010	N.R.	Corporate & Commercial Banking Operations	Chile	Royal Bank of Scotland Group PLC	Britain
2010	N.R.	Scotiabank Colombia SA	Colombia	Royal Bank of Scotland Group PLC	Britain
2012	1,229.0	Banco CorpBanca Colombia SA	Colombia	Banco Santander SA	Spain
2012	801.0	Banco Davivienda Salvadoreno SA, Banco HSBC Costa Rica SA, Banco HSBC Honduras SA	Costa Rica, Honduras	HSBC Holdings PLC	Britain
2010	25.0	Ecuadorian Branch Assets & Liabilities	Ecuador	Lloyds Banking Group PLC	Britain
2013	2,233.8	HSBC Bank Panama SA	Panama	HSBC Holdings PLC	Britain
2009	85.1	ABN AMRO Paraguay	Paraguay	Banco Santander SA	Spain
2010	N.R.	Credit Uruguay Banco	Uruguay	Credit Agricole SA	France
2012	N.R.	Uruguayan Operations	Uruguay	Lloyds Banking Group PLC	Britain
2013	0.3	Galval Agente de Valores SA	Uruguay	Grupo Financiero Galicia SA	Argentina
2009	1,050.0	Banco de Venezuela SA Banco Universal	Venezuela	Banco Santander SA	Spain
<b>Middle East, Africa, and the CIS</b>					
2015	N.R.	Egypt loan & deposit portfolio	Egypt	Bank of Nova Scotia/The	Canada
2014	N.R.	Banking business/Jordan	Jordan	HSBC Holdings PLC	Britain
2009	324.6	Societe Ivoirienne de Banque SA, Union Gabonaise de Banque SA, Credit du Congo, Societe Camerounaise de Banque, Credit du Senegal	Senegal	Credit Agricole SA	France
2013	2,106.4	Barclays Africa Ltd	South Africa	Barclays PLC	Britain
2014	177.0	United Arab Emirates retail banking operations	U.A.E	Barclays PLC	Britain
2011	16.5	Royal Bank of Scotland NB Uzbekistan CJSC	Uzbekistan	Royal Bank of Scotland Group PLC	Britain
<b>Emerging Europe</b>					
2014	N.R.	Credit Agricole Bulgaria	Bulgaria	Credit Agricole SA	France
2014	18.9	Banco Popolare Croatia dd	Croatia	Banco Popolare SC	Italy
2011	69.1	Equa Bank AS	Czech	Banco Popolare SC	Italy
2013	N.R.	ATF Bank JSC	Kazakhstan	UniCredit SpA	Italy
2011	N.R.	Banque Societe Generale Vostok, DeltaCredit Bank, Rusfinans Bank	Russia	Societe Generale SA	France
2011	N.R.	Expobank LLC	Russia	Barclays PLC	Britain
2012	158.0	Cetelem Bank LLC	Russia	BNP Paribas SA	France
2013	N.R.	Certain Russian assets	Russia	Societe Generale SA	France
2010	84.9	Millennium Bank AS	Turkey	Banco Comercial Portugues SA	Portugal
2012	3,542.5	DenizBank AS	Turkey	Dexia SA	Belgium
2013	N.R.	Turkey Consumer Banking Business	Turkey	Citigroup Inc	USA
2012	N.R.	Bank Forum JSC	Ukraine	Commerzbank AG	Germany
<b>Emerging Asia</b>					
2015	N.R.	Banking business/India	India	HSBC Holdings PLC	Britain
2015	N.R.	Banking business in India	India	HSBC Bank Oman SAOG	Oman
2010	50.5	Royal Bank of Scotland Ltd/Pakistan	Pakistan	Banco Santander SA, RBS Group PLC, Kingdom of the Netherlands	
2012	N.R.	Banking Business/Pakistan	Pakistan	HSBC Holdings PLC	Britain
2014	N.R.	Banking business in Pakistan	Pakistan	HSBC Holdings PLC	Britain
2010	N.R.	RBS Philippines Inc	Philippines	Royal Bank of Scotland Group PLC, RFS Holdings BV	
2014	N.R.	Trust business of Deutsche Bank Manila Branch	Philippines	Deutsche Bank AG	Germany
2012	113.3	Retail Banking and Wealth Management business	Thailand	HSBC Holdings PLC	Britain

Source: Bloomberg, LLP.

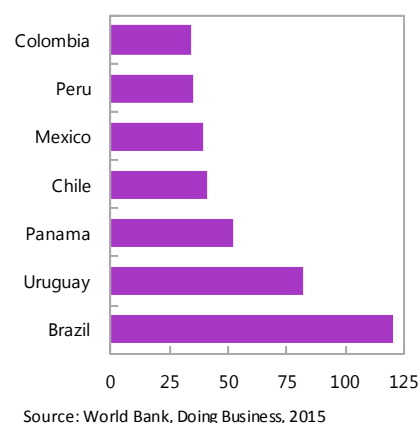
real economy ties with North America and Europe have so far dampened pressures for regional financial integration. Furthermore, from a financial stability perspective, at least until the GFC, global banks were considered by most countries to have advantages that made them preferable to regional Latin American banks: they were considered easier to “discipline”, less politically connected, and more accountable.

**40. While the Mexican, Chilean, and Peruvian banking systems are very open, equity prices appear to be a deterrent for acquisitions.** Chile, Mexico, and Peru liberalized their banking systems in the 1990s, and they all attracted foreign capital, especially from North America and Europe. Only a few large LA banks are able to afford entry to these markets, given high equity prices compared to valuations. Large Colombian banks find markets in Chile and attractive, but prices of assets can be prohibitive, and concentrated markets represent a barrier to entry. Of the Colombian banks, GNB Sudameris acquired HSBC’s operations in Peru, whilst Brazil’s Bank Itaú and BTG Pactual entered the market as investment banks. In addition, Bank Itaú acquires Corpbanca in Chile (and merge with Corpbanca Colombia).

**41. In some countries, such as Brazil, high bank concentration and size of the market, are potential barriers to regional bank entry.** High bank concentration is likely due to the role played by family and publicly owned banks. The power of incumbents, including of financial conglomerates with linkages to the real sector, could act as strong deterrent to entry. The Brazilian banking system has been consolidating, and Bradesco, the second largest private bank, is now closing acquiring the retail business of HSBC (increasing its market share from 11 to 14 percent). In addition, the three large government-owned banks have grown significantly since the GFC. BNDES, the development bank, lends to large conglomerates at subsidized rates. The legal regime for entry by foreign banks in Brazil is relatively opaque, and entry requires presidential approval, which may have a “chilling effect” for potential entrants (see below). In Uruguay, BROU has had a legal monopoly on public employee accounts, which has given the public bank a majority share of the peso deposit market. The only regional bank in the Uruguayan market is Bank Itaú, following Banco do Brasil’s exit in 2005 after 20 years. Banking fees and rates in Uruguay are high compared to the region because banks’ operating costs are very high, while profits are relatively low. Uruguayan banks have consolidated in an attempt to gain scale economies: in 2002, there were 20 private banks; today, there are only nine.

**42. Ease of doing business (i.e. getting credit, protecting investors, and enforcing contracts) is hampered by institutional and regulatory factors and lack of competition.** For example in Brazil, there is no full depth of, and access to, credit information, especially distribution of both positive data (repayment of loans and loans due performance) to build positive credit files for borrowers to benefit from lower interest rates, compared for example to Mexico, which has achieved the highest rating in terms of full depth of credit information (see Doing Business Report, 2015). Colombia also has a high rating in terms of depth of credit information, given that all financial

**Figure 10. Ease of Doing Business**  
(Rank, 1 (high) to 189 (low))





institutions supervised by the Financial Superintendency of Colombia (SFC), including small banks, have access from, and report data to, the credit bureau, and must have well-defined credit-granting criteria (e.g. take into account information on the debtor's current and past payment performance; pay timely attention to their liabilities; and consider the financial and credit history from credit bureaus or rating agencies). While supervised entities provide credit information to determine asset quality in monthly and quarterly financial statements, some credit exposures are currently not covered, such as off-balance sheet exposures, letters of credit and bank collateral and sureties.

**43. High concentration and lack of competition likely explain high loan spreads in some of the LA-7.** Competition, low taxation and reserve requirements, strong creditor rights and legal framework, availability of information on borrowers, and a stable macro environment would be expected to reduce bank spreads. While some of the LA-7 banking systems have similar levels of concentration, they have diverging interest rate spreads, explained in part by institutional and regulatory factors,<sup>14</sup> competition, and level of foreign bank participation (and the technological spillovers from foreign banks which lower costs and improve efficiency in the market). This combined with a more stable macro environment could help explain lower spreads in Mexico.

**44. Another impediment to safer cross-border regional banking integration is the fact that countries are moving at different speeds in adopting the new regulatory agendas.** There are big differences in the speed of adoption of enhanced supervisory and regulatory frameworks, such as a consistent capital definition (Basel III), as well as adoption of the International Financial Reporting Standards (IFRS), which makes it hard to establish a level playing field across countries during the (possibly protracted) transition period. Brazil and Mexico lead the region in the implementation of Basel III, following closely the international timeline, followed by Peru, while Chile and Colombia have taken a more gradual approach. Colombia has enhanced its capital measure, bringing it closer to the Basel III definition.

**45. A bank's ownership structure could also be an impediment for regional acquisitions.** When HSBC tried to sell its operations to GNB Sudameris (Colombian) in Uruguay, the deal fell apart reportedly because the banks owned by the owner of GNB Sudameris do not have the same holding structure in different jurisdictions, a situation that was considered inappropriate by the Uruguayan supervisor. The SFC affirmed to the Uruguayan supervisor that it performs supervision on a consolidated basis over its supervised entities, and therefore requires GNB Sudameris to fulfill prudential regulations such as capital requirements, but this was deemed not sufficient.

#### ***Global Financial De-Integration:***

**46. Regulations in home countries of global banks aimed at strengthening banks' resilience have reduced the profitability of subsidiaries.** These measures have discouraged bank subsidiaries from playing an active role in markets as intermediaries or liquidity providers. Liquidity in sovereign debt

<sup>14</sup> Jorgenson and Apostolou (2013) find that institutional and regulatory factors are the most significant factors in determining spreads in Brazil, when examining the period 1995–2009.

markets has fallen as certain big banks (mainly from the U.S. and U.K.) have substantially reduced their presence in regional markets. Consolidation rules applied globally by parent banks on their subsidiaries appear in some cases to have come into conflict with the legal regulations in LA host countries, and raised the costs of doing business in those countries, not only vis-à-vis prior requirements but also relative to local banks. Vigorous application of these regulations could further the “de-globalization” trend. In the new regulatory environment, the costs and benefits of subsidiaries operating in emerging markets are likely to shift, possibly initiating further downsizing or withdrawal from these markets.<sup>15</sup>

**47. Bilateral and multilateral initiatives to increase the transparency of the international financial system have also contributed to a loss of correspondent banks in LA.** U.S. agencies’ enforcement actions against breaches of compliance with domestic regulations on trade and economic sanctions, tax evasion and AML/CFT, as well as other post-GFC developments, lead international banks operating under U.S. regulations to withdraw from activities seen as “high risk”. This has had a particular impact on correspondent banking relationships. A small number of large international banks dominate the provision of correspondent banking services for banks in the region. Some of these have been ending, or reducing, the provision of these services for local banks. For example, in Mexico, JPMorgan is maintaining its wholesale business, but is withdrawing from providing correspondent bank services to small and medium sized banks. Bank of America is for some local banks the only major U.S. bank still offering correspondent banking facilities. This evolution overall is intended to increase transparency in financial transactions and financial institutions’ risk management policies. However, authorities in the region have raised their concerns about these developments in various forms. They report the withdrawal of lines to medium-sized banks, which cater to SMEs, raising the cost of finance for these enterprises, and in some cases causing firms loss of access to credit from US exporters, who fear for the safety of their payment in the future.

#### **Recommendations:**

- Move forward in harmonizing regulatory frameworks across the region, as well as the legal framework for bank restructuring and resolution, towards international standards and best practices, with a view to promoting financial stability and establishing a level playing field across countries as well as across banks operating cross-border in the region.
- Strengthen consolidated supervision. Supervisory agencies should have adequate powers over non-bank holding companies of banks, both domestically and cross-border.
- Increase transparency regarding entry of foreign banks. To increase competition and lower the cost of financing, foreign banks should be allowed to enter the banking system through an explicit,

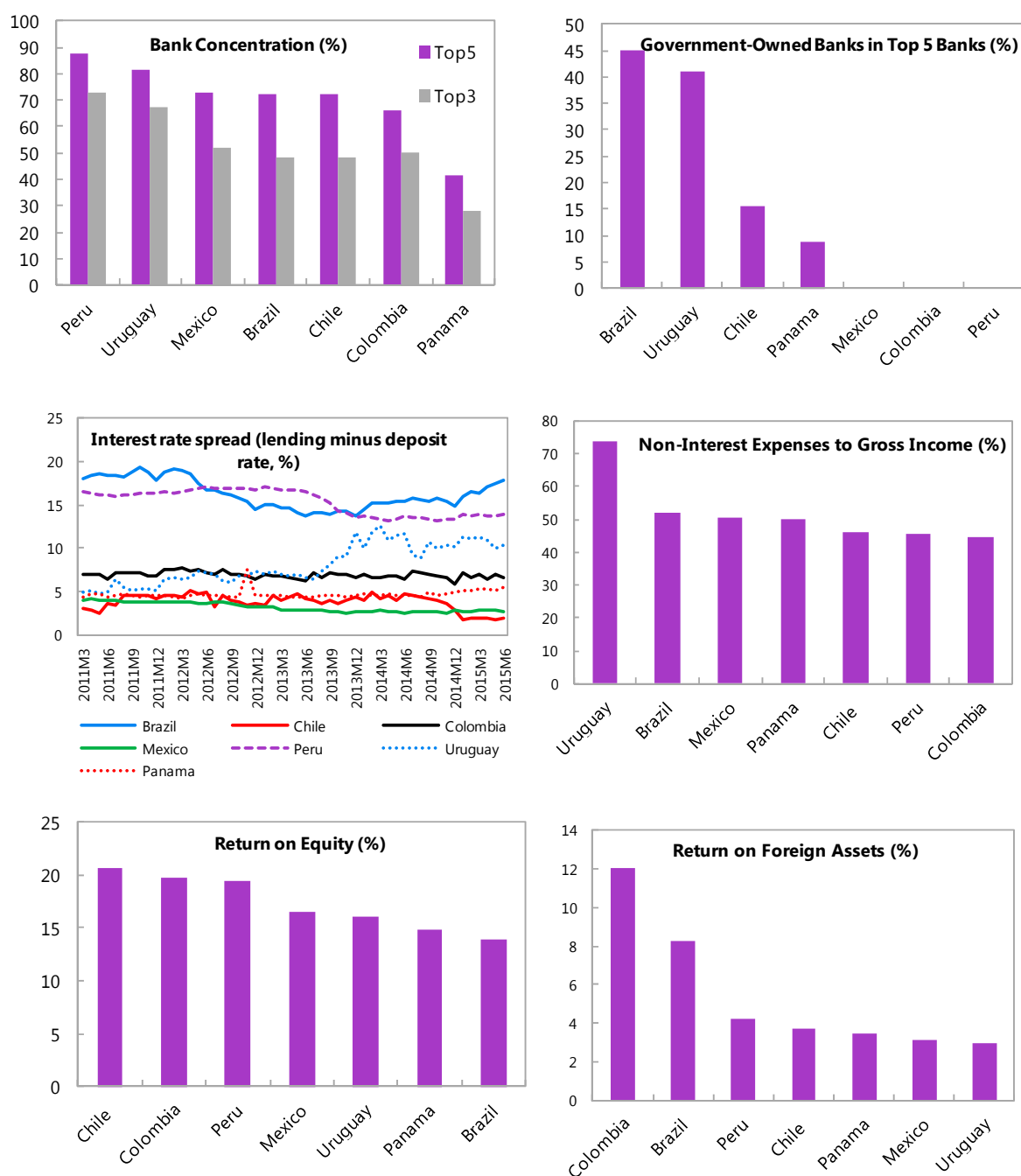
<sup>15</sup> April 2015 Global Financial Stability Report, Chapter 2 documents the decline in cross-border lending and finds it can be explained by a combination of regulatory changes, weaknesses in bank balance sheets, and macroeconomic factors.

open, objective and non-discriminatory statutory and regulatory framework (see also below).<sup>16</sup> At this point regional banks seem to be more likely than global banks to respond to such opening.

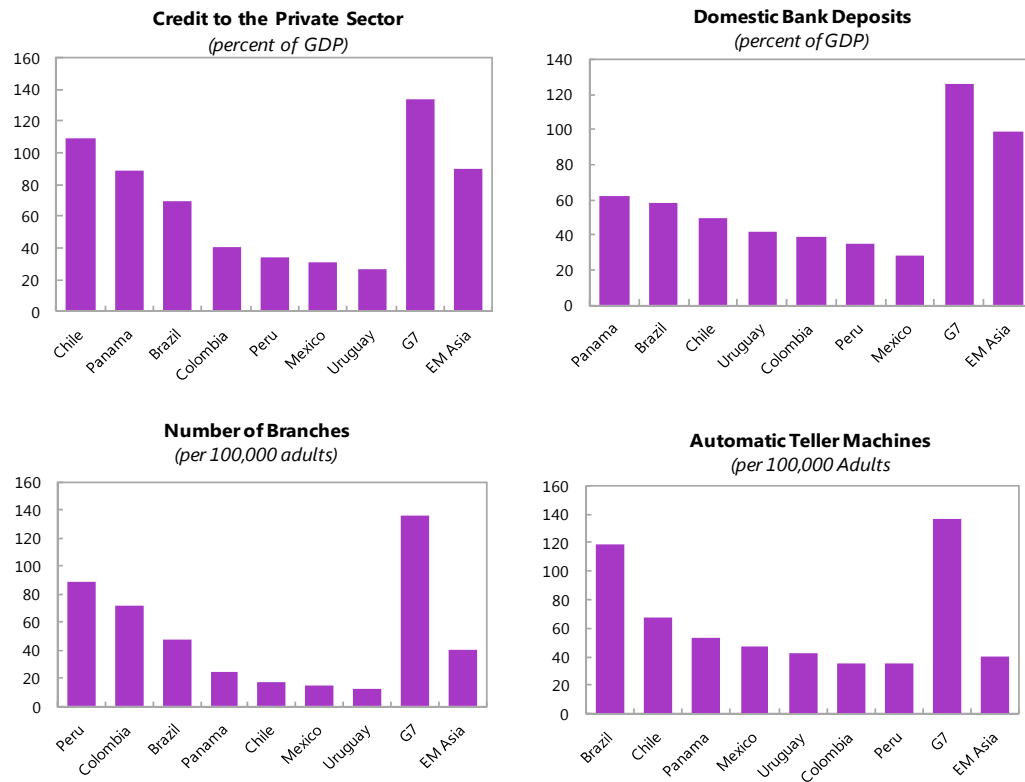
- In dollarized economies, strengthen prudential requirements on dollar lending and encourage the private sector to hedge its foreign currency exposures, and further support the de-dollarization process whilst deepening financial and capital markets. Indeed, deepening financial markets has proven to be an effective way to achieve de-dollarization, including through an active policy of de-dollarizing public debt, deepening local-currency bond markets, and promoting the development of markets for FX derivatives along with FX flexibility. In Brazil and Colombia, when market conditions and financial stability considerations permit, relaxing the constraints on foreign exchange activities and adjusting net open FX position limits for settlements in other currencies, where present limits are low could be considered.
- Continue to promote best efforts to ensure strong direct home and cross-border supervision, including measures to ensure that effective customer due diligence measures are in place. Countries should work with key international financial centers' regulators and international bodies, such as the FSB and the FATF, to ensure a clear understanding of regulations and policies relevant for their financial institutions. They should also be encouraged to assess the need of adapting their financial system to the new regulatory environment and to consider public sector support in case of market failure.

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<sup>16</sup> For instance, the process for meeting the requirement of a presidential approval for a foreign bank to enter the Brazilian market could be made fully transparent.

**Figure 11. Profitability, Concentration, and Competition, 2014**

Source: National authorities, Central Bank of Brazil, IFS, and IMF FSIs and staff calculations.

**Figure 12. Indicators of Financial Deepening, 2013**

Source: National authorities, World Bank, and staff calculations.

## B. Pension Funds

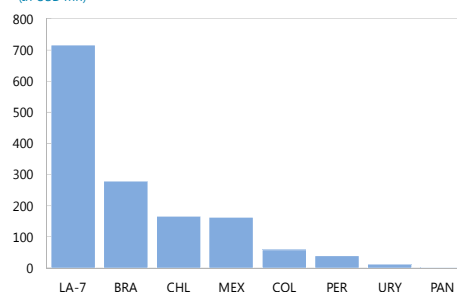
Pension funds are increasingly important in LA-7 financial markets, as their size has surpassed 17 percent of GDP in assets under management, largely driven by growing participation following legal changes in most of the region. Brazil dominates the LA-7 pension fund assets in value terms, while the Chilean pension fund industry—whose framework has often been used as a model in the region—remains the largest in relation to the country size. Despite the rapid growth, total assets and participation rates within the LA-7 remain below advanced country averages, thus, strengthening expectations that LA-7 pension funds growth will continue to outstrip that of regional GDP. Most pension funds are restricted to largely investing domestically, although in many cases LA pension funds have outgrown domestic capital markets.

**Figure 13. Indicators Pension Asset Growth, Size, and Manager Concentration**

**48. For over a decade, domestic pension funds have been among the largest institutional investors in many LA countries, increasingly expanding their importance in the capital markets (GFSR April 2014).** Pension fund participation in government securities markets increased significantly over the last decade. Pension funds' share of the sovereign debt market in Peru, for example tripled, while in Colombia their share of the market almost doubled. Brazilian Previ, Chilean AFP Provida, and Mexican Afore XXI Banorte are now ranked among the largest 100 pension funds in the world<sup>17</sup>.

**Figure 14. LA-7: Size of Pension Funds**

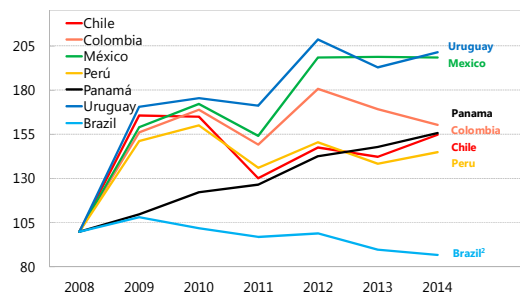
**Pension Funds: Assets Under Management (In USD mn)**



**49. Overall, assets under management of the LA-7 pension funds have reached US\$700 billion through the combination of healthy returns and rising contributions that reflect higher incomes and a growing participation base as younger, more urban population segments enter the formal workforce.** Authorities have also promoted private pension participation as a means to build domestic savings and stem the growth of public pensions. As a result, pension funds asset accumulation has well outpaced regional economic growth, significantly increasing their importance in the regional financial systems and domestic capital markets. Between 2008 and 2014 LA-7 pension assets have experienced growth rates that ranged between 50 and 100 percent<sup>18</sup>. Pension fund assets in many LA-7 countries now rank second largest among financial intermediaries, trailing only the banking system.

**Figure 15. Pension Fund Assets**

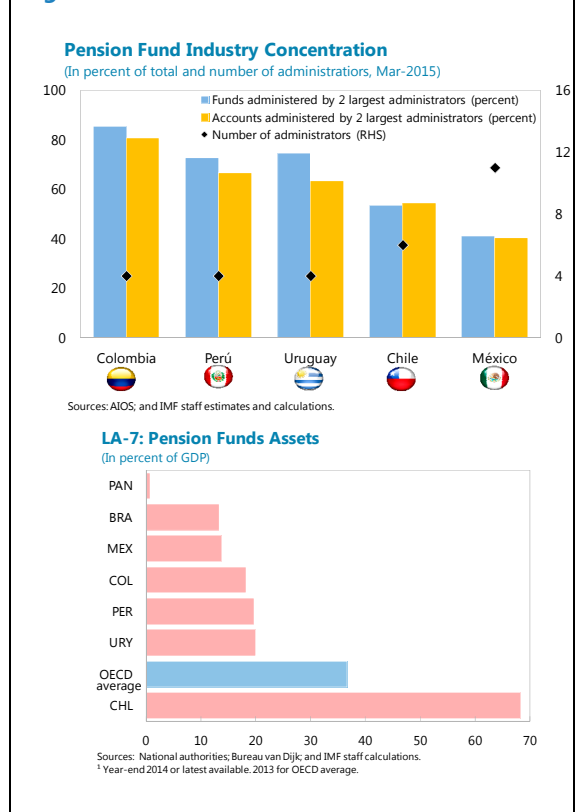
(Index, 2008=100, in percent of GDP in USD<sup>1</sup>)



<sup>17</sup> Towers Watson ratings of the largest pension funds (2014).

**50. Given their relatively recent establishment, however, LA-7 pension funds have ample room for further growth, as their size remains well below developed country averages.** LA-7 pension fund assets amounted to about 17% of LA-7 GDP at end-2014, well below the OECD average of 37% of GDP<sup>18</sup>, for every country, except Chile. The majority of the current pension fund systems in LA-7 trace their origin to the introduction of mandatory participation in defined contribution pension systems in the 1990s, following that of Chile in 1981. Brazil has an organization-sponsored pension system that is largely of defined benefit nature, but transitioning to an increasing number of defined contribution. The public sector pension plan is transitioning from defined benefit to defined contribution. Chile, Colombia, Mexico, Peru and Uruguay have implemented various forms of a multi-fund system, where younger participants are steered toward more aggressive funds while older contributors deposit into safer portfolios. Panama has retained its single-fund system. Another distinguishing characteristic of LA pension funds is the highly elevated levels of industry concentration; the largest two pension funds in Colombia, Peru, and Uruguay manage more than 70 percent of the industry assets, pension administrators. While the total number of pension fund administrators in each country is no more than four. In Chile and Mexico, by contrast, the two largest pension funds manage about 50 and 40 percent of total assets, respectively. While there is significant variation between the countries, pension fund performance in LA-7 largely remains on par with other financial intermediaries.

**Figure 16. LA-7 Pension Size and Concentration**



### State of play

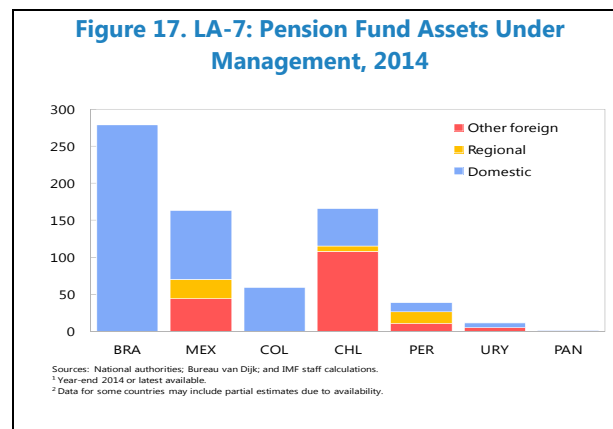
**51. Regional integration of pension fund markets is quite limited.** Financial integration of pension funds—regional and with the rest of the world—has historically occurred through two main channels: the internationalization of pension fund management firms and cross-border investments of pension funds' assets. While the recent years have witnessed some activity of the former, the latter continues to be held back by the low regulatory investment limits.

<sup>18</sup> Assets doubled as a share of GDP in Mexico and Uruguay, and increased by about half in Panama, Colombia, Chile and Peru. Mexican and Chilean pension fund assets have been doubling every 5–6 years.

<sup>19</sup> Based on OECD country estimates (2014).

**52. Cross-border management of pension funds' asset has experienced a pick-up in recent years, in light of consolidation trends and the withdrawal of a number of global institutions, while regional asset managers are beginning to assert themselves.** Throughout the region, the largest pension funds and the majority of assets are controlled by domestic asset managers, except in Chile. However foreign asset managers have sizeable market shares in Chile, Mexico, Peru and Uruguay. In recent years, many LA-7 countries have seen a number of M&As, involving either domestic

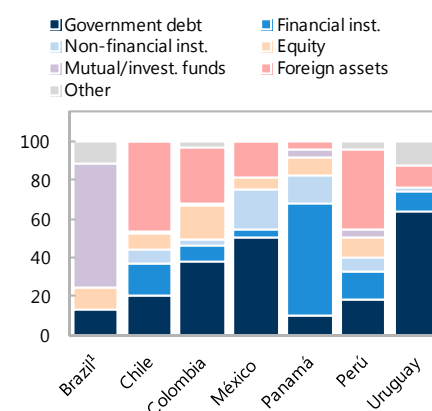
or foreign asset management firms. The sector has seen a withdrawal of several foreign institutional investment groups from the pension fund industry in the region, such as BBVA, ING, and HSBC, among others, which have been partially replaced by others, including Principal Financial Group and MetLife. At the same time, Latin American financial groups, such as Grupo Suramericana de Inversiones (Colombia) and its affiliates have acquired interests of controlling positions in Chile, Mexico, Colombia, Peru, and Uruguay. This trend, largely accomplished through M&A, has resulted in higher industry concentrations, with Colombia and Mexico being the more prominent examples. The number of pension fund administrators dropped in Mexico from 21 at end-2007 to 11 at end-2014, while the number of pension fund administrators in Colombia fell from 6 in 2012 to 4 in 2014.



**53. International investments are an important asset class for regional pension funds, but regional exposure is small.** The overwhelming share of foreign holdings is invested in advanced economies, such as the Euro Area, United States, and Japan, with a somewhat smaller share attributed to EMs. Investments in other LA countries are relatively low, Peruvian pension managers for example reported LA-7 investments of just 3.7% of assets (9.3% of foreign allocations), although this share increases marginally if indirect investments through ADRs and LA focused ETFs and mutual funds are taken into account. Foreign securities investments are often allocated to debt securities, given that many countries also place a regulatory limit on equities, both for foreign and domestic markets. Pension funds have greatly contributed to the development of domestic debt securities markets, but their role in the expansion of equity markets has been rather limited. (Figure 11)

**54. In addition to explicit caps on foreign asset holdings, many countries in the region have regulations that indirectly discourage financial integration.** For example, Uruguay's low foreign asset cap of just

**Figure 18. Pension Funds Investment**  
(Percent of Total, Mar. 2015)



Sources: AIOS; ABRAPP; PREVIC; and IMF staff estimates and calculations.  
 1/ ABRAPP and PREVIC estimates for Brazil.  
 Classification may vary from other countries.  
 Government debt includes only public bonds; other includes private loans and deposits, SPE, structure investments, real estate, operations with participants, and others.



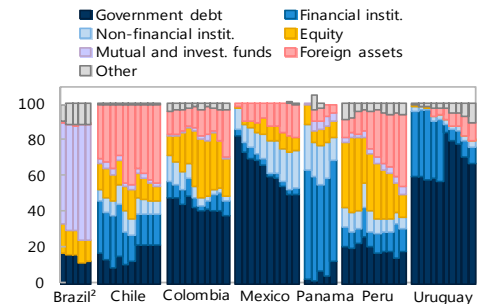
15% is further hindered by rules that limit external investments to securities from multilateral institutions. In Chile, while the regulatory limit does not appear to be binding in aggregate, foreign asset holdings are effectively constrained by additional caps on risk tolerance, as measured by sovereign ratings.<sup>20</sup> Brazilian pension funds are required to collaborate with at least three other asset managers through a dedicated fund if they wish to invest abroad.

## Analysis

**55. Consolidation in the pension management industry has reduced the scope for regional firms to enter neighboring markets, restraining competition and prompting higher pension fund fees.** Regulatory treatment of foreign and domestic companies in most cases is largely equivalent<sup>21</sup>. However de facto barriers arising from high market concentrations with incumbent power present significant impediments to new entrants. The competitive advantages<sup>22</sup> held by dominant, established asset managers are deemed too great for institutional investors to set up greenfield operations and grow organically. And as with the banking industry, consolidation has also pushed up corporate valuations beyond what foreigners are willing to pay to enter a market.

**56. As assets under management continue to grow, pension systems in most countries of the region will have to increase their international exposures.** Asset allocation strategies are likely to come under more strain as fund inflows continue to grow faster than net government borrowing, while excess allocations into bank deposits threaten to drag down returns. Issuance of corporate debt and equity can meet some of the pension fund demand for local currency investments, but in many countries there can be volume, liquidity, and maturity concerns in addition to corporate risks with these instruments. Alternative assets like private equity and infrastructure have

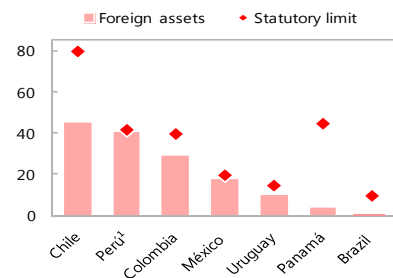
**Figure 19. Pension Funds Investment Flows**  
(Percent of total, 2005-14<sup>1</sup>)



Sources: AIOS; and IMF staff estimates and calculations.

<sup>1</sup> 2010-14 for Panama and Brazil.

<sup>2</sup> ABRAPP and PREVIC estimates for Brazil. Classification may vary from other countries. Government debt includes public bonds; other includes private loans and deposits, SPE, structure investments, real estate, operations with participants, and others.



Sources: AIOS; PREVIC; and IMF staff estimates and calculations.

<sup>1</sup> While the regulatory limit established by law in Peru is 50, the pension fund supervisor slowly continues to increase it. Currently set at 42 percent.

<sup>20</sup> Chilean pension funds may hold no more than 20% of assets in securities of countries with sovereign risk ratings lower than Chile (AA). This could likely be a complicating restriction when encouraging regional holdings as targeted partners would all fall below this threshold.

<sup>21</sup> The absence of foreign asset managers in Brazil reflects regulatory limits on new investments in the Brazilian financial sector. Brazilian law allows any individual resident to make investments abroad, provided that they declare the investment and the fund's origins to the local authorities.

<sup>22</sup> Recognized advantages include that well-established institutions have greater access to securities brokers and have the first pick of the investment offerings, and the assessment among pension participants that the largest funds are the least risky.

garnered more attention in recent years especially in Brazil, Peru and Uruguay, but prudential limits are low and the class is generally considered too risky to expect caps to rise quickly. In the last two decades, regulators have been keener to raise caps on foreign asset holdings. While this asset class introduces foreign exchange risk, most funds have invested in highly liquid segments of advanced country markets for which currency hedging is less expensive.

**57. The internationalization of pension assets is restrained by limits on some asset classes.**

Regulatory limits and restrictions on investments vary by country (Table 5), and generally span multiple categories, such as foreign securities, equity, foreign currency, commodities, derivatives, single issuance holdings, and debt securities of lower ratings among others. On average, limits on variable rate instruments tend to be more restrictive. Countries with a multi-fund system—which allows risk profile differentiation—over time have been able to ease their regulatory restrictions allowing larger shares of investments in variable rate instruments (Chile, Colombia, Mexico, and Peru).

**58. Pension funds in the region have outpaced the growth of domestic capital markets, complicating the task of optimal portfolio diversification, and making a case for the expansion of investment opportunities through financial integration.** In addition to providing retirement funding, the development of the pension fund sector has generated a number of benefits. Pension funds have contributed to higher savings rates, broadening the domestic investor base, and deepening of the local securities markets. However, their asset growth has long outpaced the supply of domestic securities, triggering an array of challenges. First, pension funds now find it more difficult to achieve optimal portfolio diversification. Second, equity markets may have become more prone to asset price bubbles—as pension funds pursue a limited number of securities—which is further magnified by herd behavior as asset managers chase the same type of securities. Third, the large size and established investment behavior of pension funds, which is based largely on a buy-and-hold strategy, combine to further diminish financial market liquidity. Trading volumes in the financial markets have declined substantially as pension funds absorb significant portions of new and existing products. And, finally, pension funds' appetite for domestic instruments crowds out other financial intermediaries, such as insurance companies from the domestic financial markets. Stronger regional integration could enable greater diversification by pension funds and enhance competition, and hence development, in financial markets.

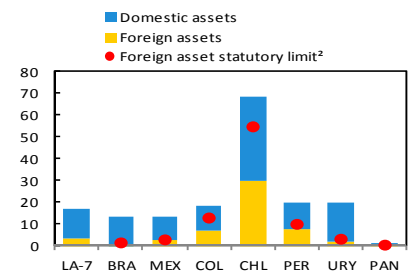
**59. While the minimum return requirements enforced in some countries inspire confidence in the systems, they can incentivize a herd mentality among asset managers and reduce diversification efforts into new foreign markets.** The minimum returns requirement compels pension funds to disclose their asset composition and portfolio returns, and requires asset managers to top up returns by injecting their own cash into the fund when the return deviates significantly—generally more than 2-4 percentage points—below the minimum required threshold over an extended period, usually about 36 months. Typically, the industry average serves as the minimum required rate. To avoid underperforming their peer group, pension fund asset managers to mimic the portfolio allocation schemes of the largest pension funds, which tend to drive the reference rate. While this mechanism has successfully inspired some level of confidence in the systems, it also encourages herd behavior among asset managers. Strong homogeneity of returns across funds in a system shifts competitive pressures to management fees and marketing savvy. In such an environment, where risk

taking by asset managers can be substantially hemmed, as negative consequences of poor returns outweigh perceived rewards of stronger performance, initial cross-border activity by market leaders would likely be followed quickly by the other market participants, if sufficient cross-border opportunities are available.

**60. It is easier for regulators in countries with age/risk differentiated funds to introduce new limits on asset classes with higher risk/return profiles.** Softer caps on foreign assets, corporate paper, or alternative assets can be introduced in funds with the highest risk tolerances (those designed for the youngest contributors). If over time the changes meet regulator expectations, similar reforms can be introduced into less aggressive funds.

**61. In an effort to diversify investments, pension funds have turned their attention to infrastructure products.** So far, investments in infrastructure are in the range of 3-5 percent of pension fund investments, well below regulatory limits. A number of barriers prevent higher infrastructure investments, including lack of expertise in the infrastructure sector, problems of scale of pension funds, lack of transparency in the infrastructure sector, shortage of data on the performance of the infrastructure projects, and lack of a benchmark. Given the unique nature of each investment, investments in infrastructure, either directly or through a fund, also require significant time to complete due diligence and establish the appropriate framework for investment and risk management.<sup>23</sup> LA-7 pension funds see infrastructure vehicles as a promising instrument for diversification, particularly as they align with the authorities' strategies for public investment and structural reform implementation. In Mexico, for example, the recent energy reform is expected to provide a boost for the development of energy products. The long-term investment horizon of pension funds makes them natural investors in less-liquid and long-term infrastructure products. While prudential limits may have contributed to preventing pension funds from investing much in such infrastructure, own risk appetite also had a part to play. Such risk appetite and internal risk controls would also help to ensure pension funds do not hold too high a share of highly illiquid infrastructure assets.

**Figure 20. Pension Fund Asset Allocations, 2014<sup>1</sup>**



Sources: National authorities; Bureau van Dijk; and IMF staff calculations.  
<sup>1</sup> Year-end 2014 or latest available.  
<sup>2</sup> Statutory limits on holdings of foreign assets (in percent of total pension fund assets) are: Brazil (10%); Mexico (20%); Colombia (40-70%); Chile (80%); Peru (50%); Uruguay (15%); and Panama (45%).

<sup>23</sup> Infrastructure investments of global pension funds vary greatly. Some Canadian and Australian pension funds register about 10% investment in infrastructure, for example, where the necessary knowledge, expertise and resources to invest directly into infrastructure have already been acquired. Other countries' infrastructure investments remain limited largely due to the remaining perceived risk of the sector. Based on OECD (2011) "Pension fund Investment in Infrastructure. A Survey."

### Box 3. LA-7 Pension Funds: Operating Costs and Pension Fees<sup>1</sup>

**Pension fund fees levied on contributors directly affect the size of their retirement income.** In a pension fund system with defined contribution arrangements, the size of retirement benefits depends not only on the contributions and the investment returns earned by such contributions, but also on the amount of fees levied by the pension fund providers. This implies that, while the size of the mandatory pension fund contribution is often determined by legislation, accruing sufficient retirement benefits requires the combination of high returns and low fees<sup>2</sup>.

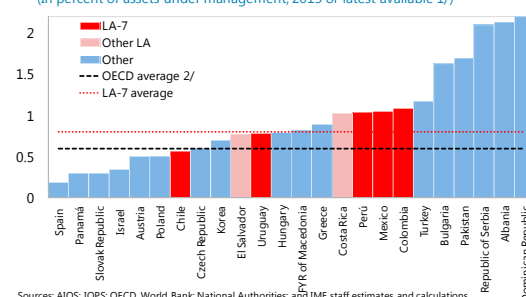
**Comparison to other countries indicates that LA-7 pension funds fees are higher than the level suggested by their operating costs<sup>3</sup>.** LA-7 pension funds on average charge higher fees than OECD country average, when taken in percent of total assets under management. Fee size is largely driven by the structure of operating costs, as pension providers charge fees to cover operating expenses, which largely include fund administration expenses, marketing costs, and commission of sales agents, among others. However, the size of operational expenses in relation to total assets under management of LA-7 pension funds largely remains comparable to the OECD-country average. This implies that, based on international comparison, for a given level of operating costs, average pension fund fees in LA-7 exceed those levied by their OECD counterparts.

**Fees levied on contributors by pension funds in LA-7 are almost double the size that is needed to cover operating expenses.** In Panamá and México, for example, while the operating costs constitute less than half of income collected from fees, the structure of operating costs differs; as Panamanian pension funds spend the bulk of their operating expenses toward the administration purposes, meanwhile more than half of the operating costs of their Mexican counterparts goes towards the commission of sales agents.

**LA-7 pension fund fees are also influenced by the industry characteristics and regulatory frameworks, largely exhibiting preference for fees levied on contributions rather than on asset balances.** Pension fund fees collected from individual contributors depend on a number of factors, including the size and maturity of the system, market structure, competition, as well as

#### Pension Fund Fees

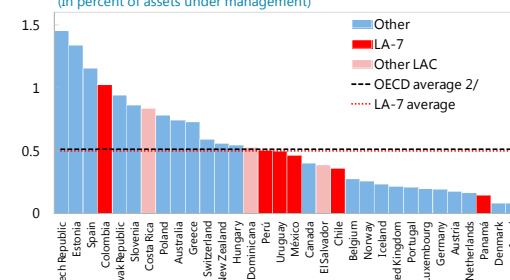
(In percent of assets under management, 2015 or latest available 1/)



Sources: AIO; OECD; World Bank; National Authorities; and IMF staff estimates and calculations.  
1/ Occupational category for Spain; 2nd pillar for Slovak Republic; and voluntary plan for FYR of Macedonia.  
2/ Includes selected OECD (non-LAC) countries for which data are available. Data may not be comparable due to differences in definitions.

#### Pension Funds' Operating Expenses

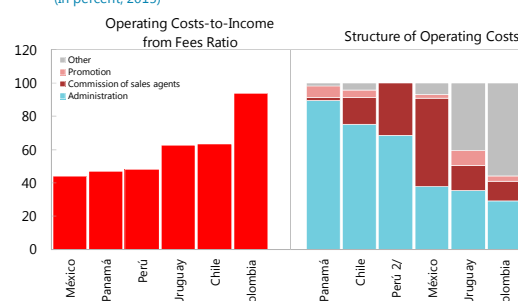
(In percent of assets under management)



Sources: OECD; AIO; and IMF staff estimates and calculations.  
1/ For Latin and Caribbean: annual data include July, 2013 to June, 2014. Data for LAC may not be fully comparable to other economies. 2/ Includes selected OECD (non-LAC) countries for which data are available. Data may not be comparable due to differences in definitions.

#### Pension Funds: Operating Costs and Fees

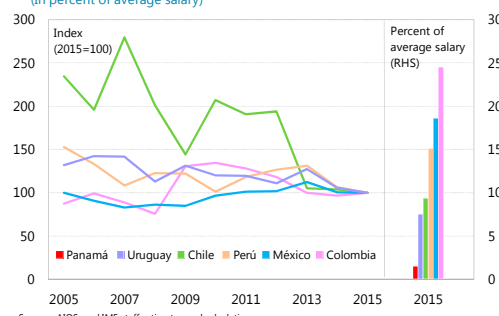
(In percent, 2015)



Sources: AIO; OECD; and IMF staff estimates and calculations.  
1/ Ratio of operating costs to total income from fees, implied estimate for some countries based on available data. 2/ Commission of sales agents costs for Peru may include promotion costs. Data for LA-7 cover July-June period.

#### Pension Funds: Income from Fees per Contributor

(In percent of average salary)



Sources: AIO; and IMF staff estimates and calculations.  
1/ Annual data cover July-June period.

### Box 3. LA-7 Pension Funds: Operating Costs and Pension Fees (concluded)

the investment strategy and regulatory frameworks, among others. Fairly recent and less mature pension fund systems – which is the case for LA-7 – tend to have relatively higher fees. Asset allocation decisions and investment regulations also tend to influence fees, as investments in interest bearing assets, such as debt instruments, are usually cheaper than active investments, such as equities. Thus, the higher fees in nominal terms in Peru could potentially be partially explained by the relatively larger share of asset allocations toward equities. The structure of pension funds' fees in general tends to be fairly complex. Unlike Central and Eastern Europe where preference is often given to fees levied on asset balances, Latin American pension funds mainly emphasize fees on contributions. Colombia, for example, levies a fee on contributions of 16 percent, while Peru and Chile have a 10 percent fee on contributions in place. LA-7 pension funds also impose a fee on salary, which vary from about 1.2 percent in Peru to 3 percent in Uruguay. Mexican pension funds, on the other hand, rely instead on fees imposed on asset balances.

Selected LA-7: Pension Fund Fee Structure (As of June, 2015)

	Fees on contribution	Fees on salary	Fees on assets 1/	Fees on return	Fixed Fee
	Percent				USD
Chile	10.0	1.3	...	...	...
Colombia	16.0	1.4	...	...	...
México <sup>2</sup>	...	...	1.1	...	...
Perú - Comision por Flujo	10.0	1.6	...	...	...
Perú - Comision Mixta	10.0	1.2	1.2	...	...
Uruguay	15.0	3.1	0.0	...	...

Source: AIOS.

1/ Fees on balance are taken as average. For Uruguay, data refer to custody fees.

**More optimal fee structure in Latin America would instigate a decline in pension fund fees without jeopardizing optimal returns and their corresponding alignment with the managers' cost strategies.**

Both types of fees, contribution fees and those levied on asset balances, have a number of disadvantages. While contribution fees generate revenues at the start, they may not be completely aligned with the continuously changing nature of the fund managers' cost structure. Asset management fees on balances (levied as a percentage), on the other hand, while responding quickly to the funds' costs, do not generate revenues initially. Meanwhile performance fees tend to distort the funds' long term goals and objectives. Against this backdrop, it is often more advisable to implement annual flat fees—to cover transactions carried out during each period—combined with the asset management fees, which are aimed to absorb the portfolio management costs. Such a strategy may be more aligned with the cost structure of the manager and have fewer distortions on the long term investment strategies of the pension providers.

**Greater regional financial integration in Latin America would prompt higher competition within the pension fund industry, while simultaneously relieving the burden of high pension fund fees levied on customers' contributors.**

In some instances, such as Mexico for example, lower pension fund concentration may have been accompanied with higher fees. This could possibly be explained by higher operating expenses – incurred as a result of the increased efforts of the marketing and sales agents to encouraged pension fund members to switch providers, which drive up fees, given that some contributors may be more responsive to marketing rather than to the size and structure of the fees. In response to this, increased regional integration, in combination with continued efforts to promote financial education among contributors, would allow greater access of regional companies to domestic markets and increase competition within the pension fund industry, thus, forcing managers to reduce the size of fees they levy on their customers. This, in turn, would reinforce contributors' efforts to accumulate sufficient funds for retirement.

<sup>1</sup> Data references based on data by OECD, AIOS, and IMF staff estimates and calculations.

<sup>2</sup> Tapia, W. and J. Yermo (2008), "Fees in Individual Account Pension Systems: A Cross-Country Comparison", OECD WP No. 27.

<sup>3</sup> OCED country averages may not be fully comparable due to variations in country and time period samples.

*Recommendations*

**62. Higher regulatory limits on foreign security investments would ease demand pressures in domestic financial markets.** The fact that Latin American pension funds have outgrown domestic securities markets provides a strong argument for an increase in regulatory limits on foreign securities, perhaps to about 50% percent in countries where they are currently set lower. Low limits not only may have led to suboptimal portfolio holdings and asset bubble developments in the domestic markets, but also may provide a source of instability as they fail to accommodate portfolio reallocations in response to changes in domestic financial conditions. Relaxing limits on foreign, particularly regional, investments, subject to risk safeguards around such investments abroad and availability of hedging instruments, plus enhancements to transparency and improvements in data, would allow pension funds to invest more cross-border, hence easing their demand for domestic securities and allowing other financial intermediaries, such as insurance companies, greater access to financial instruments.

**63. Given regional labor mobility among the LA-7 countries, authorities should seek to institute pension fund portability across the region.** Currently, Chile and Peru have a signed bilateral agreement that allows citizens of both countries to transfer the balances accumulated in their individual accounts voluntarily from one country to another. Not only does this action facilitate the transfer of savings, but it also encourages countries to adopt best standards and practices and harmonize asset management processes.

**64. Authorities should simplify the process of creating infrastructure products and allow pension funds to access these instruments in other LA countries.** Unrestricted access to regional infrastructure projects would provide a boost to the development of regional infrastructure products and further contribute to the development of securities markets. This would be beneficial to pension funds, as it would allow them to ensure better diversification of portfolios, given that infrastructure projects are long-term investments which could match the long-term duration of their liabilities. The benefit would also extend to the regional economy, as this would facilitate infrastructure financing overall.

**Table 6. Pension Funds in Latin America - Limits on Foreign Investments**

Country	Legal Instrument	Foreign Investments allowed	Foreign Investment Limit
<b>Brazil</b>	Banco Central do Brasil- Resolução No. 3792	<ul style="list-style-type: none"> <li>- Assets issued abroad belonging to the portfolios of the funds constituted in Brazil.</li> <li>- Shares of investment funds and shares of investment funds in shares of investment funds classified as external debt.</li> <li>- Shares of foreign index funds admitted to trading on the stock exchange in Brazil.</li> <li>- Brazilian Depositary Receipts.</li> <li>- Shares issued by foreign companies based in MERCOSUR.</li> </ul>	10%
<b>Chile</b>	Decreto Ley No. 3500 de 1980  Banco Central de Chile Acuerdo No. 1680-03-120517- Circular No. 3013-699	<ul style="list-style-type: none"> <li>- Credit instruments or negotiable securities issued or guaranteed by foreign governments, central banks and banks;</li> <li>- Stocks and bonds issued by foreign companies;</li> <li>- Participation shares usually traded on international markets issued by mutual funds and investment funds.</li> </ul> <p>Debt instruments must have at least two risk ratings by international rating agencies above BBB and N-3.</p>	<p>The Law sets the maximum limits range for all the funds combined (30%-80%), and the maximum limit range for each type of fund:</p> <ul style="list-style-type: none"> <li>- Fund A 45%-100%</li> <li>- Fund B 40%-90%</li> <li>- Fund C 30% -75%</li> <li>- Fund D 20%- 45%</li> <li>- Fund E 15% - 35%</li> </ul> <p>The Central Bank set the limits within the above range as follows:</p> <ul style="list-style-type: none"> <li>- Maximum limits for the funds combined</li> </ul>

**Table 6. Pension Funds in Latin America - Limits on Foreign Investments (continued)**

			<p>cannot exceed 80% of their value.</p> <ul style="list-style-type: none"> <li>- Fund A 100%</li> <li>- Fund B 90%</li> <li>- Fund C 75%</li> <li>- Fund D 45%</li> <li>- Fund E 35%</li> </ul>
<b>Colombia*</b>	Ministerio de Hacienda y Crédito Público- Decreto No 857/2011	<ul style="list-style-type: none"> <li>- Debt securities issued or guaranteed by foreign governments or foreign central banks.</li> <li>- Debt securities issued, guaranteed, or originated by foreign commercial or investment banks; or by foreign non-bank entities.</li> <li>- Debt securities issued or guaranteed by multilateral lending institutions.</li> <li>- ETFs, foreign mutual or investment funds.</li> <li>- Equity securities.</li> <li>- ADRs and GDRs</li> <li>- Private equity funds established abroad</li> </ul>	<ul style="list-style-type: none"> <li>- Conservative Fund: 40%</li> <li>- Moderate Fund: 60%</li> <li>- Riskier Fund: 70%</li> </ul>
<b>México</b>		<ul style="list-style-type: none"> <li>- Foreign debt securities and foreign equity securities;</li> <li>- Real estate investment vehicles;</li> <li>- Bank demand deposits in foreign financial institutions;</li> <li>- Derivatives with foreign equity as underlying assets</li> </ul>	<ul style="list-style-type: none"> <li>- Funds 1-4: up to 20% for foreign debt securities</li> </ul> <p>At the same time, the law establishes limits per type of investment –equity, structured investments for each type of Fund.</p>



**Table 6. Pension Funds in Latin America - Limits on Foreign Investments (concluded)**

<b>Panama</b>	Comisión Nacional de Valores Acuerdo No 11-2005	- Shares issued by foreign companies  - Debt securities issued by governments, central banks, foreign financial institutions and companies that at least 50% are investment grade by the country of origin or by a recognized international rating agency.	Foreign investments cannot exceed 50% per type of asset
<b>Perú</b>	Texto Único Ordenado de la Ley del Sistema Privado de Administración de Fondos de Pensiones-  Banco Central de Reserva del Perú Circular No. 032-2014-BCRP	- Financial instruments issued or guaranteed by foreign governments or central banks; shares and securities representing rights to shares registered in stock exchanges; debt securities, participation in mutual funds and hedge operations issued by foreign institutions.	50% established by Law.  The Central bank set the operational limit at 42% starting on January 1, 2015  Limits are also added per category of instrument, depending on the type of fund.
<b>Uruguay</b>	Ley 16.713	Debt securities issued by international credit organizations or foreign governments with a very high credit rating	15%
Note: In addition to the global investment limits specified above, some countries also set limits per issuer and per issuance. Colombia, for example, sets a limit of 10% of the value of each fund per issuer, and a 30% limit per issuance. Mexico also adds a 5% limit of the total assets of the fund per issuer and a 35% per issuance.			

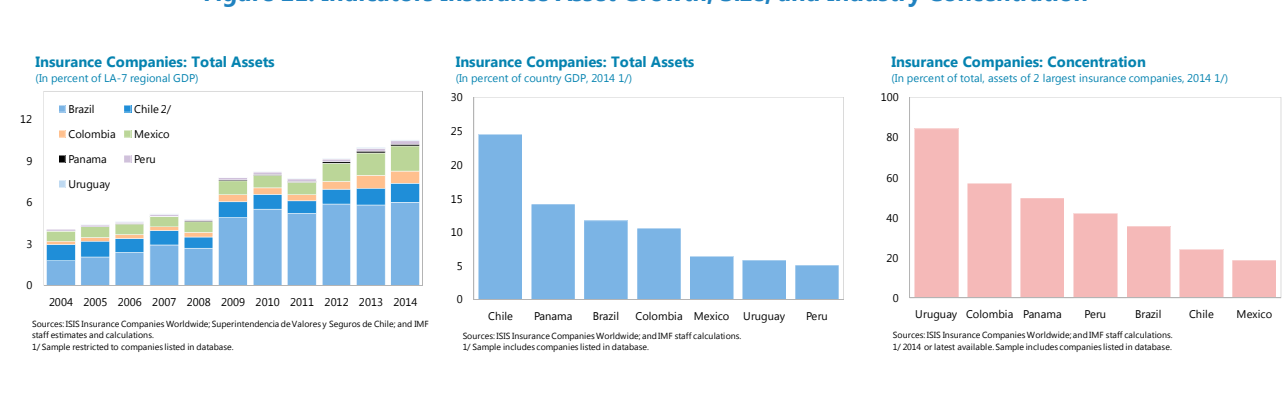
**65. Countries of the region should demonstrate their commitment to integration with an understanding that in the future their pension regulators will agree to treat each other's securities as domestic.** Critically, such an agreement would be preconditioned on countries' adoption of the highest standards in pension and financial system regulation and regulatory collaboration. Additionally, countries would have to have harmonized their accounting standards through adopting the IFRS, and have signed the multilateral memorandum of observance of international principles and practices relating to governance, monitoring, mitigating financial and operational risk. A token of this commitment could be the establishment of a special category for the holding of bonds issued in the region that would not count against foreign asset limits. While initially this category can be set at

lower levels of about 5%, relaxation of these limits could be envisaged, should asset holdings reach them and they become binding.

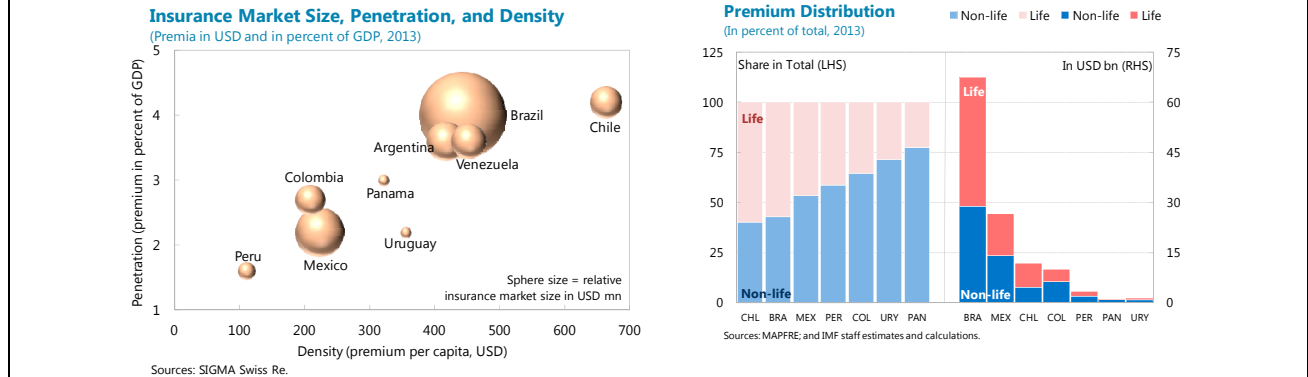
## C. Insurance Firms

*Insurance penetration in LA-7 markets remains low, ranging from 1 to 4 percentage points of GDP, although the sector has expanded at a significant rate over the past decade, reaching almost 10 percent of the regional GDP in 2014, often influenced by changes in the domestic regulatory frameworks. While economic formalization, and possible increased occurrences of natural disasters are likely to fuel the non-life segment, purchases of life and retirement products are already quickly increasing the life portion of the insurance sector. Its growth is partly stymied by the limited availability of long-term financial instruments denominated in the domestic currency, given that their demand for financial vehicles is often crowded out by pension funds.*

**Figure 21. Indicators Insurance Asset Growth, Size, and Industry Concentration**



**66. The insurance sector in Latin America has achieved significant growth over the last decade (GFSR, April 2014).** Insurance premia of the Latin American market quadrupled between 2003 and 2013, reaching almost 160 billion of USD by 2013, in large part on the back of resilient economic performance and strong employment growth, also supported by vigorous foreign direct investment, regulatory reform implementation, and improvements to the business environment in the region. Robust vehicle sales have contributed to the non-life insurance sector expansion, while pension-related products have fueled life insurance segments in many countries. Market maturity varies greatly by

**Figure 22. Selected Insurance Market Indicators**

country, with Chile and Brazil having the longest maturities, as indicated by larger contributions of life premia. In Latin America compulsory insurance has played a number of roles: life insurance in Chile, for example, is strongly driven by mandatory products, while the absence of compulsory federal auto insurance in Mexico<sup>24</sup> has reduced the non-life insurance sector penetration.

**67. Both the size and the rate of market growth are influenced by the regulatory environment, which remains at different stages of development across the region.** Some countries are currently setting the stage for risk-based capital model implementation, with Brazil and Mexico being at the forefront meeting Solvency II equivalent standards. Chile is also expected to adopt frameworks similar to Solvency II in the coming years. Other countries, however, continue to operate under regimes similar to Solvency I, with Colombia and Peru considering comprehensive regulatory reforms, as they continue to implement risk capital requirements (see box 3).

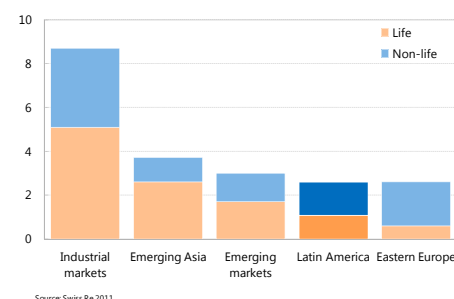
**68. The main insurance distribution channels include agents, brokers, and banks, which vary by type of insurance sold.** Many companies specializing in life insurance, for example, create their own networks of agents, which only sell the home company's products. This distribution channel can be very costly due to the large resource requirements for agents' management, remuneration, training, and supervision.

**69. Market concentration across the LA-7 region varies by country but on average remains elevated.** In Uruguay, for example, the large state-owned insurance company controls 80% of the market, while the two largest companies in Peru manage about 60% of total premia. Colombia's ten largest companies account for almost 80% of the market share; meanwhile in Brazil, while there are over 110 companies, the largest 10 companies account for around 65% of the sector premia. Chile's market concentration too appears to be somewhat lower, since the largest 10 companies account for about 60% of the market share.

<sup>24</sup> Compulsory auto insurance in Mexico is being phased in, and began to apply to certain cars since September 2014.

**70. Prospects for future growth of the insurance sector remain promising.** The low insurance penetration of the LA-7 market, when compared to advanced and other Ems, testifies to the sizable unrealized potential. The relatively young population across the region provides expectation of future purchases of life and retirement products, while rising income levels are likely to stimulate automobile sales and drive non-life insurance growth. Regional susceptibility to natural disasters is likely to feed property and casualty market expansion, while the authorities' efforts to increase the level of formalization of LA-7 countries are also likely to contribute to future growth.

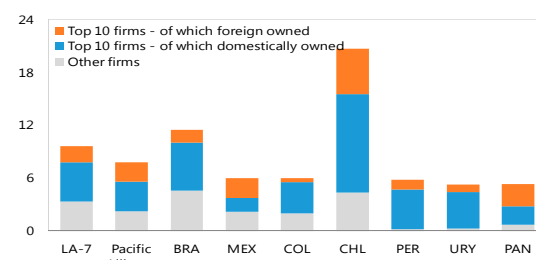
**Figure 23. Insurance Penetration**  
(Premium, in percent of GDP)



### State of play

**71. Cross-border financial integration—regional and foreign—has been largely observed in the form of cross-border company ownership and reinsurance growth, rather than investments in foreign assets.** While the former is largely a direct result of the growing importance of the sector, the latter is an effect of the product structure of many insurance companies in the region. Reinsurance has become particularly important in the property and casualty segment of non-life insurance, particularly given the region's high exposure to natural disasters and the need to reinsure such risks. Nonetheless, reinsurance in LA remains relatively small, as the proportion of ceded premia is low, while the majority of the reinsurance activity is carried out by foreign, primarily European, companies.

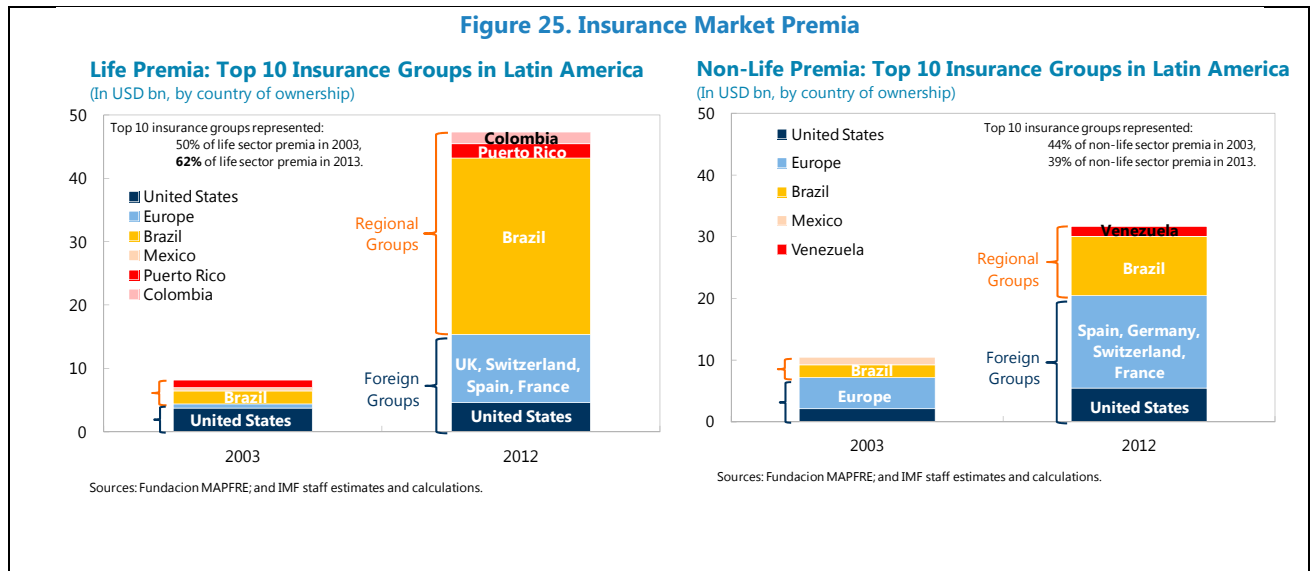
**Figure 24. LA-7: Insurance Firm Ownership, 2014<sup>1</sup>**  
(Insurance sector assets in percent of GDP)



**72. Growth in the Brazilian and Colombian companies has shifted the ownership structure and revised the rankings of the largest insurance groups operating in the region.** LA has seen a notable shift in the ownership structure of the largest 10 insurance groups, which account for almost half of the market share. Among these ten groups, the market share of regional companies increased from 32 to 54 percent since 2003.<sup>25</sup> This upsurge is mainly due to the life insurance segment, as the share of regional companies within the life segment more than doubled over the last decade, rising from 32 to 68 percent of the market (see table 7). This reordering was brought on by the fast expansion of such regional companies as Bradesco, Itau/Unibanco, and Brasilprev (all Brazil), and to a lesser degree Suramericana (Colombia). Bradesco has been the leading insurance group in the region

<sup>25</sup> Based on estimates by Fundacion MAPFRE and IMF staff calculations.

since 2004, largely fueled by domestic market growth. But the region has also witnessed a number of mergers and acquisitions, which have pushed up the size and the ranking of the largest regional companies. In the non-life segment, the growth of regional insurance groups, while still exceeding that of foreign, has been less pronounced, with both, regional and foreign companies doubling in size.



## Analysis

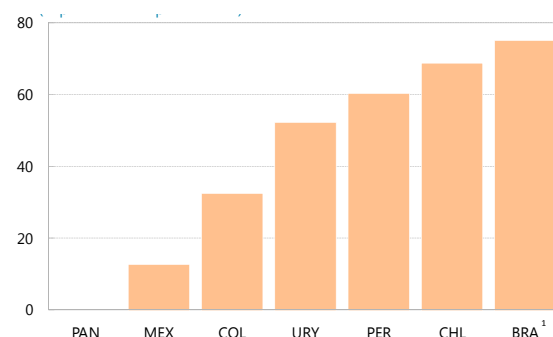
**73. M&As are viewed by many as the preferred method of growth, which is largely shaped by the characteristics of the LA-7 insurance market, rather than by regulatory regimes.** Sizable growth potential and market stability make LA-7 countries appealing for new entrants. Most companies prefer brownfield investment to organic growth. In the absence of major regulatory barriers to cross-border expansions, high market concentration is considered by companies as the largest barrier to entry. Among the companies specializing in life insurance, the distribution channel is a potential barrier to greenfield investment, given that setting up a network of agents can translate into a sizable up-front fixed cost, and developing a sound agent base can take several years. Relative product complexity in many markets—usually in the form of bundled products to attract a larger customer base—also serves as a barrier to entry. The general lack of trust in insurance companies and their products, and limited product awareness, also depress market deepening. Insurance products remain unaffordable for a large fraction of the population of the region, and the lack of products for these segments contributes to low insurance penetration.

**74. Shortages of domestic securities have forced some companies to face maturity and currency mismatches.**

Investment portfolio allocation decisions are largely directed by regulatory limits and insurance product specialization. Portfolio allocations of life and non-life insurance companies differ based on the currency and maturity composition of their liabilities. The composition of country portfolios continues to shift toward life insurance, driven largely by the flow of funds from those retiring and converting their pensions into annuities. Within the LA-7, Chile, Peru, and Uruguay have the largest contributions of private pensions to life insurance growth<sup>26</sup>, some of

which is driven by legal and regulatory frameworks. In Chile, for example, life annuities grow at low double-digit rates due to the participation of life insurance companies in the social security system. Accordingly, an insurance company selling annuities generally must be able to begin paying out a stream of payments denominated in domestic currency soon after the annuities are purchased and over an extended period of time, thus requiring currency and maturity hedging of its assets and liabilities. Some insurance companies have difficulties in matching the currency and maturity of their assets and liabilities, largely due to the weak supply of domestic securities, scarcity of foreign exchange derivatives of sufficiently long duration, and the shortage of long-term assets in the domestic markets. These result in up to 3- to 5-year maturity mismatches. Chilean life insurers with annuity liabilities, for example, show a systematic maturity mismatch of assets and liabilities due to the shortage of assets with similar durations as liabilities.

**Figure 26. Private Pension Plan Premia, 2013**  
(percent of life premia)



Sources: MAPFRE; and IMF staff estimates and calculations.  
<sup>1</sup> Includes VGBL (Vida Gerador de Benefício Livre) products.

**75. Due to the growing need for domestic instruments, holdings of foreign securities are reported to remain well below the regulatory limits in many countries.** In Mexico, for example, the share of foreign securities remains below 3%, while the regulatory limit is currently 10%. Mexican companies which offer insurance products in foreign currency tend to have slightly higher shares of foreign securities holdings. In general, LA-7 insurers largely choose to invest in debt securities, more so in Colombia, Mexico, Peru, and Uruguay, where about  $\frac{3}{4}$  of investment portfolio allocations of life insurers are held in bonds. In Panama, on the other hand, only about a quarter of portfolio is allocated toward bonds. While companies in Mexico and Uruguay tend to hold mostly government bonds, in Chile, Colombia, Panama and Peru companies appear to favor private debt securities. The rest of the portfolio usually includes equity shares, real estate investments, and other instruments. Real estate investments are typically small, with the largest share around 10%, observed for Chile. Equity shares are also relatively low, except in the case of Panama, where the majority of portfolio is invested in equities.

<sup>26</sup> In Brazil the fastest growth market has been the Life Free Benefits Generator, a product with all pension characteristics but classified as life insurance. This is now the largest segment in Brazil.

#### Box 4. Insurance Regulation in Latin America

**The LA insurance industry has been undergoing significant regulatory reforms designed to strengthen stability, improve transparency, generate efficiency, and align with the worldwide trend of more rigorous rules.** While most countries continue to strive to improve insurance industry regulation, the pace and the degree of development varies across the region. Mexico, Brazil, and Chile are leading the way in the introduction of Solvency II-type frameworks in Latin America, as regulations are set to be implemented in the next three years.

**Regulatory changes are expected to tighten prudential requirements, encourage product diversification, promote transparency, and strengthen linkages with foreign countries through higher reinsurance.** The impact of the regulatory changes is expected to vary by country, but some general effects are likely to exist. More advanced regulatory frameworks that incorporate risk-based charges will likely generate higher overall capital requirements, in particular under Solvency II-type regimes. This may encourage insurers to diversify their business and product portfolios. Efforts to decrease capital requirements may also translate into higher demand for reinsurance, essentially strengthening linkages with other countries, including the EU, given that a large portion of reinsurance is done through European companies. New regulations will also impose tougher rules governing the process of risk identification and monitoring, and will set strict disclosure standards.

**Stricter regulatory frameworks may generate M&A in the region, as smaller companies may face difficulties complying with tougher guidelines.** Smaller single-line insurers may encounter difficulties operating under the new guidelines as they may be unable to face the expected changes in governance, risk management, capital requirements and reporting—potentially leading to M&A and higher industry concentration. In Chile Colombia and Mexico, more stringent regulatory frameworks increasing transparency and efficiency, meanwhile making the insurance companies more streamlined.

**Further convergence of Latin American and European regulation via the implementation of Solvency II-type regimes will even the playing field for foreign subsidiaries and empower Latin American insurers to access EU markets.** For large multinational insurance groups, such as Mapfre for example, which have their home offices in the EU, Solvency II-type regulation largely extends to their subsidiaries in Latin America and Asia-Pacific. While the subsidiary structure of foreign companies operating in Latin America compels them to comply with the host country regulation, they may also be required to conform to the tougher Solvency II regulations of the parent country in the EU, including higher capital reserves. Thus, domestic insurers in Latin America—those without operations in the EU, but who compete against EU rivals in their home markets—could retain some competitive advantage as long as the Solvency II-type rules continue to be implemented. Once implemented, the introduction of Solvency II—type regulatory frameworks in Latin America will even the playing field for domestic and foreign insurance market players, thus making some Latin American markets—particularly in Brazil, Mexico, and Chile—more attractive to foreign entities.

#### Recommendations

**76. Harmonize financial infrastructure and operational practices across the countries.** This may require legal changes in a number of countries.

**77. Relaxing regulatory foreign asset limits for pension funds would also ease the burden of optimal portfolio allocation for insurance companies.** Limited domestic investment opportunities have led to a number of challenges for the insurance companies in the region. The shortage of supply of domestic securities is magnified by the overwhelming presence of pension funds, which increasingly

hold securities to maturity and crowd out investment opportunities for the insurance sector. Insurance companies thus are in need of better domestic options in local currency and of long-term maturity. Relaxing foreign investment limits for pension funds, would not only ease the difficulty of optimal pension fund portfolio allocation, but would also provide additional investment opportunities for the insurance sector.

**78. Simplifying new product development policies would foster capital market expansion and increase investment opportunities.** Authorities should also review regulatory requirements to ease the process of creating new products in the domestic capital markets. Infrastructure product development, for example, could provide a valuable instrument for portfolio diversification for pension funds and insurance companies alike.

**79. Data quality and provisions need further improvements to support industry monitoring and diagnosis of vulnerabilities.** Data quality and availability on insurance companies vary by country, while the heterogeneity of publicly available information on insurance companies in many cases prevents proper comparison of the industry performance across countries. As such, data harmonization, improved quality, and availability would not only support monitoring by the authorities, but also increase transparency of the sector.



**Table 7. Ranking of Top 10 Insurance Groups in Latin America  
(2003 and 2012)**

2003				2012			
Group	Country	Premia (USD mn)	Market share (percent)	Group	Country	Premia (USD mn)	Market share (percent)
<b>Total Insurance</b>							
ING	Holand	2,996	7.5	BRADESCO	Brazil	13,540	8.7
BRADESCO	Brazil	2,328	5.8	ITAU/UNIBANCO	Brazil	11,620	7.4
METLIFE	United States	1,977	5.0	MAPFRE	Spain	10,625	6.8
AIG	United States	1,927	4.8	BRASILPREV	Brazil	8,030	5.1
GNP	Mexico	1,720	4.3	ZURICH	Switzerland	6,689	4.3
MAPFRE	Spain	1,484	3.7	METLIFE	United States	5,090	3.3
TRIPLE-S	Puerto Rico	1,335	3.3	PORTO SEGURO	Brazil	4,435	2.8
ITAU	Brazil	1,256	3.1	LIBERTY MUTUAL	United States	4,020	2.6
ALIANZ	Germany	894	2.2	CNP	France	3,119	2.0
ZURICH	Switzerland	880	2.2	ALLIANZ	Germany	2,952	1.9
Top 10 groups		16,797	42.1	Top 10 groups		70,120	44.8
of which Latin American <sup>1</sup>		5,304	31.6	of which Latin American <sup>1</sup>		37,625	53.7
Total sector		39,897	100.0	Total sector		156,449	100.0
<b>Non-Life Insurance</b>							
ING	Holland	2,368	10.0	MAPFRE	Spain	7,763	9.5
AIG	United States	1,415	5.9	PORTO SEGUROS	Brazil	4,198	5.1
MAPFRE	Spain	1,275	5.4	LIBERTY MUTUAL	United States	3,817	4.7
GNP	Mexico	1,187	5.0	BRADESCO	Brazil	2,882	3.5
BRADESCO	Brazil	891	3.7	ZURICH	Switzerland	2,880	3.5
ALLIANZ	Germany	744	3.1	ALLIANZ	Germany	2,475	3.0
ZURICH	Switzerland	718	3.0	ITAU/UNIBANCO	Brazil	2,423	3.0
LIBERTY MUTUAL	United States	621	2.6	AXA	France	1,901	2.3
ITAU	Brazil	589	2.5	MERCANTIL	Venezuela	1,642	2.0
PORTO SEGUROS	Brazil	563	2.4	ACE	United States	1,623	2.0
Top 10 groups		10,371	43.6	Top 10 groups		31,604	38.7
of which Latin American <sup>1</sup>		3,230	31.1	of which Latin American <sup>1</sup>		11,145	35.3
Total sector		23,791	100.0	Total sector		81,580	100.0
<b>Life Insurance</b>							
METLIFE	United States	1,794	11.1	BRADESCO	Brazil	10,659	14.2
BRADESCO	Brazil	1,437	8.9	ITAU/UNIBANCO	Brazil	9,189	12.3
TRIPLE-S	Puerto Rico	1,207	7.5	BRASILPREV	Brazil	8,030	10.7
ITAU	Brazil	667	4.1	METLIFE	United States	4,512	6.0
ING	Holland	628	3.9	ZURICH	Switzerland	3,808	5.1
GNP	Mexico	533	3.3	MAPFRE	Spain	2,862	3.8
AIG	United States	511	3.2	CNP	France	2,245	3.0
MCS	United States	504	3.1	TRIPLE-S	Puerto Rico	2,223	3.0
HUMANA	United States	433	2.7	HSBC	UK	1,898	2.5
NEW YORK LIFE	United States	425	2.6	SURAMERICANA	Colombia	1,873	2.5
Top 10 groups		8,139	50.5	Top 10 groups		47,299	63.2
of which Latin American <sup>1</sup>		2,637	32.4	of which Latin American <sup>1</sup>		31,974	67.6
Total sector		16,106	100.0	Total sector		74,869	100.0

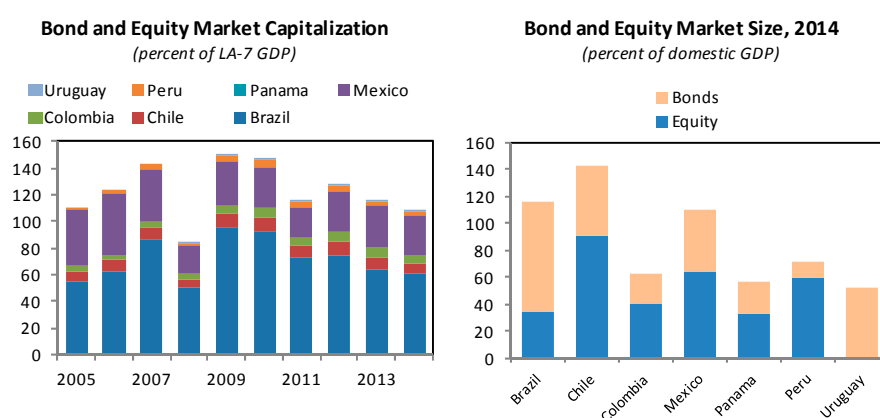
Sources: Fundacion MAPFRE; and IMF staff estimates and calculations.

<sup>1</sup> In percent of top 10 premia.

## D. Capital Market Integration in the LA-7

Capital markets in the LA-7 are moderately sized by emerging market standards, but are facing competitive pressure from large exchanges in advanced economies. As of the end of 2014, capitalization of LA-7 equity markets was 47% of regional GDP while the value of domestically traded bonds outstanding was about 61% of GDP. In dollar terms the largest bond and equity markets are found in Brazil and Mexico, while the Chilean markets stand out for their relation to the size of the economy (91.6% stock and 51.0% for bonds). Despite solid market capitalization, low trading volumes are an emerging concern. Declining liquidity is frequently evident, attributed to high transaction costs, as well as the significant “buy and hold” positions of institutional investors.

**Figure 27. LA-7 Indicators of Capital Market Growth and Size**



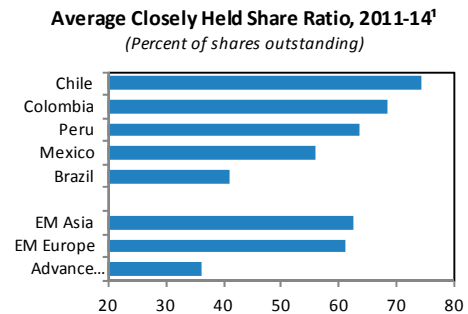
Sources: Bank for International Settlements; Federation of Iberoamerican Exchanges; and Haver analytics.

**80. Debt and equity markets in Latin America are generally smaller and less liquid than those found in advanced countries as well as emerging Asia and Europe.** Even though most LA-7 exchanges are well established institutions that predate the great depression of the 1930s, their size and importance have tracked the cycles of macroeconomic prospects in the region. Since liberalization in the mid-1990s, Latin American stock markets have been characterized by a relatively low number of listed firms, limited sectoral diversity and a general reluctance among firms to raise capital in equity markets.

**81. Equity market depth has been hampered by a number of factors.** A significant hindrance is the ambivalence towards equity financing thought to be rooted in the tendency for family and conglomerate owners of Latin corporates to maintain strong controlling interests in their firms, thus preferring debt to equity financing. Furthermore, this creates perceptions that Latin markets have more limited “free floats” of tradable shares in the market and have corporate governance that are less responsive to minority shareholder interests.

**82. Domestic bond markets are generally livelier, especially for sovereign paper, but are often considered second best options after international bond markets.** Sovereigns and highly rated corporates generally find better terms (lower rates, longer maturities and larger borrowing amounts) on international markets. For most of the commodity boom period, currency risks were low and could be hedged cheaply given broad EM appreciation. Borrowers that come to domestic bond markets typically face higher (and often variable) interest rates, shorter maturities, and smaller volumes to borrow. Consequently, corporates obtain significant shares of their financing from bank loans and supplier credit, especially small and medium enterprises.

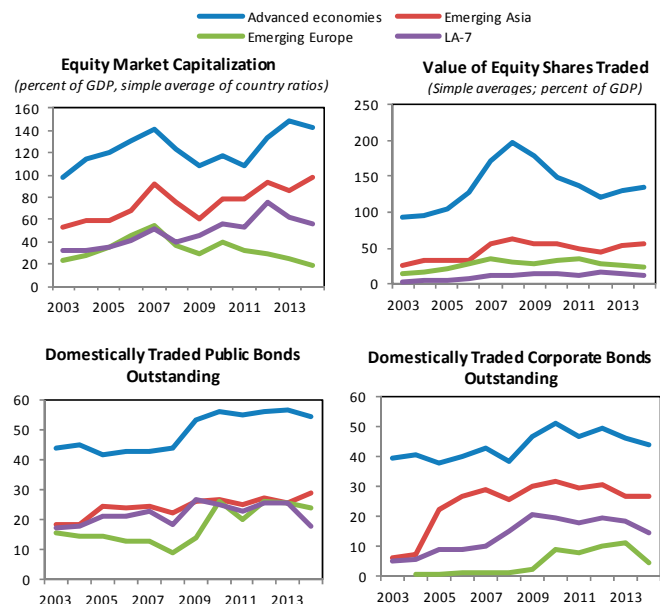
**Figure 28. Average Closely Held Shares Ratio, 2011–14<sup>1</sup>**  
(Percent of shares outstanding)



Source: Thomson Reuters Worldscope.

Note: **Advanced economies** includes AUS, AUT, BEL, CAN, DEN, FRA, GER, HKG, IRL, ITA, JPN, KOR, NLD, NOR, SGP, ESP, SWE, GBR, and USA; **emerging Asia** includes CHN, IND, IDN, MYS, PAK, PHL, THA, and VNM; **Emerging Europe** includes BLG, CZE, HUN, POL, ROM, RUS, SLK, and TUR; **LA-7** includes BRA, CHL, COL, MEX, PAN, PER, and URY. <sup>1</sup> Closely held shares can include cross holding shares, related companies, holding companies, Governments, employees, principal individuals or other insiders.

**Figure 29. Equity and Bond Market Indicators**



Sources: Bank for International Settlements; World Bank, Financial Development and Structure Database; World Federation of Exchanges and IMF staff calculations.

Note: **Advanced economies** includes AUS, CAN, FRA, GER, HKG, ITA, JPN, KOR, NOR, SGP, ESP, SWE, TWN, GBR, and USA; **emerging Asia** includes CHN, IND, IDN, MYS, PHL, and THA; **Emerging Europe** includes HUN, POL, RUS, and TUR; **LA-7** includes BRA, CHL, COL, MEX, PAN, PER, and URY.

## State of Play

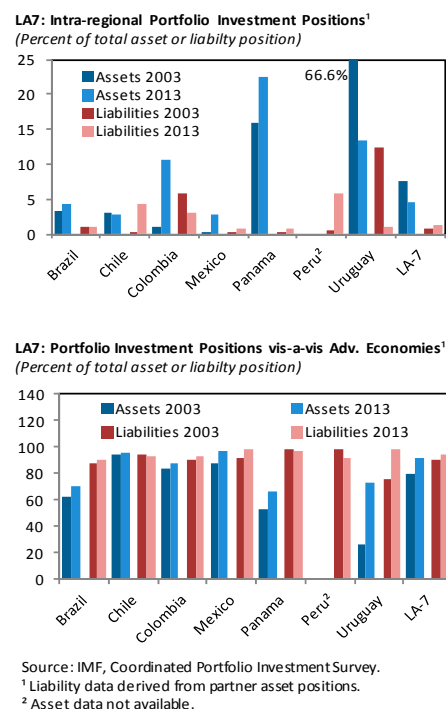
**83. One measure of capital market integration is the stock and flow of cross-border transactions in portfolio securities that are conducted through the financial networks that comprise capital markets.** Financial integration literature has used both International Investment Positions (IIP) and balance of payments capital flow measures of integration into global capital markets to test theories that greater integration can help financial systems more efficiently meet domestic financing needs of governments, corporates and households in capital-scarce countries or to deliver higher financial returns in those with excess savings. The Coordinated Portfolio Investment Survey (CPIS), which reports bilateral, international portfolio asset positions (stocks) for about 80 countries with data since 2001, can be used to measure the degree of cross-holdings of portfolio securities among a subset of countries or within a region.

**84. Regional cross-holdings of securities have increased in most of the LA-7 economies in the last decade.** Over the period 2003-2013 only Chile and Uruguay witnessed declines of regional assets as a share of total assets. However, as Uruguay comprises over half the region's cross-border assets, rebalancing translated in a decline in the share of LA-7 asset cross-holdings. On the liability side, Chile, Mexico, Panama and Peru all increased their share of regional financing. While regionalism may have grown over the last decade, linkages with advanced country markets grew even more, such that now 91.4% of external assets and 93.9% of liabilities are held vis-à-vis advanced economies.

**85. There are several impediments to regional capital market integration including:**

- Operating in the cross-currency markets add costs to transactions. Brokers, bankers, and institutional investors that do not have internal access to foreign currency and look to buy a foreign security must first sell local currency for dollars (usually through New York), then buy the foreign currency (again through New York) before buying the asset. Both F/X transactions incur charges and then incur charges again when the position is sold and receipts repatriated. Additionally, capital controls in Brazil further raise costs when investors look to enter the largest capital market in the region.
- Higher costs to operate in local markets. In so far as there are higher transaction costs and larger bid/ask spreads in the region, smaller less liquid markets, this is likely to dampen regional investor appetites for securities in the region.

**Figure 30. Global Integration of LA-7 Securities Markets**



- Poor sector diversity across some markets. The largest and most liquid debt and equity issuers in Chilean, Colombian and Peruvian markets tend to be natural resource/mining firms which over the last decade have experienced highly correlated business cycles. This is less of an issue as regards Brazil and Mexico.
- The variance in tax rates/rules and administrative procedures. There is particular scope for standardizing and coordinating clearing and depository practices across the region.

### *Analysis*

**86. Regional capital markets are tentatively moving towards more operational integration to increase scale and address structural issues.** Operational integration can take many forms such as when securities exchanges reach collaborative agreements on mutual access, post-trade clearing procedures and adopting the same electronic trading platform. Capital markets also become more synergistic when they harmonize trading hours, tax treatments and supervisory practices. Operational integration can increase when broker/dealers purchase or establish new operations abroad, facilitating the foreign trading activity of clients in both countries. Integration can also occur through enhanced infrastructure for payment and settlement across borders. LA countries could assess the compliance of regulatory frameworks of CCPs, as well as the safety and soundness of individual CCPs, using the CPSS-IOSCO PFMI through peer reviews. Upon compliance, LA-7 countries may recognize each other's CCPs and/or regulatory frameworks.

**87. LA-7 exchanges are modernizing their organizational structures, trading and settlement systems.** In the last decade both BMF&Bovespa and Bolsa Mexicana stock exchanges have fully demutualized. The Chilean stock exchange is developing plans to demutualize as well. Other exchanges remain mutualized, though Bolsa de Lima and Bolsa de Colombia have publically traded floats and as such must comply with financial reporting requirements that provide greater transparency of operations. The major exchanges have adopted electronic trading platforms which facilitate more cost effective back-office support in brokerages than when OTC negotiations dominated trading. Exchanges in Brazil, Chile and Mexico, have instituted independent central counterparty (CCP) entities that settle and clear trades in all markets (stocks, bonds, foreign exchange and derivatives) as well as maintaining broker collateral against default. On the Colombian, Peruvian, Panamanian, and Uruguayan bolsas, stock and bond trades clear through the exchange itself. Bolsa de Colombia also operates a CCP for derivative and foreign exchange trades.

**88. The trend for stock exchanges to build strategic alliances through ownership stakes in each other is also occurring in Latin America.** Increasingly, exchanges are building international alliances with hopes of facilitating cross-border trades that may then mobilize larger pools of savings to increase market size, trading activity and cut costs through scales of operation and back-office synergies. Many global banks and exchanges have stakes in Latin American bourses, but regional cross-ownership is also on the uptick. In early 2015, BM&FBovespa purchased an 8% stake in the Santiago exchange and is working with it to set up an electronic derivatives market in Chile. BM&FBovespa was also said to be interested in acquiring stakes in the other MILA exchanges as well as the Bolsa de Buenos Aires. The acquisition in 2013 that earned the Bolsa Mexicana an 8% stake in

the Lima exchange was significant, not only because it thereby became the largest independent share holder of the Peruvian Bolsa, but it signaled Mexico's growing interest in the MILA initiative (see box 7).

**89. Successfully expanding networks of internationally affiliated brokerages reduces the cost of cross-border trades and promotes greater integration.** Several international brokerages have obtained seats or licenses to be broker/dealers in many LA-7 markets. While their motivations could vary substantially, likely benefits would include reducing transaction costs for regional trades (compared to similar trades with correspondent brokers); broadening client bases and hopefully transaction volumes which in turn could drive down average costs of back-office support. The larger regional players too have set up shops across borders, and thus are facilitating regional cohesion. BTG Pactual has brokerages on the most dynamic regional exchanges including those in Brazil, Chile, Colombia, Mexico, and Peru. Other investment bank/brokerages with intra-regional operations include Itau (Brazil), Sura (Colombia), Credicorp (Peru), GNB Sudameris (Colombia) and LarrainVial (Chile).

**90. Greater integration of regional capital markets could potentially increase market depth, liquidity, and scale of operations for both exchanges and market participants.** LA capital markets need to increase the scale of their operations to be competitive with financial markets in the United States and Europe and to overcome the emerging regulatory bias in those countries which are drawing more transactions onto their domestic exchanges. Regional integration can foster a higher volume of transactions conducted on LA exchanges, which in turn can support the engineering of LA specific financial products; preserve financial expertise and innovation in the region; and preserve regulatory expertise and surveillance of regional players. Moreover, larger regional markets are likely to attract greater extra-regional flows, thus promoting both regional and global integration.

### Recommendations

- Harmonize financial infrastructure, including through adoption of IFRS; those countries that have not yet done so should adopt the multilateral memorandum of observance of principles and practices as set out by the BIS and IOSCO related to governance, monitoring, mitigating financial and operational risk, and to exchanging information; also, where not yet done, to sign double taxation avoidance treaties; and over time to seek convergence in tax rates.
- Encourage inter-operability of trading and settlement platforms across the region that will lower trading costs by reducing reliance on correspondent brokerage services.
- Harmonize trading and extended trading hours.
- Broker-dealers to be permitted to operate cross-country, while subject to supervision from both home and host supervisors, and receive the same regulatory treatment as domestic firms.

### Box 5. Mexico: Interest Rate Derivatives Market

**The bulk of the interest rate derivatives denominated in Mexican peso continue to be traded predominantly in the offshore markets, mainly in the US.** Mexico's vibrant interest rate derivatives market is largely comprised of TIE (Tasa de Interés Interbancaria de Equilibrio, the equilibrium interbank interest rate) interest rate swaps, with an overwhelming share of trading taking place outside of platforms via the OTC market. OTC turnover of single currency interest rate derivatives denominated in the Mexican peso stood at USD 12.3 bn in April 2013<sup>1</sup>, representing about 0.4% of the global OTC single currency interest rate derivatives market, trailing only the OTC interest rate market denominated in the Brazilian real and as the second largest in Latin America<sup>2</sup>. However, less than a fifth (USD 2.4 billion) of the Mexican peso turnover is cleared in Mexico, while the remaining 82 percent clear through offshore markets, mainly in the US.

**A number of factors have accounted for the burgeoning offshore OTC market, including close ties with the US, delay in establishing a well-functioning trading platform, and lower costs of OTC transactions.** Despite its establishment in the late 90's, MexDer—Mexican derivatives platform (Mercado Mexicano de derivados)—became an important financial player only a few years ago. Thus, until recently, in the absence of a well-functioning platform, interest rate hedging needs were predominantly met through the OTC market. Higher fees, associated largely with the technological and technical costs of the trading platform, continue to contribute to the general preference for the OTC market.

**The GFC prompted regulatory changes aimed to provide transparency and reduce counterparty risks in the global derivatives markets.** Recent regulatory adjustments in the EU and US call for the trading of standardized OTC derivative contracts on exchanges or electronic platforms, and for their clearance through a recognized CCP, while non-centrally cleared contracts would be subject to higher capital requirements. In the spirit of alignment with the global standards, the Mexican authorities introduced a new regulation, scheduled for gradual implementation, which will require OTC derivative trades to take place on exchanges or through inter-dealer brokers, and calls for a mandatory clearing of standardized derivatives through a CCP – Mexican (established in Mexico and authorized by the SHCP) or foreign (if recognized by Banco de Mexico). In April 2016, compliance with the new regulation will be required for transactions between Mexican entities, while November 2016 is the start date for transactions involving foreign financial institutions.

**In addition to making derivatives markets safer, the regulation is expected to improve competition between the domestic and foreign clearing houses.** Over the medium term, the new Mexican regulation is broadly expected to increase the volume of contracts traded through MexDer and cleared through Asigna – the Mexican central clearing counterparty house for derivatives. However, given the large presence of foreign institutions, going forward, Asigna is likely to continue facing strong competition from offshore CCPs, such as CME (Chicago Mercantile Exchange) and LHC. Clearnet Ltd (European clearing house), for example, as foreign institutions are expected to continue clearing their derivatives offshore. By clearing through a CCP in the parent country, multinational entities can consolidate their operations through netting their derivative positions vis-à-vis the positions of the parent and other subsidiaries, thereby decreasing capital requirements. Operations of MexDer and Asigna, are likely to continue expanding largely through the derivative trading businesses of Mexican institutional investors, such as pension funds. While the new regulatory changes constitute a welcome step to market transparency and lower risk, further technical and technological improvements are required to boost Asigna's and MexDer's competitiveness.

<sup>1</sup>Based on Triennial Central Bank Survey, BIS.

<sup>2</sup>Database covers following Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, and Peru.

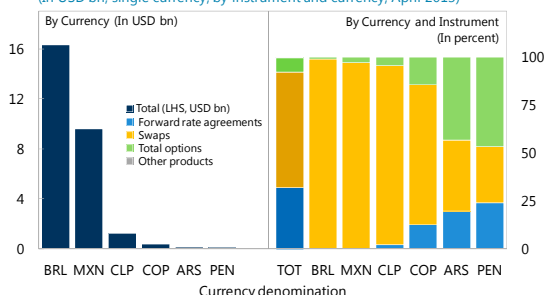


### Box 6. Latin American OTC Interest Rate Derivatives<sup>1</sup>

Interest rate derivatives in LA-6<sup>2</sup> currencies represent about 1.2% of the global derivative turnover, with Brazilian real and Mexican peso constituting 60% of the market, largely in swaps.

#### OTC Interest Rate Derivative Turnover

(In USD bn, single currency, by instrument and currency, April 2013)



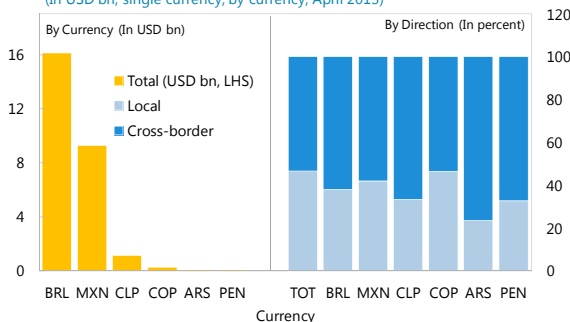
Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

1/ Total = all currencies, ARS=Argentine peso, BRL=Brazilian real, CLP=Chilean peso, COP=Colombian peso, MXN=Mexican peso, PEN=Peruvian New Sol.

Interest rate swaps represent the larger portion of instruments in LAC-6 currencies, with a larger portion of cross-border activity.

#### OTC Interest Rate Derivative Turnover: Swaps

(In USD bn, single currency, by currency, April 2013)



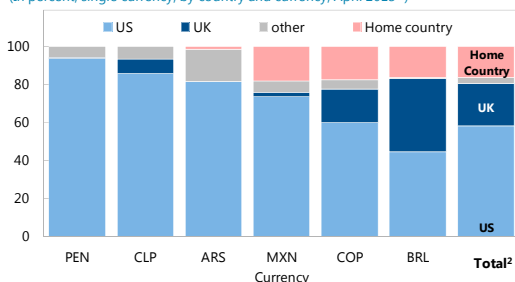
Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

1/ Total = total, ARS=Argentine peso, BRL=Brazilian real, CLP=Chilean peso, COP=Colombian peso, MXN=Mexican peso, PEN=Peruvian New Sol.

Most of the interest rate derivatives in LA-6 currencies are traded in the US, while only about 16% is traded domestically.

#### OTC Interest Rate Derivative Turnover

(In percent, single currency, by country and currency, April 2013<sup>2</sup>)



Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

<sup>2</sup> Total = total, ARS=Argentine peso, BRL=Brazilian real, CLP=Chilean peso, COP=Colombian peso, MXN=Mexican peso, PEN=Peruvian New Sol. Forward rate agreements, swaps, options and other products. Adjusted for local inter-dealer double-counting (ie "net-gross" basis). <sup>3</sup> All Latin American currencies in the sample.

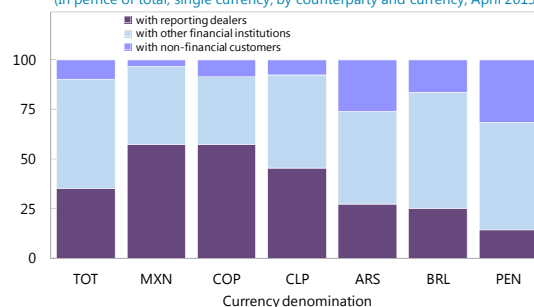
<sup>1</sup> For definitions of categories refer to the source: BIS Triennial Survey (2013).

<sup>2</sup> LA-6 refers to Argentina, Brazil, Chile, Colombia, Mexico, Peru.

Majority of interest rate derivative transactions in Latin American are conducted with other financial institutions, in instruments denominated in Mexican and Colombian currencies, however, reporting dealers play a larger role.

#### OTC Interest Rate Derivative Turnover

(In percent of total, single currency, by counterparty and currency, April 2013)



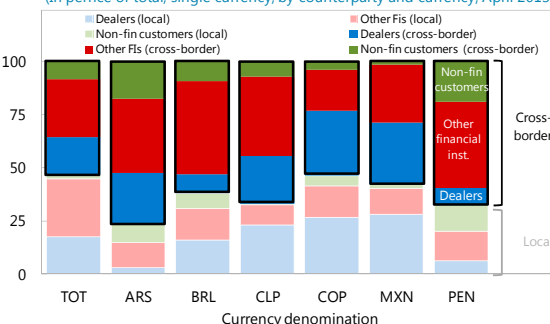
Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

1/ Total = total, ARS=Argentine peso, BRL=Brazilian real, CLP=Chilean peso, COP=Colombian peso, MXN=Mexican peso, PEN=Peruvian New Sol.

Offshore trading is mostly done with other financial institutions as the main counterparties.

#### OTC Interest Rate Derivative Turnover: Swaps

(In percent of total, single currency, by counterparty and currency, April 2013)



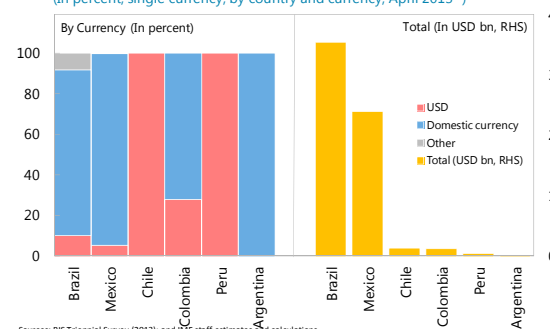
Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

1/ Total = total, ARS=Argentine peso, BRL=Brazilian real, CLP=Chilean peso, COP=Colombian peso, MXN=Mexican peso, PEN=Peruvian New Sol.

There is a lot of heterogeneity in the domestic IRS markets, as USD is the primary currency used in CHL and PER, while Brazil, Mexico, Argentina, and Colombia have IRS markets primarily dominated by domestic currencies.

#### OTC Interest Rate Derivative Turnover

(In percent, single currency, by country and currency, April 2013<sup>3</sup>)



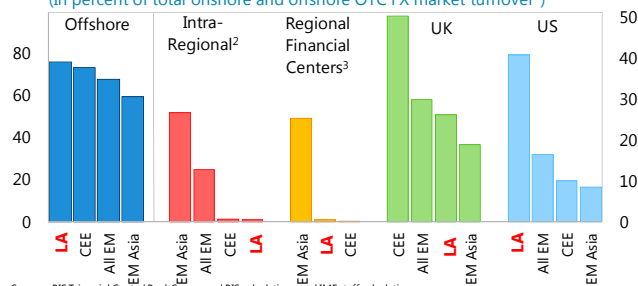
Sources: BIS Triennial Survey (2013); and IMF staff estimates and calculations.

Adjusted for local inter-dealer double-counting (ie "net-gross" basis).



### Box 7. Foreign Exchange Turnover of Latin American Currencies

**Offshore trading continues to dominate turnover rates of LA currencies, with the majority of transactions taking place in the US and the UK<sup>1</sup>.** Foreign exchange turnover of emerging market currencies has been predominantly driven by the offshore component in many regions, which testifies to the growing currency internationalization, particularly as foreign exchange turnover expansion outpaces trade growth. Latin America continues to have the largest share of offshore currency trading among emerging markets, closely followed by Central and Eastern Europe (CEE), and well above the Emerging Asian economies. Market patterns of offshore turnover of the currencies of Latin America, Emerging Asia, and CEE, however, appear to vary in response to geographic proximity, as well as trade and financial linkages with offshore jurisdictions.. Emerging Asian currencies, for example, have the lowest share of offshore trading and nearly half of their offshore transactions occur in the regional financial centers—Hong Kong SAR and Singapore. Offshore trades of LA and CEE currencies, however, are largely concentrated in extra-regional financial centers, given the absence of sufficiently large financial centers in the region. While the majority of offshore turnover of CEE currencies occurs in the UK, financial centers in the US constitute the largest markets for trading LA currencies, accounting for more than half of the offshore turnover.



Sources: BIS Triennial Central Bank Survey and BIS calculations; and IMF staff calculations.

<sup>a</sup>Daily average in April 2013. Adjusted for local and cross-border inter-dealer double-counting (ie net-net basis). Latin American currencies (LA) = Argentine peso, Brazilian real, Chilean peso, Colombian peso, Mexican peso and Peruvian new sol. Weighted averages based on FX turnover. Central and eastern European currencies = Bulgarian lev, Czech koruna, Hungarian forint, Lithuanian litas, Latvian lats, Polish zloty, Romanian leu, Russian ruble and Turkish lira. Emerging Asian currencies = Chinese renminbi, New Taiwan dollar, Hong Kong dollar, Indian rupee, Indonesian rupiah, Korean won, Malaysian ringgit, Philippine peso, Singapore dollar and Thai baht. All emerging market currencies = Asia, CEE, LA, Bahraini dinar, Israeli new shekel, South African rand and Saudi riyal. <sup>b</sup>Intra-regional is defined as offshore derivatives within a region. <sup>c</sup>Regional centers: Hong Kong SAR and Singapore for EM Asia, Brazil and Mexico for Latin America, and Toronto and Buenos Aires for CEE.

**Global turnover of LA currencies is dominated by the Mexican peso, and followed by the Brazilian real.** The Mexican peso accounts for about 65 percent of offshore turnover of LA currencies. In 2013, the Mexican peso joined the ranks of the ten most traded currencies, largely against the US dollar and in the form of foreign exchange swaps and spot transactions. In terms of turnover ranking, the Mexican peso is only trailing the national currencies of the United States, European Union, Japan, United Kingdom, Australia, Switzerland, and Canada. The Mexican peso is fully convertible, free-floating, without any exchange controls, and widely accepted across the world. It saw one of the biggest increases in market share up to 2013 among the major emerging market currencies, when its turnover reached US\$135 billion, raising its market share in global FX trading to 2.5%, from 1.3% in 2010<sup>2</sup>, and significantly lifting Mexican peso turnover in the domestic market and in offshore jurisdictions. At 80 percent, the share of offshore trading of Mexican peso is among the highest among emerging markets, only trailing the Polish Zloty and the Turkish lira.

**Turnover in the Mexican peso increased largely on account of strengthening investor confidence and growing market liquidity.** Unrestricted access, given that the Mexican peso trades globally 24 hours a day, plays a fundamental role in its rising popularity. The high liquidity of Mexican assets also stimulates turnover of the domestic currency. Its popularity received a boost after the size of the Mexican bond market led Citigroup to add Mexican peso-denominated debt to its World Government Bond Index in late 2010, making Mexico the first Latin American country in the benchmark.

<sup>1</sup> Based on BIS Triennial Central Bank Survey (April, 2013) data and analysis.

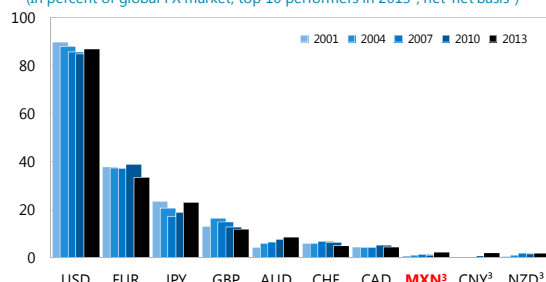
<sup>2</sup>Because two currencies are involved in each outstanding contract, the sum of the percentage shares of individual currencies total 200%.

## Box 7. Foreign Exchange Turnover of Latin American Currencies (concluded)

In 2013 the Mexican peso joined the ranks of the most traded currencies...

### Global Foreign Exchange Market Turnover

(In percent of global FX market, top 10 performers in 2013<sup>1</sup>, net-net basis<sup>2</sup>)

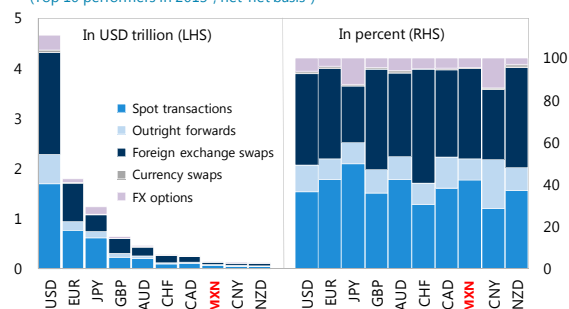


Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Percentage shares of average daily turnover in April. <sup>2</sup>Because two currencies are involved in each transaction, the sum of the percentage shares of individual currencies totals 200% instead of 100%. <sup>3</sup>Turnover for years prior to 2013 may be underestimated owing to incomplete reporting of offshore trading in previous surveys. USD - US dollar, EUR - euro, JPY - Yen, GBP - Pound sterling, AUD - Australian dollar, CHF - Swiss franc, CAD - Canadian dollar, MXN - Mexican peso, CNY - Renminbi, NZD - New Zealand dollar.

... with transactions taking place mostly in the form of spots and foreign exchange swaps.

### Global FX Market Turnover: By Currency and Instrument

(Top 10 performers in 2013<sup>1</sup>, net-net basis<sup>2</sup>)

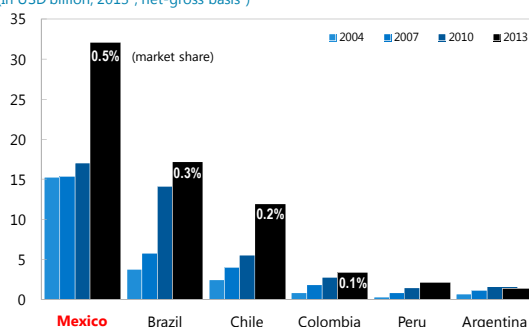


Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Percentage shares of average daily turnover in April. USD - US dollar, EUR - euro, JPY - Yen, GBP - Pound sterling, AUD - Australian dollar, CHF - Swiss franc, CAD - Canadian dollar, MXN - Mexican peso, CNY - Renminbi, NZD - New Zealand dollar.

While the increase in MXN trading lifted turnover in the domestic market, more than three quarters of trading continues to take place offshore...

### Geographical Distribution of Global FX Market Turnover

(In USD billion, 2013<sup>1</sup>, net-gross basis<sup>2</sup>)

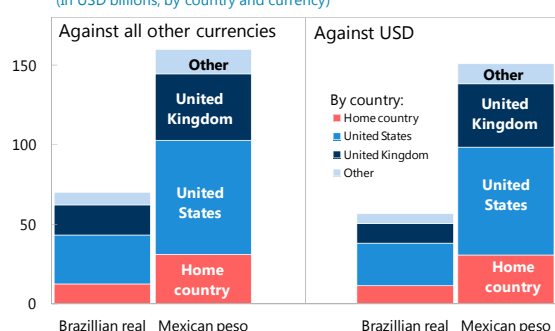


Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Daily turnover in April. <sup>2</sup>Adjusted for local inter-dealer double-counting (ie "net-gross" basis).

... as nearly 70 percent of OTC FX turnover occur offshore, mostly in the US and the UK.

### OTC Foreign Exchange Turnover

(In USD billions, by country and currency)

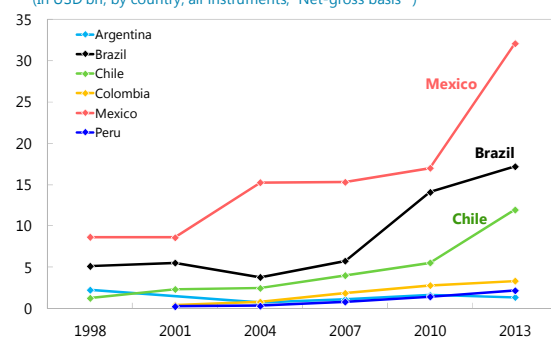


Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Daily averages as of April 2013.

FX turnover in Mexico continues to outperform other Latin American countries on aggregate and in the OTC market...

### OTC Foreign Exchange Turnover

(In USD bn, by country, all instruments, "Net-gross basis"<sup>1</sup>)

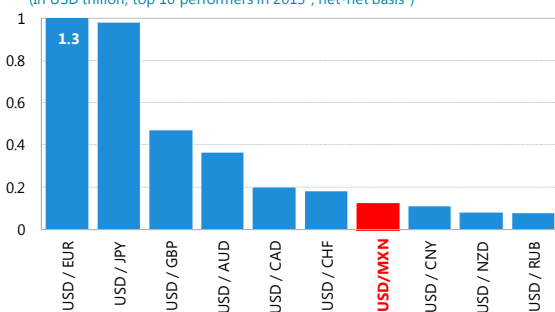


Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Daily averages as of April 2013. Adjusted for local inter-dealer double-counting (ie "net-gross" basis).

... with the Mexican peso vis-à-vis US dollar currency pair comprising the majority of Mexican peso trading.

### Global FX Market Turnover: by Currency Pair

(In USD trillion, top 10 performers in 2013<sup>1</sup>, net-net basis<sup>2</sup>)



Sources: BIS Triennial Central Bank Survey, 2013; and IMF staff estimates and calculations.  
<sup>1</sup>Daily turnover in April. <sup>2</sup>Adjusted for local and cross-border inter-dealer double-counting (ie "net-net" basis). USD - US dollar, EUR - euro, JPY - Yen, GBP - Pound sterling, AUD - Australian dollar, CHF - Swiss franc, CAD - Canadian dollar, MXN - Mexican peso, CNY - Renminbi, NZD - New Zealand dollar, RUB - Russian ruble.

## LEGAL BARRIERS TO REGIONAL INTEGRATION<sup>27</sup>

**91. This section will discuss legal barriers to the cross-border integration of financial systems, and ways in which such barriers can be removed.** Staff's analysis focuses on those legal issues that hinder cross-border integration directly or indirectly, namely the opening of cross-border establishments by banks and insurance firms, and the cross-border acquisition of financial services.<sup>28</sup>

**92. Overall, countries in the region have made considerable progress in removing legal barriers.** As part of a broader process of opening up their economies, the LA-7 countries have removed most of the legal barriers on the cross-border provision of financial services. This being said, the next paragraphs will give examples of actual or potential legal barriers that remain in place in some countries.<sup>29</sup> To complete the quest to a better balance between openness and financial stability, this paper will suggest some avenues for removing those barriers, combined with some measures that would actually strengthen the legal underpinnings for financial stability in the context of cross-border integration.

### A. Cross-border Establishments of Financial Institutions

**93. A few of the LA-7 still maintain in their legislation formal legal barriers to the opening of certain types of establishments of foreign financial firms.** While all seven countries generally authorize the opening abroad of establishments of their local financial firms, they differ considerably in the degree to which they authorize the opening of establishments in their own jurisdictions by foreign financial firms.<sup>30</sup> Several countries (e.g., Chile, Colombia, Panama and Peru) have *de iure* open regimes: their financial legislation allows explicitly for the opening of both subsidiaries and branches of foreign banks and insurance firms. Other countries are more restrictive. For instance, Mexico prohibits branches of foreign banks explicitly, and only authorizes subsidiaries under specified conditions.<sup>31</sup> Brazil, in turn, prohibits formally the opening of new branches and subsidiaries in its Constitution, but

<sup>27</sup> This section has been prepared by the Legal Department.

<sup>28</sup> This paper does not address mechanisms (e.g., creditor rights and quality of the judiciary) that hinder financial sector development more broadly, without posing a cross-border barrier per se.

<sup>29</sup> In this section, references to barriers to financial sector integration are not intended to imply that any such barriers would necessarily be considered as a "restriction" under relevant international agreements (e.g., the OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations).

<sup>30</sup> Subsidiaries and branches are the two main types of establishments of foreign banks. Once licensed, they are both authorized to offer banking services (taking deposits and making loans), albeit possibly under certain limitations, especially for branches. The difference between the two is that subsidiaries have a separate legal personality under the law of the host country, whereas branches do not have separate legal personality, and are legally one with the parent bank in the home country. The third form of establishment, representative offices, is not allowed to offer banking services and is less relevant for this exercise.

<sup>31</sup> Only a foreign financial institution established in a country with which Mexico has entered into a treaty or agreement allowing for the establishment of subsidiaries, can establish a subsidiary in Mexican territory (Article 45-A Banking Law). Mexico also requires that a majority of the members of the board of directors and all members of the executive board reside in Mexico: Art. 45-K and L of the Banking Law.

provides waivers through a complex legal framework that ultimately requires approval by the President.

**94. Even if their legislative regimes for entry are *de iure* open, some countries impose conditions on branches of foreign banks that effectively diminish the advantages of that business model.** This is the case where foreign branches are regulated in exactly the same manner as locally incorporated banks, notwithstanding their differences in circumstances.<sup>32</sup> In particular, the imposition of identical capital adequacy requirements on branches and locally incorporated banks ignores the fact that the branch's parent remains legally liable for the obligations of the branch, and imposes a high cost upon what is otherwise a low cost form of entry (compared to subsidiaries). Separately, the application of discriminatory "ring fencing" rules<sup>33</sup> against foreign-owned branches effectively discourages foreign or non-resident parties from maintaining deposits in or providing loans to foreign owned branches: as the claims of such creditors would be subordinated to the claims of local creditors upon the liquidation of the branch, they will be more likely to establish business relationships with locally-incorporated institutions where such discriminatory treatment will not apply upon insolvency.

**95. Finally, even for countries whose legislative frameworks do not set out explicit barriers to entry, some contain very broad provisions whose implementation may inhibit access to the local market.** One such example consists of statutory conditions that make the licensing of the establishment of firms subject to a very broadly drafted "best interests of the economy" test.<sup>34</sup> Some countries' supervisory legislation also features broad discretionary powers of supervisors in issuing normative instruments or individual decisions. For instance, in Panama, the Banking Law authorizes the supervisor to make the license subject to "any criterion it deems pertinent."<sup>35</sup> While none of these provisions are restrictive *per se* or have been found in practice to have led to discriminatory treatment of foreign firms, their very broad wording could, in principle, be used to restrict market access.

## B. Barriers to Cross-border Acquisition of Financial Services

**96. Several countries prohibit residents from acquiring certain types of financial services abroad.** This is, for instance, the case of Panama and Mexico, where local residents are precluded from acquiring certain types of insurance contracts abroad.<sup>36</sup> Separately, some countries impose restrictions

<sup>32</sup> See, for instance, Art. 45A of the Colombia Banking Law and Art. 39, 4<sup>th</sup> para. of the Peruvian Banking Law.

<sup>33</sup> In Chile, Colombia and Peru, creditors *residing* in the country are preferred over foreign creditors (Art. 34 Chilean Banking Law, Art. 45B.2 of Colombian Banking Law, and Art. 39 *in fine* of the Peruvian Banking Law). Reservations to obligations under free trade agreements may include such "ring-fencing," see e.g. Peru.

<sup>34</sup> For instance, in Panama, the banking license can be refused if "the bank does not contribute to Panama's economy" (Art. 48.3 Banking Law). In Mexico, Rule Fourth II. *in fine* of the Rules for the Establishment of Subsidiaries of Foreign Financial Institutions requires the foreign financial institution to describe in its application the benefits it will bring to the Mexican economy by establishing a subsidiary.

<sup>35</sup> Art. 48.5 of the Banking Law.

<sup>36</sup> See Article 153 of the Panama Insurance Law and Article 21 of the Mexican Insurance Law.

on the ability of local pension funds to outsource part of their asset management tasks to foreign asset managers (this is only allowed in Chile). A third example can be found in the requirement that both retail and professional investors invest abroad only through a locally registered investment fund (Brazil).

## C. Removal of Barriers

### *In Domestic Law*

**97. Regional integration would be supported if all countries across the region were to have in place objective and comprehensive entry regimes for foreign financial firms in primary legislation.** Ideally, these regimes provide for entry in the form of both subsidiaries and branches. Moreover, overly broad “best interests” test and discretionary licensing criteria are best avoided. The use of primary legislation offers a more transparent and stable legal regime than secondary rules and regulations.<sup>37</sup> Such approach also guides individual decision-making by prudential supervisors and shields them from excessive discretionary powers that can lead to the perception of arbitrary decision-making.

**98. Beyond the rules on access to the market, there is room to consider conditions imposed upon establishments of foreign firms that do not contribute to financial stability.** Often, Latin-American countries maintain measures that, while increasing the cost of cross-border operations, are fully appropriate in light of the imperative to maintain financial stability. This is, for instance, the case of limits to intra-group exposures for subsidiaries, local asset maintenance requirements for branches, and powers to “ring fence” a local branch of a foreign bank in a nondiscriminatory manner. However, where those measures feature excessive or discriminatory characteristics that hinder cross-border integration without yielding financial stability benefits, these could be modified to better balance financial stability with openness. Removing the discriminatory feature of “ring-fencing” mechanisms, as was already done by Chile and Panama, would be particularly useful in this regard. Reconsidering nationality or residence requirements for directors and senior managers may also be appropriate.

**99. Some legal requirements for establishments of foreign firms could be strengthened to enhance cross-border integration.** This is particularly the case for countries with local asset maintenance requirements (LAMR) for branches of foreign banks that inhibit the effectiveness of ring-fencing mechanisms. Conceptually, LAMR require branches to keep a certain amount of assets in the country to satisfy local liabilities in case of insolvency. To effectively operate as a safeguard to creditors of the branch, LAMR should be applied on a significant percentage of local liabilities, and deposits in particular. However, Colombia and Peru specifically apply their LAMR only on the endowment capital of the branch, which is just a small part of liabilities, and far too low to effectively protect depositors.<sup>38</sup> These rules should be reviewed to require a higher amount of assets to be held locally. Combined with

<sup>37</sup> On this issue, see W. Bossu and D. Chew, “But We are Different! 12 Common Weaknesses in Banking Law, and What to do About Them,” IMF, WP/15/200, p. 18-22.

<sup>38</sup> See Article 2.36.12.2.2 of Colombian Decree 2555/2010 and Art. 42 of the Peruvian Banking Law.

non-discriminatory “ring-fencing” rules as discussed in the previous paragraph, well designed LAMR should give the comfort to host countries that they can manage adequately the risk stemming from branches of foreign banks. This may in turn lead to a more supportive attitude of local supervisors vis-à-vis such forms of cross-border establishments.

**100. Rules prohibiting access of local residents to foreign financial services should also be reviewed.** Chile, Colombia and Peru present good examples of how barriers can be removed in that regard, by explicitly authorizing in primary legislation their residents to acquire abroad foreign insurance coverage.<sup>39</sup>

#### **D. A Role for “Soft Law” Regional Harmonization as precondition for Opening?**

**101. Ideally, the balance between openness and financial stability is sought in the context of regional harmonization of legislative and regulatory frameworks.** A lesson from other regional integration initiatives is that a sufficient level of legal harmonization is often a precondition for opening financial markets by removing barriers, and for cross-border supervisory cooperation more broadly. In Latin America, initiatives of global regulatory *fora* (FSB, BCBS) or standards (IFRS) have achieved some, albeit an uneven, degree of legal harmonization in the region. More therefore needs to be done at a regional level, especially to harmonize supervisory rules at a more granular level.<sup>40</sup> Currently, the LA-7 countries differ considerably in the manner in which they design key banking supervisory instruments in their banking legislation. As noted in Table 8, significant disparities still exist in the LA7 countries’ legislative approaches to banks’ minimum capital, corporate governance requirements, limits on large and bank-related party exposures, and early intervention tools.<sup>41</sup> Going forward, some harmonization of legislative approaches to designing such key banking supervisory tools is likely to contribute to an increased comfort to provide market access. In promoting greater harmonization, however, the authorities will need to ensure that such initiatives are appropriately sequenced and that restrictions on market access are only removed when a sufficient level of harmonization is in place. Inter-governmental processes should be considered to achieve greater regional harmonization of financial sector legal frameworks, possibly as a precursor to regional “mutual recognition” mechanisms under which host countries grant market access to market participants from home countries that have adopted regionally harmonized rules and practices.

<sup>39</sup> See Art. 4 Decree-Law 251 in Chile, Art. 38.2 of the Colombian banking law, and Art. 10 of the Peruvian Banking Law.

<sup>40</sup> For banks, detailed supervisory rules that could usefully be harmonized (in addition to capital adequacy and liquidity dealt with by the BCBS) are those on minimum capital, bank governance, bank-related party lending and large exposures, investment portfolios, supervisory tools, exchange of information between supervisors, etc.

<sup>41</sup> It is noted that some of these issues may be regulated in secondary regulation. The point of this summary comparison is, however, merely to illustrate the diverging use of *primary legislation*.

**Table 8. Legislative Provisions For Key Banking Supervisory Instruments<sup>1</sup>**

		<b>Brazil</b>	<b>Chile</b>	<b>Colombia</b>	<b>Mexico</b>	<b>Panama</b>	<b>Peru</b>	<b>Uruguay</b>
<b>Minimum Capital (USD)</b>		Determined by National Monetary Council.	+/- \$28, 9 million.	+/- \$25, 2 million.	+/- \$26, 3 million.	\$10 million.	+/- \$4, 2 million.	Determined by the CB.
<b>Corporate Governance Rules</b>	<b>Size of Board</b>	Not specified.	Not specified.	Between 5-10 directors.	Between 5-15 directors.	Not specified.	Minimum 5 directors.	Not specified.
	<b>Independent Director</b>	Not specified.	Not specified.	Yes.	At least 25%.	Not specified.	Not specified.	Not specified.
<b>Large Exposures</b>		Not specified.	Individual limit: 10% limit for non-collateralized credit. 30% limit for collateralized credit.	Not specified.	<ul style="list-style-type: none"> <li>To be determined by supervisor.</li> </ul>	25% global limit for credit facilities, obligations.	10% individual limit for non-collateralized credit and investments. 30% individual limit for collateralized credit and investments.	Determined by CB.

<sup>1/</sup> The following legal instruments were analyzed: In Brazil, Law 4595/64; in Chile, "Ley General de Bancos" (Banking Law); in Colombia, "Estatuto Orgánico del Sistema Financiero" (Financial System Organic Statute); in Mexico, "Ley de Instituciones de Crédito" (Credit Institutions Law); in Panama, "Ley Bancaria" (Banking Law); in Peru, "Ley General del Sistema Financiero y del Sistema de Seguros y Organica de la Superintendencia de Banca y Seguros" (Financial and Insurance Systems Law and Organic Law of Banking and Insurance Superintendency); in Uruguay, "Ley de Intermediación Financiera" (Financial Intermediation Law)

Legislative Provisions For Key Banking Supervisory Instruments (Concluded)								
<b>Bank related party lending</b>		----	Includes arm's length provision.  100% Global limit.  Individual limit: 5% non-collateralized credit- 25% collateralized credit.  Bank related party: more than 1% of shares.	Includes arm's length provision.  Credit operations with related parties require unanimous approval of the Board.  Bank related party: 5% of shares.	Includes arm's length provision.  35% global limit.  Bank related party: 2% of shares.	Includes arm's length provision.  Individual limits: 5% non-collateralized credit facilities.  10% collateralized loans.  Bank related party: 5% of shares.	Includes arm's length provision.  Global limit: Credits and investments cannot be more than 30% of the total assets.  Bank related party: 4% of shares or "significant influence"	-----  No related party lending.  Bank related party: BL does not mention shareholders.
		No related party lending.  Bank related party: 10% shares.						
<b>Early Intervention</b>	<b>Stop dividends</b>	Not specified.	Not specified.	Not specified.	Yes.	General provision (broad powers).	Not specified.	Not specified.
	<b>Change management</b>	Not specified.	Not specified.	Yes.	Yes.	General provision.	Yes.	Yes.



## E. A Role for “Hard Law” International Treaties?

**102. The use of international treaties, to support regional integration could be strengthened.** Few of the free trade agreements (FTAs) and bilateral investment treaties (BITs) signed among Latin American countries incorporate a chapter on financial services. In the cases where such chapters exist, they tend to contain only standard provisions, such as national treatment, most favored nation, fair and equitable treatment and a “prudential carve-out.”<sup>42</sup> While these provisions can achieve a degree of openness, countries could consider introducing more detailed provisions in their treaty frameworks. Mexico is a good example of countries that have made a more widespread use of such treaties with more detailed provisions governing foreign entry in the local market. In fact, the NAFTA and the FTA with the EU contain provisions related to the establishment of financial institutions and cross-border trade on financial services that have been, for a long time, the only way for foreign financial firms to enter the country. NAFTA, for instance, includes specific provisions that (i) grant investors from other signatories the right to open establishments in the territory of another signatory and the right to expand geographically in that territory, (ii) establish a Financial Services Committee to oversee the application of those provisions, and (iii) provide for a specific dispute settlement procedure. The recently negotiated Trans-Pacific Partnership contains similar provisions to those negotiated in the context of NAFTA and the Mexico-EU agreements, and applies to Mexico, Chile and Peru—in addition to nine non-LA7 countries. Another important example is the BIT of Peru and Colombia, in which nationality and residency requirements for management positions in establishments of foreign financial institutions are prohibited. While these cases demonstrate that a more widespread use of detailed chapters on financial services in FTAs and BITs can help support regional integration,<sup>43</sup> they are no panacea. Rather, their effectiveness in opening up a country’s financial system to foreign participation will depend on the scope of the obligations set out in the treaty, and the extent to which they serve as a catalyst for more general and far-reaching measures directed towards the removal of barriers.

<sup>42</sup> The “prudential carve-out” stipulates that signatory countries can make exceptions to the market-access provisions for prudential reasons.

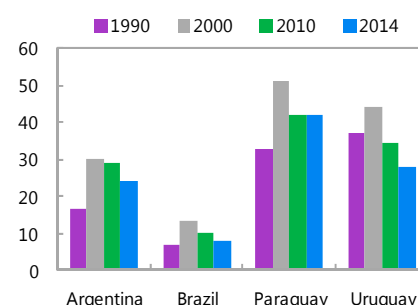
<sup>43</sup> As an example of another type of useful treaty, Chile has supported the opening up of its financial sector by entering into a wide network of double taxation avoidance agreements, which are designed to mitigate or eliminate double taxation of the cross-border movements of capital.

## REGIONAL INITIATIVES FOR FINANCIAL INTEGRATION

### A. Mercosur

**103. Mercosur was established in 1991 through the signing of the Treaty of Asuncion by the presidents of Argentina, Brazil, Paraguay, and Uruguay. Venezuela joined in 2012, and Bolivia in 2015.** Mercosur's founders were inspired by the example in Europe and aimed to go further. They intended it also to be a tool to strengthen democracy as its members recovered from the dictatorships of the 1980s and hoped it would drive political integration. Progressive preferential trade liberalization between member countries took place from 1991 to 1994, and by the time the common external tariff was established in 1995, tariffs among members had been reduced in most part. As a result, trade among Mercosur countries increased across the board throughout most of the 1990s (Figure 1). The establishment of a common external tariff was expected to lead to a customs union. However, the period from 1996 to 1999 saw a reversal in trade liberalization due to external shocks such as the Brazilian financial crisis in 1999, as well as unilateral changes in the common external tariff by Brazil and Argentina. New non-tariff barriers (import licensing requirements and anti-dumping measure) were also introduced by both countries. As a result, since 2000, trade among Mercosur countries has declined.

**Figure 31. Goods Trade within Mercosur<sup>1</sup>**  
(percent of national goods trade)



Source: IMF, Direction of Trade Statistics.

<sup>1</sup> Mercosur includes Argentina, Brazil, Paraguay, and Uruguay.

**104. In the Montevideo Protocol (1997), members made commitments to liberalization of services, including financial services.** The principles guiding the liberalization process were similar to these established for multilateral liberalization within the General Agreement on Trade in Services (GATS) of the WTO (1995), e.g. modes of provision and rules of market access and national treatment, and complete liberalization were envisaged over a ten-year period. The list of initial commitments to liberalization under the Montevideo Protocol was marginally more extensive than the list negotiated in the GATS. Argentina and Brazil maintained the liberalization levels committed in the GATS, Paraguay committed less than the amount negotiated in GATS, while Uruguay increased its commitments, particularly regarding the presence of corporates and of natural persons. Finally, Mercosur has a technical forum for financial issues—Financial Mercosur, (SGT-4), mandated with advancing the financial integration agenda.<sup>44</sup>

<sup>44</sup> SGT-4's ultimate objective is to create a single regional market for financial services, whilst maintaining monetary and financial system stability.

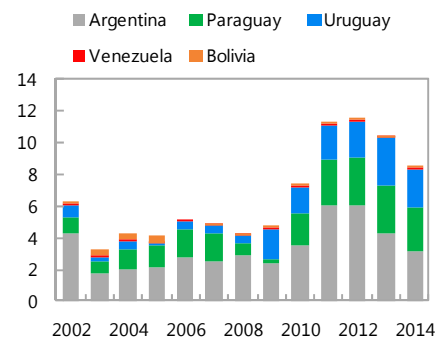
**105. Liberalization in financial services in Mercosur member countries had taken place unilaterally in the 1990s, either simultaneously with or after the Mercosur agreement, and had**

**led to increased presence of global foreign banks.** Such unilateral moves toward liberalization followed the Argentinean hyperinflation episode; the “Convertibility” plan instituted, and led to the deregulation of domestic markets, privatizations, trade liberalization, elimination of capital controls and a stable macroeconomic environment conducive to foreign investment. The Brazilian “Real” plan, which was introduced in 1994 to stabilize the economy after a bout of hyperinflation, led to the restructuring of banks, privatizations, and liberalization of the financial sector. To facilitate foreign bank entry, the restriction that the minimum capital for a foreign bank had to be twice as large as that required for a national bank was eliminated.

**106. Foreign claims of Brazil<sup>45</sup> on Mercosur countries provide some evidence of increasing regional integration since 2008 (figure 2).** They rose from an average of 4 percent of total foreign claims over 2002–08 to a peak of 11 percent in 2011–12, after which they declined due to a reduction in foreign claims on Argentina. Currently, foreign banks from Mercosur countries do not have important market shares in Brazil and Argentina, but they do hold 10 and 20 percent of assets in Uruguay and Paraguay respectively (figure 33). 17 percent of Brazilian Itau’s operations in LA are in Mercosur countries, having important market shares in the Paraguayan and Uruguayan banking systems (of 18 percent and 11 percent, respectively).

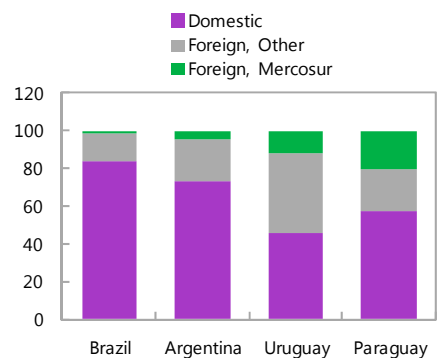
**107. While member countries committed to liberalize financial services within the GATS, various indices suggest certain restrictions to market access.<sup>46</sup>** Argentina liberalized the most, but maintained some level of protection in cross-border supply of financial services and presence of natural persons. Brazil made no commitments to liberalize cross-border supply and consumption abroad, and kept some restrictions in commercial presence and presence of natural persons. Uruguay also had some restrictions across all modes of supply, whilst Paraguay had the most restrictions. Other indices of barriers to

**Figure 32. Foreign Claims of Brazilian Banks on Mercosur**  
(percent of total claims, immediate borrower basis)



Source: BIS, Consolidated Banking Statistics.

**Figure 33. Mercosur: Commercial Bank Ownership<sup>1</sup>**  
(Mercosur bank assets in percent of total assets)



Source: Bureau van Dijk, Bankscope.

<sup>1</sup> Mercosur includes Argentina, Brazil, Paraguay, and Uruguay.

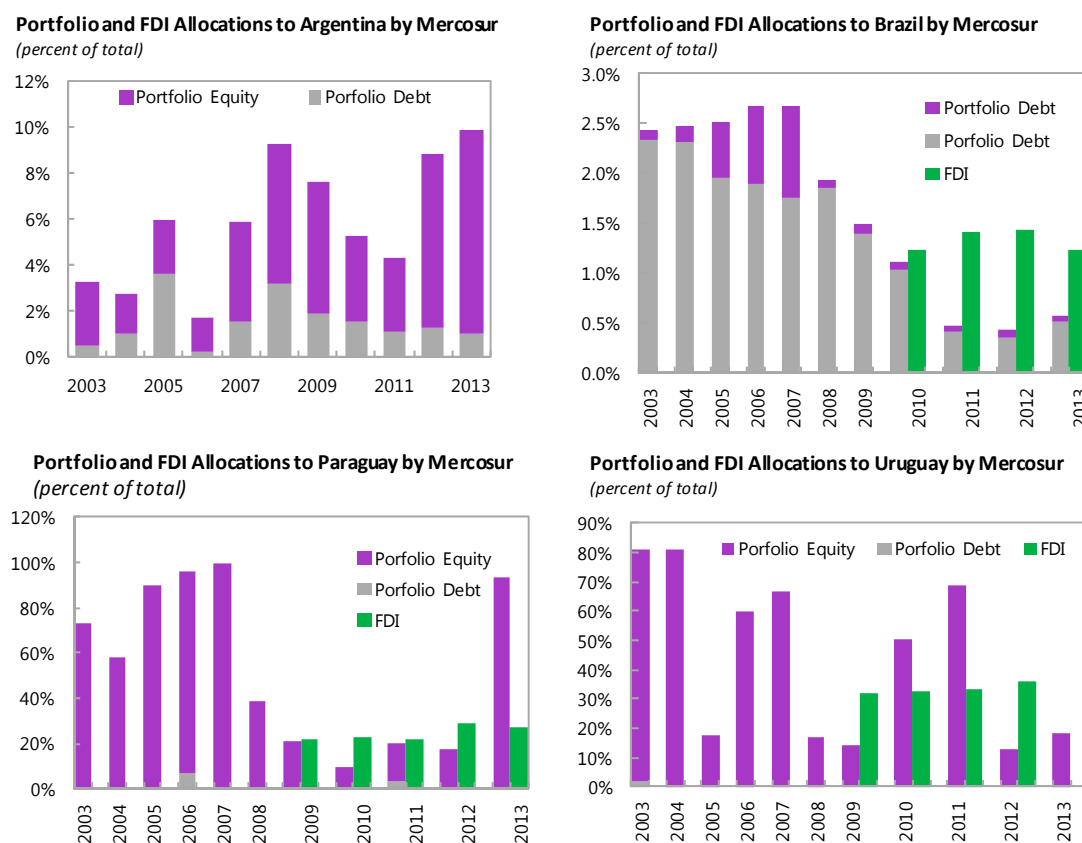
<sup>45</sup> Brazil is the only country reporting to the BIS among the Mercosur countries.

<sup>46</sup> Hoekman (1995), Dee (1995), Berlinski (2012) construct indices of restrictions for market access across the following modes of supply: cross border supply, consumption abroad, commercial presence, and presence of natural persons, assigning values to liberalization commitments made by countries.

integration suggest some restrictions with respect to licensing for foreign banks (Brazil and Uruguay), foreign bank entry (Brazil), and movement of people (Argentina, Brazil, and Uruguay). Other indicators suggest Barth et al (2007) an increase in restrictions to foreign bank entry and banking activities permitted in Argentina, while restrictions on banking activities were lowered in Brazil from 2000 to 2006.

**108. Despite problems facing the Political and Commercial Mercosur, the Financial Mercosur is moving on and achieving some progress, especially on the convergence of the members towards best practices.** The specific working group No 4 (SGT-4), mandated to address the particular needs of the financial sector, comprises financial sector regulators (banking, securities markets, insurance) of all Mercosur member countries, to oversee their integration process. The ultimate goal is to provide a regional common market in financial services. This moment may be propitious for taking further steps to achieve this goal.

**Figure 34. Mercosur<sup>1</sup>: Portfolio and FDI Allocations to Mercosur by Other Mercosur Countries, 2003–14**



Sources: IMF, Coordinated Portfolio Investment Survey and Coordinated Direct Investment Survey.

<sup>1</sup>Mercosur includes Argentina, Brazil, Paraguay, and Uruguay.

## PACIFIC ALLIANCE

**109. On April 28, 2011 then-President Garcia of Peru together with the Presidents of Chile, Colombia and Mexico signed the Lima Agreement, which pledged the four countries to work together as the PA to foster “deep integration” in a wide range of areas.** Amongst these was the immediate abolition of tariffs on 92% of merchandise trade, and a commitment to abolish the remainder by 2020. Together the countries represent 36% of Latin American GDP, and are the largest exporters from the region.

**110. The PA continues with high level political commitment, with six-monthly Presidential summits.** Most recently, Colombia passed the Presidency to Peru; at a summit in Paracas on July 2, 2015, the Presidents reaffirmed their commitment to the PA, and indicated new avenues for integration. On July 20, 2015 the framework agreement for the PA came into force.

**111. The Alliance has garnered wide international attention. 34 countries are now observers at the PA meetings.** Several smaller countries in the region are proceeding through the membership process or considering doing so. More widely, it has been suggested<sup>47</sup> that the greatest achievement of the Alliance is its ability to draw inward investment. ASEAN is observer to the PA, and the PA explicitly sees itself as outward-focused to present an integrated economic face to the world. The PA met with ASEAN in May 2015, and was observer at the ASEAN summit in the Philippines in November 2015.

**112. There is as yet no specific overall financial sector stream for integration amongst the PA countries, but it has taken over a private-led initiative for capital market integration.** The stock exchanges of Chile, Colombia and Peru agreed to merge under the MILA. There has been considerable publicity for this initiative, and in 2014 Mexico joined, with an initial trade on 2 December 2014 of shares in Chilean retailer Falabella executed in the Mexican stock exchange. The Mexican stock exchange also bought 6.7% of the Lima stock exchange. Together the joint exchange is the second largest in Latin America, slightly smaller than São Paulo.

**113. Actual results from the capital market initiative so far are minimal.** Total trades in the three years since MILA was established are less than the volume traded in Mexico alone in a week. Two sets of explanation have been put forward: first that MILA is redundant since capital market needs can be serviced either domestically or outside the region, particularly in the United States; second, that the integration process so far has been insufficiently ambitious, and that a more comprehensive set of integration policies would enable the initiative to achieve “lift-off”.

**114. The actual integration measures to date have been limited.** For instance, trades have to still be placed with a broker-dealer in the investor’s country, who has to contact a broker-dealer in the investment’s country. Also, the initiative covers only equities, although it is in the process to be

<sup>47</sup> The Economist, March 14 2015

expanded to government and corporate bonds. There has been no harmonization of operating hours and procedures, nor harmonization of tax systems to avoid double taxation. And, possibly most importantly, investors in the participating countries, particularly pension and insurance funds, have strict limits on the shares of their portfolios that they can invest cross-border, including in fellow-PA countries.

**115. It would now be opportune to make use of the political mileage achieved through the PA to take a comprehensive set of interconnecting measures to accelerate capital market integration, including through MILA.** Such measures could include relaxing the share of portfolios that pension and insurance funds could invest cross-border, or preferably allow cross-border investments into other MILA countries to be counted as domestic. For Chile, which restricts cross-border investment on the basis of country ratings, this might be superseded by corporate ratings and foreign exchange position limits. Additionally, operational procedures including all aspects of listing requirements, could be harmonized.

**116. The PA agenda is at present carried forward largely by finance ministry officials in the country holding the rotating presidency.** This has a number of advantages, including that it keeps initiatives in line with national objectives, but also has drawbacks. Most particularly, this limits the administrative resources that can be put into the initiative, and may make it largely move forward through ad hoc measures.

**117. It is therefore recommended that a small secretariat be established in one of the PA countries.** This should have overall responsibility for providing advice and executing the operational requirements for a PA financial sector integration stream. Work would include preparing and disseminating a comprehensive framework for integration, including timelines and sequencing, so as to maintain momentum for the integration process, ensure consistency, and gain the benefits of proceeding through reciprocity. It could also be the external face of the financial side of the PA, thus helping to secure foreign investment and other integration with the rest of the region and the wider world.

### *Recommendations*

**118. Mercosur to revisit its plans for financial integration and to consider how to take them forward at the present time.**

**119. PA to establish a small secretariat in one of the PA countries.** It could work to

- Permit pension funds and insurance companies to count cross-border PA investment as domestic.
- Replace remaining ratings-based country limitations for pension funds investments across MILA countries with specific foreign exchange and corporate limitations.
- Complete MILA expansion beyond equities (primary and secondary markets) to include sovereign and corporate bonds.

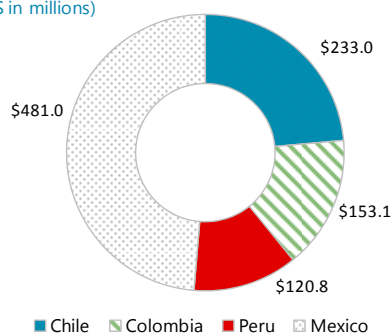
- Harmonize operational procedures, including all aspects of listing requirements, for capital markets.
- Ensure all countries have signed IOSCO MOUs.
- “Passport” the licensing of broker dealers, while keeping them subject to host as well as home regulation.
- Enhance contacts amongst national regulators and supervisors, including through exchanges of staff and secondments to the secretariat.
- Examine the potential for expanding geographic scope.

### Box 8. Integrated Securities Markets in Latin America Integrated Market (MILA) Initiative

#### Background

Regional integration and cooperation in securities markets for LA-7 countries is important to better serve the increased intensity, growth and importance of transnational and intra-regional financial services. In particular this would enhance intermediation of the rapid growth and size of FDI in financial institutions and cross-border transactions. Domestic securities markets in many LA-7 countries are restricted in size in part due to large fixed costs in set-up and a lack of economies of scale. In addition, the limited nature of liquidity and risk diversification in such markets plays a significant role. MILA was announced in September 2009 and launched in May 2011 with the intention to bolster trading volumes in three stock markets (Colombia, Chile and Peru) and provide alternative to the larger markets of Mexico and Brazil. Mexico joined MILA in December 2014. MILA exchanges are number one in Latin America for the number of listed companies, number two in terms of market capitalization and number three in terms of traded volumes.

Market Capitalization of MILA Markets as of  
December 2014  
(\$US in millions)



#### Liquidity

Investors, issuers and broker-dealers are less likely to participate in illiquid markets. Investors who hold securities in their portfolios require certainty of valuation and execution of sales of securities from such markets under appropriate pricing conditions, should they decide to offset their positions. Liquid markets enable investors to meet such needs, while benefitting from lower transaction costs. Large volumes and higher frequency of issuance of individual equity securities are necessary to create proper liquidity pools, attract investors and generate larger volume of transactions. This is a pre requisite to allow the development of efficient pricing on secondary markets. Moreover, liquid markets help investors to diversify their risks.

#### Harmonization Challenges

MILA remains a cross-border initiative to integrate equities market without any real corporate merger of stock exchanges or depositories; it has enabled cross-listings and use of technological tools to allow standardization of regulations on trading and custody across the separate MILA countries. Fuller integration would require deeper regulatory and supervisory harmonization that involved clear delineated responsibilities of different securities supervisors and



### Box 8. Integrated Securities Markets in Latin America Integrated Market (MILA) Initiative (Concluded)

harmonization of regulatory standards and supervisory approaches to best practice levels.. The creation of a fully integrated regional equity market requires that all investors benefit from equivalent legal treatment and protection regime for all transaction made through MILA. Further tax and pension fund investment regime harmonization, and unified resolution frameworks are important for a deeper integration of equity markets. There has been little or no progress in integrating fixed income (bond), currency, derivatives, repos and securities lending markets in part because harmonization of the rules for such securities are even more onerous and challenging to integrate and, unlike equities, many of these securities are not fully traded electronically on exchanges, with the majority of trades still remaining OTC. Foreign investors are also less actively involved in MILA, preferring to rely on accessing separate local markets through already well-established relationships with local custodians and broker-dealers that also benefit from tighter foreign exchange spreads when currency is converted and delivery-versus-payment settlement (DvP).<sup>1</sup>

#### Post-Trade Settlement and Counterparty Risk

MILA has so far been a trade-driven initiative with limited focus on essential back-office settlement issues that have increased settlement and counterparty risk. This operational factor remains the single most important element restricting greater trading volume growth. Currently, counterparty risk is carried by local broker dealers when settling cross-border trades. This can result in contagion and systemic risk concerns if one of the broker dealers cannot fulfill its payment or delivery obligations. Specifically, cross-border trades in MILA are conducted on a free of payment basis, where the cash and securities do not move together on settlement date. Cash in fact would move ahead of securities. For example, assume a Chilean broker-dealer buys Colombian equity for its Chilean investor through a Colombian broker. If the Colombian broker were to go insolvent and not deliver the securities, the Chilean broker would be liable to its Chilean investor. If the Chilean broker-dealer could not meet its obligations it could also fail and, if systemic, could be a cause of contagion and loss for other brokers, investors, and potentially causes a wider systemic financial distress. A multilateral process for settling cross-border trades between brokers in MILA on a DvP basis is required. So far, options to enable that through a regional clearinghouse, use of local custodians or central securities depositories have not materialized.

#### Conclusion

MILA represents an important staging post for further securities markets integration in Latin America, opening up benefits for economic growth in the region through enhanced financial intermediation and financial resilience arising out of deeper and more liquid securities markets. Further integration of securities markets should involve harmonization towards best practice regulatory standards, and should address important post-trade settlement issues for cross-border trades.

<sup>1</sup> DvP is a securities settlement mechanism that links a securities transfer and a funds transfer in such a way as to ensure that delivery occurs if and only if the corresponding payment occurs.

## RISKS AND MITIGATION

### A. Current Conjuncture

**120. Notwithstanding the growth and cross-border dimension of LA-7 financial activity, there are currently low levels of contagion spillover risks in the LA-7.** While growing cross-border activity and financial integration increase the potential for contagion spillovers in a crisis, some preliminary quantitative analysis suggests that spillover risks among Latin American financial systems are currently contained (see Background Paper - Appendix III). With conglomerates operating in LA-7 jurisdictions and wider LA, they can act as pathways for increased regional banking and financial sector connectivity through their network of subsidiaries, inter-group and other counterparty exposures. Country authorities have started to be more focused on these risks, limiting cross-border activity in

some cases by formal or informal restrictions imposed on cross-border activities. Current low levels of spillover risk provide space for further financial integration if regional supervisory and regulatory oversight is strengthened and any country-specific weaknesses in supervisory frameworks are addressed to avoid regulatory arbitrage. While contagion risks currently remain low, they would naturally rise with greater integration and/or under adverse crisis situations. This requires that such cross-border activity and exposures be monitored in a regionally coordinated manner.

## B. Analytical Work on Spillover Risks

**121. Market-based spillover analysis (based on estimated default linkages) suggests that contagion risks among large financial institutions in Latin America remain contained.** This quantitative analysis looks at the existence of market-based interlinkages of large financial institutions in the countries included in the sample, using data on traded securities. In particular, the analysis quantifies potential spillovers across institutions through the financial markets (see Background Paper - Appendix III). In the case of banks in the six-country sample, Argentinean banks (and Banorte in Mexico) appear to be the most “vulnerable to contagion” during the GFC, and also over the period from end-2010 to mid-2012. However, these spillover risks are mostly among themselves. Over the past year or so, publically-owned Brazilian banks (Banco do Brazil) appear to be driving most of the market-implied contagion among the banks in the sample, but the actual spillovers (outside Brazil) appear to be rather small. In other words, Brazilian public banks might be very important for the domestic market (in Brazil), but not really for the region, likely reflecting the lack of significant balance sheet exposures among Latin American banks.

## C. Regulatory Oversight

**A key pre-condition for substantial cross-border financial integration is to also have a robust and forward-looking best-practice regulatory and supervisory framework in place.** Since the GFC there has been an important need both domestically and internationally to enhance regulatory standards and develop macroprudential tools to reduce risks in the financial system, including cross-border risks. As regards LA cross-border financial activity, risks may be mitigated by having a suitable entry, operating and resolution framework for cross-border institutions<sup>48</sup>; having sound national regulatory frameworks in place (Basel 3) reflecting appropriate timelines and banking system complexity; having a full picture of the entire financial institution (need for cross-border consolidated and conglomerate supervision); and using the macroprudential toolkit to protect the national, and regional, financial systems from systemic financial stability risks.

<sup>48</sup> So far the assessment of EMs in Latin America on the basis of the *Key Attributes of Effective Resolution for Financial Institutions* is limited and will require further work. Colombia has recently undergone a pilot assessment which will provide useful inputs for the FSB from an EM perspective regarding the *Key Attributes*.

## I. Cross-Border Establishments

**122. As discussed above, legal and regulatory frameworks for subsidiaries and branches of foreign firms have been enhanced, but could be further strengthened.** The legal frameworks of the surveyed countries generally require that branches/subsidiaries have to follow all regulations and practices of the host countries. All countries require endowment capital of branches, and most authorities have the powers to restrict issuing of dividends of subsidiaries (including cross-border), as well as of capital of subsidiaries. In addition, the pricing of centralized functions such as IT and treasury is subject to oversight, thereby avoiding that restriction on dividend or capital transfers are circumvented. This being said, there is further room for improvement. Local asset maintenance requirements for branches and limits on intra-group exposures for subsidiaries could usefully be reviewed. In the context of a broader update of bank resolution frameworks, powers to deal with cross-border coordination should be strengthened, including by removing the automaticity and discriminatory features of ring-fencing mechanisms.

## II. Basel 3: Capital, Liquidity and Leverage Requirements

**123. Progress is marked but not yet complete amongst the LA-7 in adopting the Basel standards.** The Basel Committee's Eighth Progress Report on the adoption of the Basel regulatory agenda shows rapid recent progress in many EMs. Brazil and Mexico are fully compliant as regards the Basel 3 capital standard, the liquidity standard, and the leverage ratio. Others are implementing at a pace they consider in line with the nature of their banking systems, though a move to the Basel III capital definition across the LA-7 would further enhance financial stability (Background Paper – Box 1).

## III. Consolidated and Conglomerate Supervision

**124. Recent FSAPs for countries in the region show that for all countries there is some way to go in improving their supervisory framework and, in particular, implementing consolidated and conglomerate supervision, with legal restrictions in some countries preventing full achievement of best practices, in particular in the handling of the non-financial components of conglomerates.** Although subsidiarization, and regulatory and resolution ring fencing, can dampen cross-border spillovers, cross-border safety requires that the institution be supervised on a consolidated basis. International best practices for consolidated supervision call for establishing robust supervisory regimes, cross-border supervisory processes, joint monitoring programs, and coordinated corrective/supervisory actions amongst all parts of a cross-border financial institution or conglomerate<sup>49</sup>.

<sup>49</sup> See for instance "Financial Integration in Central America, Panama, the Dominican Republic and Colombia—Cluster Report" FO/DIS/15/86

**125. The structure of Latin American financial institutions makes consolidated supervision particularly important, given that many are parts of conglomerates, and that the non-financial parts of such conglomerates have in a number of cases already expanded cross-border to a much greater extent than the banks.** Even where there are no direct financial flows between the bank and non-bank parts of a conglomerate, problems in the non-bank can have major knock-on effects on the bank. Problems in the retail arm of the group with the first Chilean bank to move cross-border led to financial pressures and ultimate sale to another regional bank, although the Chilean bank itself had faced no difficulties and was making substantial profits.

**126. There is increasing awareness of the importance of consolidated supervision.** The Uruguayan regulators declined to give a license to a regional bank that was seeking to acquire a bank being sold in Uruguay, on the grounds that the regional bank's supervisor was not conducting consolidated supervision. Chile has reached out to the IMF, and in 2014–15 received technical assistance on this subject.

**127. Conglomerate supervision complements supervision of individual sectors by adding a layer to the solo and consolidated sectoral supervision.** Individual supervision faces limitations dealing with double gearing of capital, conflicts of interest, risks of contagion, concentration, and other specific group risks that may hamper financial stability. Conglomerate supervision should detect and monitor these risks while avoiding unnecessary duplication with sectoral prudential standards.

**128. Internationally agreed documents provide national authorities a set of principles that support consistent and effective supervision of financial conglomerates.** The main references are the “Basel core principle for effective banking supervision” and the Joint Forum’s “Principles for supervision of financial conglomerates.”<sup>50</sup> Focusing on both the cross border and cross sector dimensions of the process, these principles set expectations about supervisory powers and responsibilities, corporate governance, prudential requirements and risk management. The focus of the Principles is closing regulatory gaps, eliminating supervisory blind spots, and ensuring effective supervision of risks arising from unregulated financial activities and entities. Colombia is currently seeking parliamentary approval for a bill on providing supervisors with powers over the holding company of financial and mixed conglomerates in line with the Principles.

**129. The Principles are flexible and use a non-prescriptive approach to the supervision of financial conglomerates to cover a wide range of structures.** They emphasize the importance of recognizing structural complexity and the potential risks it poses. This includes risks arising from all entities—unregulated or regulated—that affect the financial conglomerate’s overall risk profile. The flexibility of this framework is intended to enable policymakers and supervisors to appropriately regulate and supervise financial conglomerates, while limiting the scope for regulatory arbitrage.

<sup>50</sup> The Principles were released in 2012 by the Joint Forum’s parent committees—the Basel Committee on Banking Supervision, the International Organization of Securities’ Commissions, and the International Association of Insurance Supervisions.

**130. Beyond consolidated supervision there is also need for increased cooperation amongst supervisors to tackle conglomerate and cross-border risks more broadly.** Supervisory colleges have been established for major banks in the region. Colombia has gone further as regards Central America, where its banks have established significant positions in most countries, through a multilateral MoU, a Regional Council of Finance Ministers, a Regional Monetary Council, and a joint Council of Supervisors.

#### IV. Macroprudential Toolkit

**131. Since the GFC there has been considerable progress in much of the world in designing and implementing a macroprudential toolkit.** Macroprudential authorities have the power to impose additional capital charges if they consider that cyclical conditions so warrant. Specific instruments such as limits on loan-to-value and debt-to-income are also being studied.

**132. Such instruments are likely to be designed and implemented at a national level, given the different risk exposures of each country.** Where there is cross-border financial activity, there is however a clear need for coordination, and reciprocity, to avoid arbitrage and “macroprudential leakage” across countries.

#### Recommendations

**133. Latin American countries may be assisted by taking a regional approach as they come to implement remaining elements of the global regulatory agenda and develop and implement their emerging macroprudential toolkits:**

- Seek to align timelines while reflecting international commitments and local circumstances as national authorities move forward with implementing the regulatory agenda<sup>51</sup>.
- Introduce, and/or strengthen consolidated supervision, if necessary with technical assistance from IMF or other sources, in line with recommendations from IMF FSAPs and the Joint Forum’s Principles.
- Continue the development of macroprudential tools through regional conferences, and possibly a more formal regional arrangement, so that tools can be designed and implemented on a regional basis to avoid cross-country regulatory arbitrage and coordinate eventual spillovers.

<sup>51</sup> Brazil and Mexico as members of the Basel Committee and the FSB have to abide closely with the international timeline for implementation.

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