FINANCIAL INTEGRATION IN LATIN AMERICA

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**International Monetary Fund**

**Washington, D.C.**
FINANCIAL INTEGRATION IN LATIN AMERICA

March 30, 2016

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.
FINANCIAL INTEGRATION IN LATIN AMERICA

Approved by Alejandro Werner

Prepared by a WHD team led by Charles Enoch\textsuperscript{1,2} and including, Carlos Caceres\textsuperscript{2}, Luc Eyraud\textsuperscript{2}, Alla Myrvoda\textsuperscript{2}, Anaychukwu Osueke, Diva Singh\textsuperscript{2}, Ben Sutton\textsuperscript{2}, Julia Teodoru\textsuperscript{1} (all WHD), with contributions of LEG (Jefferson Alvares, Wouter Bossu\textsuperscript{1}, Barend Jansen, Laura Lorenzo\textsuperscript{1,2}, MCM (Marco Pinon\textsuperscript{1,2}, 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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\textsuperscript{2} Participated in July mission.
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<th>Definition</th>
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<tbody>
<tr>
<td>AML/CFT</td>
<td>Anti-Money Laundering/Combating the Financing of Terrorism</td>
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<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee for Banking Supervision</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BIT</td>
<td>Bilateral Investment Treaty</td>
</tr>
<tr>
<td>BCP</td>
<td>Basel Core Principles</td>
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<tr>
<td>BROU</td>
<td>Banco de la República Oriental del Uruguay</td>
</tr>
<tr>
<td>CCP</td>
<td>Central Counterparty</td>
</tr>
<tr>
<td>CDIS</td>
<td>Coordinated Direct Investment Survey</td>
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<td>CPIS</td>
<td>Coordinated Portfolio Investment Survey</td>
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<tr>
<td>DTA</td>
<td>Double Taxation Agreement</td>
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<td>DvP</td>
<td>Delivery versus Payment</td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EM</td>
<td>Emerging Market</td>
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<td>EU</td>
<td>European Union</td>
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<tr>
<td>FATF</td>
<td>Financial Action Task Force</td>
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<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FSB</td>
<td>Financial Stability Board</td>
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<tr>
<td>FTA</td>
<td>Free Trade Agreement</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<tr>
<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IIP</td>
<td>International Investment Positions</td>
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<td>IOSCO</td>
<td>International Organization of Securities Commissions</td>
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<tr>
<td>LA</td>
<td>Latin America</td>
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<tr>
<td>LA-7</td>
<td>Brazil, Chile, Colombia, Mexico, Panama, Peru, Uruguay</td>
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<tr>
<td>LAC</td>
<td>Latin America and the Caribbean</td>
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<tr>
<td>LAMR</td>
<td>Local Asset Maintenance Requirement</td>
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<tr>
<td>MILA</td>
<td>Latin American Integrated Market</td>
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<tr>
<td>MSCI</td>
<td>Morgan Stanley Capital Interactions Index</td>
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<tr>
<td>MOU</td>
<td>Memorandum of Understanding</td>
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<tr>
<td>NAFTA</td>
<td>North America Free Trade Agreement</td>
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<tr>
<td>OTC</td>
<td>Over the Counter</td>
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<tr>
<td>PA</td>
<td>Pacific Alliance</td>
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<td>PFMI</td>
<td>Principles for Financial Markets Infrastructures</td>
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<td>PPP</td>
<td>Public Private Partnership</td>
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<td>RES</td>
<td>IMF’s Research Department</td>
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<tr>
<td>ROA</td>
<td>Return on Assets</td>
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<td>ROE</td>
<td>Return on Earnings</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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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 21st 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.

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

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of programs</th>
<th>Total borrowing (Bil of SDRs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>6</td>
<td>41.3</td>
</tr>
<tr>
<td>Chile</td>
<td>3</td>
<td>1.4</td>
</tr>
<tr>
<td>Colombia</td>
<td>3</td>
<td>0.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>5</td>
<td>17.9</td>
</tr>
<tr>
<td>Panama</td>
<td>7</td>
<td>0.4</td>
</tr>
<tr>
<td>Peru</td>
<td>9</td>
<td>1.1</td>
</tr>
<tr>
<td>Uruguay</td>
<td>10</td>
<td>2.8</td>
</tr>
<tr>
<td>All IMF programs</td>
<td>371</td>
<td>314.5</td>
</tr>
</tbody>
</table>

Source: International Monetary Fund.
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 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

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3 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. Macroprrudential 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. 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.

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4 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?**

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

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5 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.

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\(^6\)). 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 FDIs, 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

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\(^6\) 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\(^7\). 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).

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\(^7\) 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.
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 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.

References

OECD, 2014, “Private Financing and Government Support to Promote Long-Term Investments in Infrastructure.”


CEPAL, 2014, “The Economic Infrastructure Gap and Investment in Latin America.”

1Typically 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**

Sources: National authorities; Bureau van Dijk; IMF, International Financial Statistics; and IMF staff calculations.

**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**

Emerging Asia and G7. In terms of deposits, Brazil and Panamalead (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, 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

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8 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, 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, 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.

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9 The rate for Brazil averages spreads for non-financial corporations (10 percent) and households (26 percent). Jorgenson and Apastolou, 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.

10 2011 OECD Economic Surveys and Tecles and Tabak, 2010. According to the OECD, operating costs are three time higher in Brazil than in the average OECD countries, and 40 percent above the average in Latin America (see also Beck and Demirguc-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.

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

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### Table 2. Size of the Regional Market, 2014¹

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

Source: National authorities, and IMF staff calculations. ¹ Year-end 2014 or latest available.

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11 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>
<thead>
<tr>
<th>Table 3. Consolidated Foreign Claims on the World by BIS Banks in 4 Latin American Countries (Percent of GDP)</th>
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<tbody>
<tr>
<td>2005</td>
</tr>
<tr>
<td>Brazil</td>
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<tr>
<td>of which: claims on other LA7</td>
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<tr>
<td>Chile</td>
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<td>of which: claims on other LA7</td>
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<tr>
<td>Mexico</td>
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<td>of which: claims on other LA7</td>
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<tr>
<td>Panama</td>
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<tr>
<td>of which: claims on other LA7</td>
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<tr>
<td>Source: BIS, Consolidated Banking Statistics.</td>
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</table>

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>
<thead>
<tr>
<th>Table 4. Assets of Colombian Banks in the Region (Percent of parent bank’s assets)</th>
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<tbody>
<tr>
<td>Bancolombia</td>
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<tr>
<td>Banco de Bogota</td>
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<tr>
<td>Daviendi</td>
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<tr>
<td>Occidente</td>
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<tr>
<td>Sudameris</td>
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<tr>
<td>Sources: National authorities and IMF staff calculations.</td>
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</tbody>
</table>
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 Corpbanca12 (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.13 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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12 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.

13 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

<table>
<thead>
<tr>
<th>Deal Data</th>
<th>Banking Operations/Assets for Sale</th>
<th>Selling Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Latin America and the Caribbean</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td>N.R.</td>
<td>Credit card portfolio</td>
</tr>
<tr>
<td>2012</td>
<td>N.R.</td>
<td>Banco Suquía SA</td>
</tr>
<tr>
<td>2011</td>
<td>76.8</td>
<td>JP Morgan Vastera Argentina SRL</td>
</tr>
<tr>
<td>2015</td>
<td>45.0</td>
<td>Banco Standard de Inversiones SA</td>
</tr>
<tr>
<td>2009</td>
<td>18.7</td>
<td>Credit portfolio</td>
</tr>
<tr>
<td>2010</td>
<td>N.R.</td>
<td>Corporate &amp; Commercial Banking Operations</td>
</tr>
<tr>
<td>2010</td>
<td>1,229.0</td>
<td>Banco Corpbanco Colombia SA</td>
</tr>
<tr>
<td>2012</td>
<td>801.0</td>
<td>Banco Davivienda Salvadoreno SA, Banco HSBC Costa Rica SA, Banco HSBC Honduras SA</td>
</tr>
<tr>
<td>2015</td>
<td>N.R.</td>
<td>Egypt loan &amp; deposit portfolio</td>
</tr>
<tr>
<td>2014</td>
<td>N.R.</td>
<td>Banking business/Jordan</td>
</tr>
<tr>
<td>2009</td>
<td>324.6</td>
<td>Societe Ivoirienne de Banque SA, Union Gabonaise de Banque SA, Credit du Congo, Societe Camerounaise de Banque, Credit du Senegal</td>
</tr>
<tr>
<td>2015</td>
<td>2,106.4</td>
<td>Barclays Africa Ltd</td>
</tr>
<tr>
<td>2014</td>
<td>177.0</td>
<td>United Arab Emirates retail banking operations</td>
</tr>
<tr>
<td>2011</td>
<td>16.5</td>
<td>Royal Bank of Scotland NB Uzbekistan CJSC</td>
</tr>
<tr>
<td><strong>Middle East, Africa, and the CIS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td>16.5</td>
<td>Royal Bank of Scotland NB Uzbekistan CJSC</td>
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<tr>
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<tr>
<td>2011</td>
<td>16.5</td>
<td>Royal Bank of Scotland NB Uzbekistan CJSC</td>
</tr>
<tr>
<td><strong>Emerging Europe</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>N.R.</td>
<td>Credit Agricole Bulgaria</td>
</tr>
<tr>
<td>2014</td>
<td>18.9</td>
<td>Banco Popolare Croatia dd</td>
</tr>
<tr>
<td>2011</td>
<td>69.1</td>
<td>Equa Bank AS</td>
</tr>
<tr>
<td>2011</td>
<td>158.0</td>
<td>Cetelem Bank LLC</td>
</tr>
<tr>
<td>2013</td>
<td>N.R.</td>
<td>ATF Bank JSC</td>
</tr>
<tr>
<td>2011</td>
<td>N.R.</td>
<td>Banque Societe Generale Vostok, DeltaCredit Bank, Rusfinans Bank</td>
</tr>
<tr>
<td>2011</td>
<td>N.R.</td>
<td>Exobank LLC</td>
</tr>
<tr>
<td>2012</td>
<td>542.5</td>
<td>DenizBank AS</td>
</tr>
<tr>
<td>2013</td>
<td>N.R.</td>
<td>Turkey Consumer Banking Business</td>
</tr>
<tr>
<td>2012</td>
<td>N.R.</td>
<td>Bank Forum JSC</td>
</tr>
<tr>
<td><strong>Emerging Asia</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>N.R.</td>
<td>Banking business/India</td>
</tr>
<tr>
<td>2015</td>
<td>N.R.</td>
<td>Banking business in India</td>
</tr>
<tr>
<td>2010</td>
<td>50.5</td>
<td>Royal Bank of Scotland Ltd/Pakistan</td>
</tr>
<tr>
<td>2012</td>
<td>N.R.</td>
<td>Banking Business/Pakistan</td>
</tr>
<tr>
<td>2014</td>
<td>N.R.</td>
<td>Banking business in Pakistan</td>
</tr>
<tr>
<td>2010</td>
<td>N.R.</td>
<td>RBS Philippines Inc</td>
</tr>
<tr>
<td>2014</td>
<td>N.R.</td>
<td>Trust business of Deutsche Bank Manila Branch</td>
</tr>
<tr>
<td>2012</td>
<td>113.3</td>
<td>Retail Banking and Wealth Management business</td>
</tr>
</tbody>
</table>

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
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, 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

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14 Jorgenson and Apastolou (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.\(^{15}\)

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,

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\(^{15}\) 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). 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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16 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.
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.
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 trippled, 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.

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. Pension fund assets in many LA-7 countries now rank second largest among financial intermediaries, trailing only the banking system.

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17 Towers Watson ratings of the largest pension funds (2014).

18 LA-7 LA-7 pension funds are Brazil, Colombia, Chile, Mexico, Peru, Panama, Uruguay.
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\(^\text{19}\), 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.

**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.

\(^{18}\) 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.

\(^{19}\) 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 19)

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 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.\textsuperscript{20} 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\textsuperscript{21}. However, de facto barriers arising from high market concentrations with incumbent power present significant impediments to new entrants. The competitive advantages\textsuperscript{22} 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

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\textsuperscript{20} 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.

\textsuperscript{21} 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.

\textsuperscript{22} 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.
be volume, liquidity, and maturity concerns in addition to corporate risks with these instruments. Alternative assets like private equity and infrastructure have 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. 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.

23 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."
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.

Comparison to other countries indicates that LA-7 pension fund fees are higher than the level suggested by their operating costs. 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...
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.

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.

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

Source: AIOS.

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


3 OECD 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>
<thead>
<tr>
<th>Country</th>
<th>Legal Instrument</th>
<th>Foreign Investments allowed</th>
<th>Foreign Investment Limit</th>
</tr>
</thead>
</table>
| Brazil  | Banco Central do Brasil-Resolução No. 3792 | - Assets issued abroad belonging to the portfolios of the funds constituted in Brazil.  
- Shares of investment funds and shares of investment funds in shares of investment funds classified as external debt.  
- Shares of foreign index funds admitted to trading on the stock exchange in Brazil.  
- Brazilian Depositary Receipts.  
- Shares issued by foreign companies based in MERCOSUR. | 10%                       |
| Chile   | Decreto Ley No. 3500 de 1980  
Banco Central de Chile Acuerdo No. 1680-03-120517- Circular No. 3013-699 | - Credit instruments or negotiable securities issued or guaranteed by foreign governments, central banks and banks;  
- Stocks and bonds issued by foreign companies;  
- Participation shares usually traded on international markets issued by mutual funds and investment funds.  
Debt instruments must have at least two risk ratings by international rating agencies above BBB and N-3. | The Law sets the maximum limits range for all the funds combined (30%-80%), and the maximum limit range for each type of fund:  
- Fund A 45%-100%  
- Fund B 40%-90%  
- Fund C 30%-75%  
- Fund D 20%-45%  
- Fund E 15%-35%  
The Central Bank set the limits within the above range as follows:  
- Maximum limits for the funds combined |
**Table 6. Pension Funds in Latin America - Limits on Foreign Investments (continued)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Limits on Foreign Investments</th>
<th>Debt Securities Issued or Guaranteed by Various Entities</th>
<th>Other Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colombia*</td>
<td>cannot exceed 80% of their value.</td>
<td>- Debt securities issued or guaranteed by foreign governments or foreign central banks.</td>
<td>- Conservative Fund: 40%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Debt securities issued, guaranteed, or originated by foreign commercial or investment banks; or by foreign non-bank entities.</td>
<td>- Moderate Fund: 60%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Debt securities issued or guaranteed by multilateral lending institutions.</td>
<td>- Riskier Fund: 70%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- ETFs, foreign mutual or investment funds.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Equity securities.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- ADRs and GDRs</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Private equity funds established abroad</td>
<td></td>
</tr>
<tr>
<td>México</td>
<td>Funds 1-4: up to 20% for foreign debt securities</td>
<td>- Foreign debt securities and foreign equity securities;</td>
<td>At the same time, the law establishes limits per type of investment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Real estate investment vehicles;</td>
<td>-equity, structured investments for each type of Fund.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Bank demand deposits in foreign financial institutions;</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Derivatives with foreign equity as underlying assets</td>
<td></td>
</tr>
</tbody>
</table>
Table 6. Pension Funds in Latin America - Limits on Foreign Investments (concluded)

<table>
<thead>
<tr>
<th>Country</th>
<th>Regulatory Authority</th>
<th>Limits on Foreign Investments</th>
<th>Note</th>
</tr>
</thead>
</table>
| Panama   | 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 |
| Perú     | 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. |
| Uruguay  | 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.

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
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\textsuperscript{24} 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.

\textsuperscript{24} 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.

**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.

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.\(^{25}\) 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.

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\(^{25}\) 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, 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.

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 ¾ 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.

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26 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)

<table>
<thead>
<tr>
<th>Group</th>
<th>Country</th>
<th>Premia (USD mn)</th>
<th>Market share (percent)</th>
<th>Group</th>
<th>Country</th>
<th>Premia (USD mn)</th>
<th>Market share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Insurance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ING</td>
<td>Holand</td>
<td>2,996</td>
<td>7.5</td>
<td>BRADESCO</td>
<td>Brazil</td>
<td>13,540</td>
<td>8.7</td>
</tr>
<tr>
<td>BRADESCO</td>
<td>Brazil</td>
<td>2,328</td>
<td>5.8</td>
<td>ITAU/UNIBANCO</td>
<td>Brazil</td>
<td>11,620</td>
<td>7.4</td>
</tr>
<tr>
<td>METLIFE</td>
<td>United States</td>
<td>1,977</td>
<td>5.0</td>
<td>MAPFRE</td>
<td>Spain</td>
<td>10,625</td>
<td>6.8</td>
</tr>
<tr>
<td>AIG</td>
<td>United States</td>
<td>1,927</td>
<td>4.8</td>
<td>BRASILPREV</td>
<td>Brazil</td>
<td>8,030</td>
<td>5.1</td>
</tr>
<tr>
<td>GNP</td>
<td>Mexico</td>
<td>1,720</td>
<td>4.3</td>
<td>ZURICH</td>
<td>Switzerland</td>
<td>6,689</td>
<td>4.3</td>
</tr>
<tr>
<td>MAPFRE</td>
<td>Spain</td>
<td>1,484</td>
<td>3.7</td>
<td>METLIFE</td>
<td>United States</td>
<td>5,090</td>
<td>3.3</td>
</tr>
<tr>
<td>TRIPLE-S</td>
<td>Puerto Rico</td>
<td>1,335</td>
<td>3.3</td>
<td>PORTO SEGURO</td>
<td>Brazil</td>
<td>4,435</td>
<td>2.8</td>
</tr>
<tr>
<td>ITAU</td>
<td>Brazil</td>
<td>1,256</td>
<td>3.1</td>
<td>LIBERTY MUTUAL</td>
<td>United States</td>
<td>4,020</td>
<td>2.6</td>
</tr>
<tr>
<td>ALLIANZ</td>
<td>Germany</td>
<td>894</td>
<td>2.2</td>
<td>CNP</td>
<td>France</td>
<td>3,119</td>
<td>2.0</td>
</tr>
<tr>
<td>ZURICH</td>
<td>Switzerland</td>
<td>880</td>
<td>2.2</td>
<td>ALLIANZ</td>
<td>Germany</td>
<td>2,952</td>
<td>1.9</td>
</tr>
<tr>
<td><strong>Top 10 groups</strong></td>
<td></td>
<td>16,797</td>
<td>42.1</td>
<td><strong>Top 10 groups</strong></td>
<td></td>
<td>70,120</td>
<td>44.8</td>
</tr>
<tr>
<td>of which Latin American</td>
<td></td>
<td>5,304</td>
<td>31.6</td>
<td>of which Latin American</td>
<td></td>
<td>37,625</td>
<td>53.7</td>
</tr>
<tr>
<td><strong>Total sector</strong></td>
<td></td>
<td>39,897</td>
<td>100.0</td>
<td><strong>Total sector</strong></td>
<td></td>
<td>156,449</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>Non-Life Insurance</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ING</td>
<td>Holand</td>
<td>2,368</td>
<td>10.0</td>
<td>MAPFRE</td>
<td>Spain</td>
<td>7,763</td>
<td>9.5</td>
</tr>
<tr>
<td>AIG</td>
<td>United States</td>
<td>1,415</td>
<td>5.9</td>
<td>PORTO SEGUROS</td>
<td>Brazil</td>
<td>4,198</td>
<td>5.1</td>
</tr>
<tr>
<td>MAPFRE</td>
<td>Spain</td>
<td>1,275</td>
<td>5.4</td>
<td>LIBERTY MUTUAL</td>
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</table>

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

1 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 governances 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 obtains significant shares of their financing from bank loans and supplier credit, especially small and medium enterprises.
**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.
• 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, BMFBovespa purchased an 8% stake in the Santiago exchange and is working with it to set up an electronic derivatives market in Chile. BMFBovespa 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.
Financial Integration in Latin America

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 TIIE (Tasa de Interes 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, 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. 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.

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1 Based on Triennial Central Bank Survey, BIS.
2 Database covers following Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, and Peru.
Box 6. Latin American OTC Interest Rate Derivatives

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

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

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.

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

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.
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. 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.

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, 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.

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

2 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, net-net basis)

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, net-net basis)

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-net basis”)

... 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, net-net 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)

... 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, net-net basis)
LEGAL BARRIERS TO REGIONAL INTEGRATION

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.

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. 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. 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. Brazil, in turn, prohibits formally the opening of new branches and subsidiaries in its Constitution, but

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27 This section has been prepared by the Legal Department.

28 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.

29 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).

30 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.

31 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. 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 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. 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.” 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. Separately, some countries impose restrictions

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

33 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.

34 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.

35 Art. 48.5 of the Banking Law.

36 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. 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 for foreign branches, 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.

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37 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.

38 See Article 2.36.12.2.2 of Colombian Decree 2555/2010 and Art. 42 of the Peruvian Banking Law.
These rules should be reviewed to require a higher amount of assets to be held locally. Combined with 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.39

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.40 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.41 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 form home countries that have adopted regionally harmonized rules and practices.

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

40 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.

41 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>
<thead>
<tr>
<th>Table 8. Legislative Provisions For Key Banking Supervisory Instruments1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Minimum Capital (USD)</td>
</tr>
<tr>
<td>Large Exposures</td>
</tr>
</tbody>
</table>

1/ 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)

<table>
<thead>
<tr>
<th>Bank related party lending</th>
<th>Early Intervention</th>
<th>Stop dividends</th>
<th>Change management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Includes arm’s length provision.</td>
<td></td>
<td></td>
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<tr>
<td>100% Global limit.</td>
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<td></td>
</tr>
<tr>
<td>Individual limit: 5% non-collateralized credit.</td>
<td></td>
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</tr>
<tr>
<td>Bank related party: 10% shares.</td>
<td></td>
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<tr>
<td>Bank related party: 5% of shares.</td>
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</tr>
<tr>
<td>Bank related party: 2% of shares.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank related party: more than 1% of shares.</td>
<td></td>
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<tr>
<td>Credit operations with related parties require unanimous approval of the Board.</td>
<td></td>
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<tr>
<td>Includes arm’s length provision.</td>
<td></td>
<td>Yes.</td>
<td></td>
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<tr>
<td>35% global limit.</td>
<td></td>
<td>General provision (broad powers).</td>
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</tr>
<tr>
<td>Individual limits: 5% non-collateralized credit facilities.</td>
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<td></td>
<td></td>
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<tr>
<td>10% collateralized loans.</td>
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<tr>
<td>Bank related party: 5% of shares.</td>
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<tr>
<td>Global limit: Credits and investments cannot be more than 30% of the total assets.</td>
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<tr>
<td>Bank related party: 4% of shares or ‘significant influence’</td>
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<tr>
<td>Bank related party: BL does not mention shareholders.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Early Intervention</td>
<td>Stop dividends</td>
<td>Change management</td>
<td></td>
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<td></td>
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<tr>
<td>General provision.</td>
<td>Yes.</td>
<td>Yes.</td>
<td></td>
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<tr>
<td>General provision.</td>
<td>Yes.</td>
<td>Yes.</td>
<td></td>
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</tbody>
</table>
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.” 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 under which (i) signatories commit over time to allow residents of other signatories to provide cross-border financial services and 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, 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.

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

43 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.

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 those 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.44

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44 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\textsuperscript{45} 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.\textsuperscript{46} 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

\textsuperscript{45} Brazil is the only country reporting to the BIS among the Mercosur countries.

\textsuperscript{46} 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 suggests 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.

Sources: IMF, Coordinated Portfolio Investment Survey and Coordinated Direct Investment Survey.
¹Mercosur includes Argentina, Brazil, Paraguay, and Uruguay.
B. 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 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 Saõ Paôlo.

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

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47 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 keep 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.

**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 benefiting 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 prerequisite 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

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

- **Colombia:** $233.0
- **Chile:** $153.1
- **Peru:** $120.8
- **Mexico:** $481.0
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 transactions 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).1

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 though 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.

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1 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; 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.

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.

49 See for instance “Financial Integration in Central America, Panama, the Dominican Republic and Colombia—Cluster Report” FO/DIS/15/86
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.

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.

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.

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.” 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.

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.

50 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

- 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.

---

51 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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FINANCIAL INTEGRATION IN LATIN AMERICA

BACKGROUND PAPER: ISSUES ON FINANCIAL INTEGRATION IN LATIN AMERICA

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# Glossary

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<th>Abbreviation</th>
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<tr>
<td>AFP</td>
<td>Private sector fund managers</td>
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<tr>
<td>BCCH</td>
<td>Central bank of Chile</td>
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<tr>
<td>BCP</td>
<td>Basel Core Principles</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<tr>
<td>BLV</td>
<td>Bolsa de Valores de Lima (Lima stock exchange)</td>
</tr>
<tr>
<td>BMV</td>
<td>Bolsa de Valores de Mexico (Mexico stock exchange)</td>
</tr>
<tr>
<td>BROU</td>
<td>Bank of the Republic of the East of Uruguay</td>
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<tr>
<td>CCP</td>
<td>Central Counterparty</td>
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<tr>
<td>CDS</td>
<td>Credit default swaps</td>
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<tr>
<td>CME</td>
<td>Chicago Mercantile Exchange</td>
</tr>
<tr>
<td>D-SIB</td>
<td>Domestically systemically important banks</td>
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<tr>
<td>EDF</td>
<td>Expected default frequencies</td>
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<tr>
<td>EMIR</td>
<td>European Market Infrastructure Regulation</td>
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<tr>
<td>ETF</td>
<td>Private mutual funds</td>
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<tr>
<td>GFC</td>
<td>Global financial crisis</td>
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<tr>
<td>IPC</td>
<td>Indice de Precios y Cotizaciones (Mexican price and volume index)</td>
</tr>
<tr>
<td>LA</td>
<td>Latin America</td>
</tr>
<tr>
<td>LA-7</td>
<td>Brazil, Chile, Colombia, Mexico, Panama, Peru, Uruguay</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers and acquisitions</td>
</tr>
<tr>
<td>MILA</td>
<td>Latin American Integrated Market</td>
</tr>
<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<tr>
<td>MSCI</td>
<td>Morgan Stanley Capital Interactions</td>
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<tr>
<td>NPL</td>
<td>Non-performing loan</td>
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<tr>
<td>OTC</td>
<td>Over the counter</td>
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<tr>
<td>PA</td>
<td>Pacific Alliance</td>
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<tr>
<td>PPP</td>
<td>Purchasing power parity</td>
</tr>
<tr>
<td>SBS</td>
<td>Peruvian superintendent for banks, insurance, pensions</td>
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<tr>
<td>WEO</td>
<td>IMF World Economic Outlook</td>
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</table>
THE LARGEST PRIVATE BANKS

1. Banking assets of the largest banks in Latin America (LA) are heavily concentrated in Brazil. Brazil accounts for nearly two-thirds of LA’s banking assets, while Mexico contributes just one-tenth. Looking just at private banks, Brazil’s share is closer to its share in regional GDP (45% as against 40%). A few Brazilian banks have the strength and interest to become major players and establish a significant presence across the region. However, not all Brazilian banks are looking to expand abroad, stressing the potential still available domestically.
2. **Bank Itaú, based in Saõ Paulõ, has the ambition to further expand to all major markets in LA.** The bank is close to the size of the entire Mexican banking system (US$420 billion in assets) and has already important cross-border operations in the region. The bank has grown through mergers and acquisitions (M&A)s in Brazil and cross border, being in corporate and investment banking in Colombia, Mexico, and Peru, and in retail and wholesale in Argentina, Chile, Paraguay, and Uruguay. With its most recent acquisition of Chilean Corpbanca (and merger with Corpbanca Colombia), the bank’s cross-border business will reach 13 percent now from 7 percent in 2011. Its strategy is to diversify its retail and corporate portfolio to other markets. It considers it more challenging to develop a retail business abroad, given the need for funding, while easier to follow corporate clients abroad. Its ultimate corporate vision is to go global. In Mexico, the bank is trying to develop the investment banking business using broker dealers, given it had encountered difficulties developing the credit card business. In Colombia, given the consolidated banking market, the bank will try to develop in investment banking.

3. **Investment bank BTG Pactual, based in Saõ Paulõ, aspires to be the largest investment bank of the region.** It is easier for investments banks 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 to LA following the global financial crisis (GFC) when the “global bank” model was under severe challenge. It merged with Celfin Capital, a brokerage and asset manager with operations in Chile, Colombia and Peru, and set up a Greenfield brokerage in Mexico. It sees profit opportunities in these countries given their underdeveloped capital markets and the capital markets integration initiative within the Pacific Alliance (PA). As a 100 percent wholesale funding bank, it sees its expansion through LA as providing a more diversified wholesale funding base and does not plan to enter into retail, given high retail funding costs. Most recently, however, following the arrest of its CEO on corruption charges in November 2015, BTG Pactual has experienced bouts of market pressure, has been facing significant outflows from its asset management unit, and has debt coming due in the coming months. Its high reliance on wholesale funding has translated into noticeable swings in liquidity. Any further expansion of its operations in the region in the near term will depend on its ability to ensure funding at a reasonable cost.

4. **Colombia’s three largest banks—Bancolombia (based in Medellin), Banco de Bogotá, and Davivienda (based in Bogotá) expanded aggressively to Central America.** The assets of Colombian banks’ subsidiaries abroad reached US$50 billion, accounting for 24 percent of the total assets of the
Colombian banking system. Colombian banks have attained a significant market position in Central America (on average: 22 percent). The aim of the expansion was to follow Colombian clients abroad as a first step and then diversify their portfolios to serve other clients too, using acquisition opportunities arising from the withdrawal of foreign banks from Central America and the high capitalization of Colombian banks. Banco de Bogotá has a very different loan portfolio in Colombia (leadership in corporate banking) than that in its BAC subsidiary in Central America/Panama (which has a much more important consumer credit and mortgage lending portfolio). This has enabled it to have a more diversified portfolio overall, as well as to benefit from cross-complementarities: bringing credit card technology from Panama to Colombia, and exporting corporate lending knowhow from Colombia to Panama. Bancolombia’s portfolio in Central America/Panama includes all core banking products (corporate lending, as well as consumer credit and mortgage lending), while mostly corporate banking in Colombia. Davivienda’s portfolio in Central America/Panama is now increasingly focusing on consumer lending, while withdrawing from corporate lending (which had been previously HSBC’s main portfolio focus), notwithstanding the high share of corporate lending, and smaller shares of consumer and mortgage lending in its loan portfolio in Colombia.

5. **BBVA, based in Madrid, has a well diversified portfolio across LA.** 50 percent of the bank’s profits are derived from its business in Mexico (30 percent) and South America. BBVA’s business model is retail banking, with market shares of 22 percent in Mexico and Peru, and 9.4 percent and 6.7 percent in Colombia, and Chile respectively. BBVA is the only bank in all four countries of the PA, which it views as a huge opportunity for growing its business. The bank sees room for expansion in LA, given low banking intermediation rates. Its model is to establish subsidiaries autonomous in capital and liquidity, which limits contagion risk between the group’s units and reduces systemic risk. The bank is potentially affected by the special ring fencing rules issued in Mexico in 2014, according to which not only can the Mexican authorities request full information on parent companies, but they can also stop dividends if they believe the parent company is in trouble. A further impediment for operating in LA is that in consolidation with the parent bank in Europe, home country assets might receive a lower rating (since they are in Mexican pesos for example). In general, more regulatory stringency by the European supervisory authorities, may constrain BBVA’s regional activities.

6. **Similarly, Santander, based in Madrid, has been diversifying its portfolio in the region.** 38 percent of the bank’s profits are derived from its business in Brazil (19 percent), Mexico (8 percent) and the rest of South America. Santander’s business model is mainly retail banking, focused on a few countries where it aims to reach at least a 10 percent market share (in Chile: 17 percent, Mexico: 14 percent, and Brazil: 8 percent). In Brazil, the objective is to grow its retail as well as corporate businesses. In Mexico, the objective is to grow more than the market, particularly with high income clients and SMEs, be one of the leading banks in financing the government’s infrastructure plans. In 2012 Santander sold a 24.9% stake in its Mexican bank through an IPO, following an IPO in 2009 of part of its Brazilian subsidiary, the proceeds of these sales are used to reinforce the group’s core capital. Santander and BBVA seem to have largely divided the LA markets between themselves, and where Santander is present, BBVA generally is not. Santander’s subsidiaries are completely autonomous in capital and liquidity, which limits contagion risk. There is also limited cross-funding between subsidiaries in LA, and excess liquidity cannot be moved easily (deposits cannot be shared
across countries). Regarding Brazil, as Santander Brazil is not allowed to lend in dollars to Brazilian corporates, the branch in the Cayman Islands is used (as by other Brazilian banks) for foreign currency lending to Brazilian corporates.

7. **Corpbanca, based in Santiago, was the first Chilean bank to expand abroad.** The bank invested in Colombia in view of the high banking penetration rates and low opportunities to continue growing profitably in Chile. The bank had a 5 percent market share after 10 years in the Chilean market; the large difference between the profitability and cost of funding of the biggest three banks and the rest of the market made it hard for a bank with a smaller market share to sustain profits. After searching for a jurisdiction with similar policies to Chile, it bought Santander Colombia, which had a market share of 3 percent, and then also Colombian Helmbank, since it felt it would be hard to have a profitable operation with such a small market share. Both banks were retail focused, and together achieved a 6.5 percent market share in the Colombian market.

8. **Banco de Crédito del Peru, based in Lima, has a small presence regionally.** The bank has retail businesses only in Bolivia and Central America, and entered Chile and Colombia as an investment bank (and offering a microcredit business in Colombia), given that it did not have the capital to expand to those markets as a universal bank. The consolidated nature of the market in Brazil has been seen as a deterrent for entry. The other large domestic private bank, Interbank, has a strong domestic focus, given high interest rate spreads and ROE in Peru, as well as very low bank intermediation rates.

| Table 1. LA-7: Largest Banks Operating in Each Country (Share of total assets in each country) |
|-----------------------------------------------|-----------------------------------------------|
| Brazil | Chile | Colombia |
| 10.2 Banco do Brasil | 17.1 Banco Santander-Chile | 22.6 Bancolombia |
| 15.4 Itaú | 15.4 Banco de Chile | 15.1 Banco de Bogota |
| 14.6 Caixa E.F. | 15.2 Banco del Estado de Chile | 12.4 Davivienda |
| 12.2 Bradescor | 12.8 Banco de Crédito e Inversiones | 9.4 BBVA (ES) |
| 12.0 BRKBS | 11.0 Corpbanca | 6.9 Banco de Occidente |
| 8.2 Santander | 6.8 Banco Bilbao Vizcaya Argentaria, Chile | 6.3 Corpbanca (CH) |
| 2.3 HSBC | 4.8 Scotiabank Chile | 4.8 Banco Agrario de Colombia |
| 2.1 BTG-Pactual | 4.4 Banco Itaú Chile | 4.6 Banco Coopurbien (CA) |
| 1.9 SAFRA | 2.8 Banco Security | 4.0 GNB Sudameris |
| 1.4 Votorantim | 2.7 Banco Bice | 3.8 Banco Popular |
| 7.7 Domestics banks | 59.9 Domestic banks | 38.6 Domestics banks |
| 0.0 LA-7 foreign banks | 4.4 LA-7 foreign banks | 6.3 LA-7 foreign banks |
| 10.5 Other foreign banks | 28.9 Other foreign banks | 14.0 Other foreign banks |

| Mexico | Panama | Peru | Uruguay |
|-----------------------------------------------|-----------------------------------------------|
| 22.3 BBVA Bancomer | 11.4 Banco General | 35.3 Crédito | 35.9 Banco de la Republica Oriental del Uruguay |
| 15.5 Banamex | 8.8 Banco Nacional de Panama | 21.9 Banco Continental | 14.1 Banco Santander Uruguay S.A. |
| 14.3 Santander | 77 Banistmo | 15.7 Scotiabank | 10.7 Banco Bari Uruguay SA |
| 12.5 Banorte | 7.5 Itaú | 31.3 Interbank | 8.8 BBVA Uruguay SA |
| 8.4 HSBC | 3.4 BAC International | 1.3 Citibank | 5.4 Scotiabank Uruguay SA |
| 4.2 Scotiabank | 4.6 Global Bank Corporation | 1.9 Milbanco | 4.6 Banco Hipotecario del Uruguay |
| 4.2 Itauba | 4.6 Bancolombia (Panama) | 1.5 Banco GNB | 4.1 HSBC Bank (Uruguay) SA |
| 1.9 Interacciones | 3.4 Bank of China Limited | 1.3 Citibank NA | 3.6 Citibank |
| 1.9 Banco del Bajo | 3.4 Banesco | 3.4 Discount Bank (Latin America) | 3.4 Discount Bank (Latin America) |
| 1.6 Banco Azteca | 3.4 Banco de Crédito del Peru | 1.3 Bancolombia (Panama) | 1.3 Bancolombia (Panama) |
| 22.0 Domestic banks | 32.3 Domestic banks | 72.7 Domestic banks | 40.4 Domestic banks |
| 0.0 LA-7 foreign banks | 21.6 LA-7 foreign banks | 0.0 LA-7 foreign banks | 10.7 LA-7 foreign banks |
| 64.4 Other foreign banks | 6.8 Other foreign banks | 6.8 Other foreign banks | 40.7 Other foreign banks |

Sources: National authorities and Bankscope.
Implementation of Basel Standards

**Figure 3. Basel 2 Implementation Progress**

Sources: Data for G20 countries from BCBS progress report on implementation of the Basel Regulatory Framework (October 2015). Data for other countries from BIS FSI BASEL II, 2.5, and III Implementation Survey (June 2015).

**Figure 4. Basel 2.5 Implementation Progress**

Sources: Data for G20 countries from BCBS progress report on implementation of the Basel Regulatory Framework (October 2015). Data for other countries from BIS FSI BASEL II, 2.5, and III Implementation Survey (June 2015).
Figure 5. Basel 3 Implementation Progress

Sources: Data for G20 countries from BCBS progress report on implementation of the Basel Regulatory Framework (October 2015). Data for other countries from BIS FSI BASEL II, 2.5, and III Implementation Survey (June 2015).
Box 1: Capital Definitions and Capital Ratios Across Latin America

Background
A robust bank capital framework helps ensure financial stability and sustain bank lending during economic downturns. Bank provisions and profits are an important buffer with provisions in particular able to absorb expected losses. However, in the event that losses exceed earnings capital provides banks with a cushion to absorb unexpected losses to reduce the risk of bank failures and prevent interruption of banking services and financing to the real economy. Unfortunately loss absorbency elements like provisions, capital definitions and actual regulatory capital levels across Latin America are not easily comparable even after using harmonized market-based measures.

Capital Definition and Adequacy
Capital definitions differ across Latin American countries and comparisons must be made with utmost caution. Some cross country differences in the computation of capital include, for example, the treatment of the revaluation of fixed assets; the accounting of profits from current or past accounting periods; treatment of investments in capital instruments or requirements on donated capital; and treatment of some deductions from capital (goodwill, intangibles and deferred tax assets); grandfathering of some capital (debt) components. Moreover, capital differs depending on the degree of consolidation undertaken, whether at individual (solo) bank level, banking group level, or at even higher at financial conglomerate level. Furthermore there can be sizeable differences in regulatory risk weights applied to the same asset classes across jurisdictions. Differences in the national definition of capital the Basel framework in use and accounting standards across Latin America imply that any direct comparison of total regulatory capitalization should be interpreted with caution.

Market Based Estimates of Capital
Some systemic Colombian banks have lower levels of capital in excess of the regulatory minimum than some regional peers. Regulatory capital requirements differ across Latin American countries with some higher—Brazil (11 percent), Peru, Guatemala and Uruguay (10 percent)—and some lower than Colombia’s (9 percent)—Chile, Argentina (8 percent) and Mexico (10.5 percent). The decision to choose a given level of national minimum regulatory capital reflects a series of factors, including supervisory judgment and discretion. The four largest banks in Colombian have lower capital than the large banks in some other Latin American countries. Total capital ratios in excess of the regulatory minimum requirement, stood at 2.9 percent, the lower end of regional peer comparisons. Attempts to obtain a more consistent harmonized measure of capital across Latin America

| Regulatory Capital Requirement and Total Capital Above Requirement (In Percent) |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Argent. | Brazil | Guat. | Peru | Chile | Col. |
| Regulatory Requirement | 18.9 | 16.5 | 16.4 | 15.6 | 12.4 |
| Excess Capital | 8.0 | 10.0 | 10.0 | 8.0 | 9.0 |

| RAC Ratio for the Largest Rated Latin America Banks (In Percent) |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Brazil | Chile | Colombia | Mexico | Panama | Peru |
| 7.0 | 8.0 | 9.5 | 8.9 | 7.4 |

Sources: Bankscope, company filings, country Financial Sector Stability Assessments, and Article IV reports.

Source: Standard & Poor's.
Box 1: Capital Definitions and Capital Ratios Across Latin America (Concluded)

have been tried by rating agencies but again depending on the measure used comparisons on quantity and quality of capital vary. For example, Colombian banks have lower levels of capital according to the Standard and Poor’s risk-adjusted capital (RAC) measure—which deducts all goodwill on the balance sheet from banks’ respective total adjusted capital. This measure is important inasmuch as Colombia has seen a large number the mergers and acquisitions following the financial crisis of the late 1990s that, together with the geographic expansion of the largest banks over the last few years, has created large amounts of goodwill assets. Using the Fitch Core Capital (FCC) measure Brazil, Chile and Colombia have much lower capital due to higher leverage of the system, sizeable investments in insurance companies and high levels of goodwill and deferred tax assets which are all deducted from equity to reach FCC levels.

![2013 Fitch Core Capital](image)

2013 Fitch Core Capital
(Generally Adequate Capital Ratios in Latin America, in percent)

Source: Fitch Ratings.

Additional Loss Absorbency

While capital ratios on market based measures may seem low for some Latin America countries these countries have additional loss absorbency in the banking system. Many banks hold high levels of provisions (Brazil, Colombia), have lower NPLs (Colombia) and have more conservative risk weights (Colombia, Chile).

Basel III

Many Latin American countries are adopting Basel III standards, albeit at different paces. The adoption of Basel III standards should help address inconsistency of capital definitions with recent work by the Basel Committee ensuring harmonization of risk weights. Notwithstanding the move to Basel III actual implementation may still see differentiation of capital stem from differences in adoption of above minimum capital (Pillar 2 and conservation, countercyclical and D-SIB buffers). This may reflect the need to address supervisory failings and the desire to tailor capital to bank risks across Latin America which may well be above Basel III voluntary minimums in some countries.

Conclusion

The addition of further consistency to the already robust capital framework across Latin America will help to ensure financial stability and sustain bank lending during economic downturns. Challenges from moderating economic growth, low yield environment, volatility around US monetary policy normalization, cross border risks and conglomerate expansion require that Latin American banks adopt a more conservative long-term capital planning approach. Moving to Basel III should help and is attainable for most Latin American banking systems as current capital is sufficient to support transition and additional loss absorbency exists beyond capital.
### Basel Implementation Progress

<table>
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<th>Basel 2</th>
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<tbody>
<tr>
<td>• Brazil, Mexico most advanced in terms of implementation</td>
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<tr>
<td>• For others implementation is progressing reflecting national banking system development while further work is needed in terms of legal enhancements, development of risk-based supervision, and development of supervisory capacity and guidelines.</td>
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<th>Basel 2.5</th>
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<tr>
<td>• Brazil, Mexico most advanced in terms of implementation</td>
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<tr>
<td>• For others there is no regulation for implementation or regulator decided it is not currently applicable given state of development of financial markets and institutions’ business models.</td>
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<table>
<thead>
<tr>
<th>Basel 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Brazil, Mexico most advanced in terms of implementation</td>
</tr>
<tr>
<td>• In others implementation is on slower track especially with respect to liquidity, leverage and capital buffer implementation. While reflecting domestic financial development slower progress in implementation could lead to inadequate identification of cross-border and interconnected risks and insufficient holding of capital against such risks. Different speeds of implementation could lead to inconsistent regulatory and supervisory oversight resulting in potential gaps especially with regard to consolidated and conglomerate supervision.</td>
</tr>
</tbody>
</table>
QUANTIFYING THE IMPACT OF REGIONAL INTEGRATION

A. Measuring the Degree of Integration of LA Countries

9. The measurement of financial integration can be refined. Simple cross-country comparisons may paint a distorted picture of the degree of integration of LA markets relative to other regions, for instance, because countries that are less advanced economically often have shallower financial markets. This section attempts to quantify the extent to which LA markets are “under-integrated” given their economic fundamentals by controlling for factors such as the level of economic development (proxied by GDP per capita in PPP dollars), trade openness (exports plus imports divided by GDP), the past history of financial crises (measured by the Reinhart and Rogoff database indicators), the level of public debt-to-GDP ratio (which, as a stock variable, cannot be easily modified by the government), and the quality of the institutional framework (measured by the investment profile subcomponent of the International Country Risk Guide Index). Variables that are more directly and immediately affected by economic policy, such as the extent of capital controls, are not included, as the purpose of the econometric analysis is not to provide the best fit of the data but to control for exogenous factors.

10. The models relate financial integration to a set of control variables. In each specification, a measure of financial integration is regressed (either the baseline or alternative composite indices of financial integration presented in Box 2 or their subcomponent of openness) on its macroeconomic determinants and fixed effects. The degree of under or over-integration is then calculated as the difference between the estimated country (or region) fixed effect and the sample average of all country (or region) fixed effects. As the purpose of the regressions is to filter out the effect of certain fundamentals and not to interpret a causal model, the endogeneity problem, inherent to this type of analysis, is less of an issue. The following equation is estimated over a sample of 67 countries between the mid-1980s and 2014:

\[ FI_{it} = \beta X_{it} + \alpha_i + \epsilon_{it} \]

where \( FI_{it} \) denotes the financial integration indicator, \( X_{it} \) are control variables, and \( \alpha_i \) is the fixed effect.
Box 2: Building a Synthetic Index of Financial Integration

Our baseline composite index combines information from two main dimensions of integration: financial openness and financial convergence. The first component is the de facto openness of the financial account measured by the sum of stocks of foreign assets and liabilities as a share of GDP. The inclusion of this variable follows directly from the definition of financial integration (see section II in the main paper). The second component is the regional dispersion of stock market returns measured by the standard deviation of returns of Morgan Stanley Capital Interactions (MSCI) indices across countries of the same region (lower standard deviations would imply greater convergence). Although this indicator of regional convergence is widely used in the literature (Baele and others, 2004), it presents obvious drawbacks (in particular, differences in returns may be related to idiosyncratic risks) but the analysis is limited by data availability. To combine the two indicators, a principal component analysis is used, where the standardized variables’ weights are the squared factor loadings. The objective is to reduce the number of variables of interest into a single factor, which captures most of their variances (for the three indices constructed in this exercise, the first component explains more than 50 percent of the total variance).

The analysis also uses three alternative integration indices:

- The first alternative index replaces the traditional broad indicator of external openness (stock of external assets plus liabilities as a ratio to GDP) with the narrower external liability-to-GDP ratio. Indeed, some countries may hold large proportions of financial assets abroad, while having a low level of de facto integration. These assets, which may coexist with capital controls, may reflect past capital outflows (e.g., Argentina) or large current account surpluses (e.g., China). Limiting the measure of openness to include only external liabilities is one way of circumventing this problem and testing whether the results still hold.

- In the second alternative indicator, the first two components are identical to those used in the baseline index but a third component is added, which is the ratio of private sector credit by banks to GDP. There are two reasons why a measure of financial depth may enter the integration index. First, since financial integration allows savers to invest in a broader range of investment and risk-sharing instruments, while enabling borrowers to tap a broader range of financing and risk management instruments, at home and abroad, the concepts of integration and depth are closely related. Second, to reap the full benefits of integration and be a meaningful contributor to an integrated playing field, individual markets need to have a certain size. Thus, the depth criterion excludes markets that are too small even if they meet the other two criteria.

- The third alternative index provides a better picture of regional integration by including a measure of relative regional openness (ratio of regional assets and liabilities to total foreign assets and liabilities of a given country), alongside global financial openness and regional convergence. The intuition is that countries are regionally integrated when they fulfill three conditions: they have to be (i) open globally, (ii) relatively more open to their neighbors, (iii) and present signs of financial
Box 2: Building a Synthetic Index of Financial Integration (Concluded)

Several variants of the regional openness concept are developed as defining regions can be tricky. The first is an 8 region world (advanced economies, Africa, Asia, emerging Europe, Latin America and the Caribbean, Middle East and North Africa, Commonwealth of Independent States, and other small states) based on IMF WEO classifications that emphasizes regionalism among emerging/developing economies. The second approach consolidates to just 4 regions (Asia, Europe, Western Hemisphere, and rest of the world) and captures the observed behavior that emerging/developing countries tend to integrate with nearby advanced economies (for instance, Mexico with the United-States, or Eastern with Western Europe). The third version replaces pre-determined regions with distance-based weights whose values rise when countries are geographically close. Bilateral financial positions are then weighted with this distance, so that the regional openness indicator increases when countries are more financially open to neighbors.

**Box Table 1. Principle Components for Financial Integration (FI) Indicators**

<table>
<thead>
<tr>
<th>Measures of global financial openness</th>
<th>FI: baseline</th>
<th>alternate 1</th>
<th>alternate 2</th>
<th>alternate 3,1</th>
<th>alternate 3,2</th>
<th>alternate 3,3</th>
<th>alternate 3,4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock of external assets plus liabilities vis-à-vis the rest of the world, ratio to GDP</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Stock of external liabilities vis-à-vis the rest of the world, ratio to GDP</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Measures of regional convergence</th>
<th>FI: baseline</th>
<th>alternate 1</th>
<th>alternate 2</th>
<th>alternate 3,1</th>
<th>alternate 3,2</th>
<th>alternate 3,3</th>
<th>alternate 3,4</th>
</tr>
</thead>
<tbody>
<tr>
<td>8 Region world: Standard deviation of equity returns among countries of the same region²</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>4 Region world: Standard deviation of equity returns among countries of the same region³</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial system depth</th>
<th>FI: baseline</th>
<th>alternate 1</th>
<th>alternate 2</th>
<th>alternate 3,1</th>
<th>alternate 3,2</th>
<th>alternate 3,3</th>
<th>alternate 3,4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking system credit to the private sector, ratio to GDP</td>
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<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Measures of regional financial openness</th>
<th>FI: baseline</th>
<th>alternate 1</th>
<th>alternate 2</th>
<th>alternate 3,1</th>
<th>alternate 3,2</th>
<th>alternate 3,3</th>
<th>alternate 3,4</th>
</tr>
</thead>
<tbody>
<tr>
<td>8 region world: Stock of external assets plus liabilities vis-à-vis countries of the same region, [regions] share of total external position²</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>4 region world: Stock of external assets plus liabilities vis-à-vis countries of the same region, [4 regions] share of total external position³</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Proximity based: weighted average distance vis-à-vis all other countries of the world: weighted by reporting country’s share of external assets plus liabilities to each partner⁴</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Proximity based: weighted average distance vis-à-vis all other countries of the world, weighted by reporting country’s share of external liabilities to each partner⁴</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

---

¹ We include global openness (defined in absolute terms) in addition to the regional openness measure (defined in relative terms) in order to ensure that the concept of “regional integration” is meaningful and captures both the scale and the direction of financial flows. For example, a country could be a closed economy with the exception of small linkages with one neighbor. If we were not to include the global openness measure, this country would appear to be highly regionally integrated despite the fact that it is a de facto closed economy.
11. The econometric results confirm that the LA-7 countries are under-integrated as a whole, although there are important differences between countries, as well as across the various dimensions of financial integration. In each model, the sign of the control variables is consistent with priors. The main result is that although the LA-7 countries do not appear under-integrated from the perspective of international cross-border capital flows, once broader measures of integration are used through the composite integration indexes, these countries do appear to be under-integrated, even after controlling for fundamentals. The extent of under-integration varies across the countries, and there is one notable exception, Panama, which is well-integrated across most specifications.

- Table 2 shows the outcomes of various models explaining the degree of financial openness (measured either as the ratio of gross external assets and liabilities to GDP or as the liability ratio). The results suggest that LA-7 countries are relatively well integrated from an openness perspective compared to the sample average, but this result is partly driven by Panama and Chile, which clearly show a greater degree of openness than the others.

- Table 3 presents the results using the baseline consolidated index of financial integration (described in Box 2). After combining the dimensions of financial openness and financial convergence, it appears that the LA-7 countries are indeed under-integrated, with the exception of Panama, which shows a level of integration in line with the sample average after controlling for fundamentals. This result suggests that the relatively high degree of openness of countries such as Chile and Peru in Table 2, is dominated by the lack of regional convergence exhibited by their financial markets.

- Table 4 reports the results using the first alternative consolidated index of financial integration, which combines convergence and external liabilities-to-GDP, as a measure of openness (described in Box 2). The results using this narrower measure of openness, which helps preclude cases where large external assets do not correspond to integration, corroborate the findings of the baseline index. With the exception of Panama, the LA-7 countries show a degree of under-integration virtually identical to the baseline results presented in Table 3. In this case, Panama stands out as the one LA-7 country whose level of integration is above the sample average.

- Table 5 presents the findings using the second alternative consolidated index of integration, incorporating three components: openness, convergence and depth. The results support the outcomes of Tables 3 and 4, confirming that even with the added dimension of depth, the LA-7 countries—excluding Panama—are under-integrated relative to the sample average, after controlling for fundamentals. An interesting nuance of these results is that after adding depth, the integration outcomes worsened for all LA-7 countries except for Panama and Chile. Panama’s result was not only above the sample average but significantly stronger than its outcomes using the two-component indexes of integration. Regarding Chile, while the integration outcome was still negative, the magnitude of under-integration was halved relative to Chile’s results using the two-component indexes, suggesting a relatively deep market. Combined with Chile’s positive result in the openness models presented in Table 2, one could surmise that Chile’s under-integration comes largely from a lack of convergence with the region rather than other factors. For the
remaining five LA-7 countries, the onus of under-integration falls on the lack of convergence and depth of their financial markets.

- Table 6 displays the findings of the third alternative consolidated index of integration, which includes a measure for relative regional openness, in addition to the measure for global financial openness and regional convergence. The results including the regional measure stand out from the previous findings in that all LA-7 countries, including Panama, exhibit underintegration relative to the sample average. That said, Panama still shows the lowest degree of underintegration among the LA-7 countries. This may suggest that Panama’s high degree of financial integration, demonstrated in the previous results, largely reflects extra- rather than intra-regional integration. Another interesting finding that emerges is that Brazil, Colombia, Peru and Uruguay are less underintegrated relative to the sample than Chile and Mexico, using this index. Mexico’s result may reflect its higher degree of integration with the U.S.A. (which was not included in the same regional grouping as Mexico) relative to with the region. In the case of Chile, which showed a relatively high degree of openness compared to other LA7 countries in the previous indexes, the results suggest that the interconnections of its relatively deep financial markets principally stem outside the region rather than within.
Table 2. Financial Market Integration: Financial Openness

<table>
<thead>
<tr>
<th></th>
<th>Stock of gross external assets+liabilities/GDP</th>
<th>Stock of gross external liabilities/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OLS (1) 1/</td>
<td>OLS (2) 1/</td>
</tr>
<tr>
<td>Log of GDP per capita (PPP)</td>
<td>0.31***</td>
<td>0.43***</td>
</tr>
<tr>
<td></td>
<td>8.44</td>
<td>8.20</td>
</tr>
<tr>
<td>Government Debt/GDP</td>
<td>0.37***</td>
<td>0.48***</td>
</tr>
<tr>
<td></td>
<td>5.20</td>
<td>6.28</td>
</tr>
<tr>
<td>Trade Openness</td>
<td>0.66***</td>
<td>0.43***</td>
</tr>
<tr>
<td></td>
<td>6.53</td>
<td>2.86</td>
</tr>
<tr>
<td>Institutional Quality 3/</td>
<td>0.04***</td>
<td>0.05***</td>
</tr>
<tr>
<td></td>
<td>2.77</td>
<td>4.38</td>
</tr>
<tr>
<td>History of Bank Crises (t-10) 4/</td>
<td>-0.14**</td>
<td>-0.06</td>
</tr>
<tr>
<td></td>
<td>-2.38</td>
<td>-1.66</td>
</tr>
<tr>
<td>LA7 dummy 5/</td>
<td>-0.13***</td>
<td>0.16***</td>
</tr>
<tr>
<td></td>
<td>-6.18</td>
<td>5.98</td>
</tr>
<tr>
<td>Non-LA7 dummy 5/</td>
<td>0.01***</td>
<td>-0.02***</td>
</tr>
<tr>
<td></td>
<td>8.44</td>
<td>-7.17</td>
</tr>
<tr>
<td>Brazil dummy 5/</td>
<td>-0.34***</td>
<td>0.00***</td>
</tr>
<tr>
<td></td>
<td>-3.55</td>
<td>-3.54</td>
</tr>
<tr>
<td>Chile dummy 5/</td>
<td>-0.01***</td>
<td>0.10***</td>
</tr>
<tr>
<td></td>
<td>3.11</td>
<td>3.10</td>
</tr>
<tr>
<td>Colombia dummy 5/</td>
<td>-0.65***</td>
<td>-0.48***</td>
</tr>
<tr>
<td></td>
<td>-3.84</td>
<td>-3.85</td>
</tr>
<tr>
<td>Mexico dummy 5/</td>
<td>0.12***</td>
<td>0.33***</td>
</tr>
<tr>
<td></td>
<td>3.50</td>
<td>3.43</td>
</tr>
<tr>
<td>Peru dummy 5/</td>
<td>0.89***</td>
<td>0.79***</td>
</tr>
<tr>
<td></td>
<td>3.03</td>
<td>3.13</td>
</tr>
<tr>
<td>Panama dummy 5/</td>
<td>-0.19***</td>
<td>-0.30***</td>
</tr>
<tr>
<td></td>
<td>-3.56</td>
<td>-3.74</td>
</tr>
<tr>
<td>Uruguay dummy 5/</td>
<td>0.12***</td>
<td>0.33***</td>
</tr>
<tr>
<td></td>
<td>3.50</td>
<td>3.43</td>
</tr>
</tbody>
</table>

Observations: 5,681  1,336  1,336  1,336  1,336  1,336
R-squared: 0.23  0.71  0.91  0.57  0.85

Notes: Time dummies have been incorporated in all specifications.
1/ The OLS regressions are ordinary least squares regressions with standard errors adjusted for clustering at the country level for a panel of 67 countries from 1986-2011. Selected country and/or regional dummies are included.
2/ The FE regressions estimate country fixed effects for all countries in the sample, but only the LA7 results are reported in this table.
3/ The investment profile subcomponent of the International Country Risk Guide political risk index is used to gauge institutional quality.
4/ Reinhart and Rogoff indicator of past banking crises.
5/ Demeaned estimates: fixed effect estimates minus a sample average of fixed effects.

Robust T-statistics are in italics. *** p<0.01, ** p<0.05, * p<0.1
### Table 3. Financial Market Integration: Composite Financial Integration Index with Two Components

<table>
<thead>
<tr>
<th></th>
<th>OLS (1) 2/</th>
<th>OLS (2) 2/</th>
<th>OLS (3) 2/</th>
<th>FE 3/</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log of GDP per capita PPP)</td>
<td>0.27***</td>
<td>0.27***</td>
<td>0.38***</td>
<td>0.79***</td>
</tr>
<tr>
<td></td>
<td>5.20</td>
<td>5.20</td>
<td>4.26</td>
<td>3.18</td>
</tr>
<tr>
<td>Trade Openness</td>
<td>0.63***</td>
<td>0.58**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3.36</td>
<td></td>
<td>2.34</td>
<td></td>
</tr>
<tr>
<td>Government Debt/GDP</td>
<td>0.22***</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>3.59</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutional Quality 4/</td>
<td>0.04**</td>
<td>0.06***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2.34</td>
<td>2.86</td>
<td></td>
<td></td>
</tr>
<tr>
<td>History of Bank Crises (t-10) 5/</td>
<td>-0.11</td>
<td>-0.21***</td>
<td>-1.57</td>
<td>-2.88</td>
</tr>
<tr>
<td>LA7 dummy 6/</td>
<td>-0.71***</td>
<td>-0.02***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>-6.46</td>
<td>-4.56</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-LA7 dummy 6/</td>
<td>0.08***</td>
<td>0.08***</td>
<td>0.00***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>5.42</td>
<td>5.41</td>
<td>4.40</td>
<td></td>
</tr>
<tr>
<td>Brazil dummy 6/</td>
<td>-0.93***</td>
<td>-0.07***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>-7.00</td>
<td>-3.11</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile dummy 6/</td>
<td>-0.81***</td>
<td>-0.85***</td>
<td>-3.61</td>
<td></td>
</tr>
<tr>
<td></td>
<td>-6.68</td>
<td>-3.29</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colombia dummy 6/</td>
<td>-0.85***</td>
<td>-0.09***</td>
<td>-3.29</td>
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<tr>
<td></td>
<td>-7.06</td>
<td>-3.52</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mexico dummy 6/</td>
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<td>-0.78***</td>
<td>-3.52</td>
<td></td>
</tr>
<tr>
<td></td>
<td>-6.83</td>
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<tr>
<td>Peru dummy 6/</td>
<td>-0.72***</td>
<td>0.04***</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>-6.97</td>
<td>3.36</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Panama dummy 6/</td>
<td>-0.05***</td>
<td>0.07***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>-5.29</td>
<td>3.32</td>
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<td></td>
</tr>
<tr>
<td>Uruguay dummy 6/</td>
<td>-0.76***</td>
<td>-0.51***</td>
<td>-3.42</td>
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</tr>
<tr>
<td></td>
<td>-6.62</td>
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<td>Observations</td>
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<td>3,901</td>
<td>1,289</td>
<td>1,601</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.13</td>
<td>0.14</td>
<td>0.42</td>
<td>0.61</td>
</tr>
</tbody>
</table>

Notes: Time dummies have been incorporated in all specifications.
1/ Principle component from 2 variables: openness (external assets+liabilities as a ratio to GDP) and convergence.
2/ The OLS regressions are ordinary least squares regressions with standard errors adjusted for clustering at the country level for a panel of 67 countries from 1986-2011. Selected country and/or regional dummies are included.
3/ The FE regression estimates country fixed effects for all countries in the sample; only LA7 results are reported.
4/ The investment profile subcomponent of the International Country Risk Guide political risk index is used to gauge institutional quality.
5/ Reinhart and Rogoff indicator of past banking crises.
6/ Demeaned estimates: fixed effect estimates minus a sample average of fixed effects.

Robust T-statistics are in italics. *** p<0.01, ** p<0.05, * p<0.1
<table>
<thead>
<tr>
<th></th>
<th>OLS (1) 2/</th>
<th>OLS (2) 2/</th>
<th>OLS (3) 2/</th>
<th>FE 3/</th>
</tr>
</thead>
<tbody>
<tr>
<td>Log of GDP per capita PPP)</td>
<td>0.21***</td>
<td>0.21***</td>
<td>0.36***</td>
<td>0.81***</td>
</tr>
<tr>
<td></td>
<td>4.03</td>
<td>4.03</td>
<td>3.88</td>
<td>3.18</td>
</tr>
<tr>
<td>Trade Openness</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>0.65***</td>
<td>0.53**</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>3.58</td>
<td>2.23</td>
</tr>
<tr>
<td>Government Debt/GDP</td>
<td></td>
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Notes: Time dummies have been incorporated in all specifications.
1/ Principle component from 2 variables: external liabilities as a ratio to GDP and convergence.
2/ The OLS regressions are ordinary least squares regressions with standard errors adjusted for clustering at the country level for a panel of 67 countries from 1986-2011. Selected country and/or regional dummies are included.
3/ The FE regression estimates country fixed effects for all countries in the sample; only LA7 results are reported.
4/ The investment profile subcomponent of the International Country Risk Guide political risk index is used to gauge institutional quality.
5/ Reinhart and Rogoff indicator of past banking crises.
6/ Demeaned estimates: fixed effect estimates minus a sample average of fixed effects.
Robust T-statistics are in italics. *** p<0.01, ** p<0.05, * p<0.1
Table 5. Financial Market Integration: Composite Financial Integration Index with Three Components

<table>
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<tr>
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<th>FE 3/</th>
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<td>-7.10</td>
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<td>0.06***</td>
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<td>0.77</td>
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</table>

Notes: Time dummies have been incorporated in all specifications.
1/ Principle component from 3 variables: openness, convergence and depth.
2/ The OLS regressions are ordinary least squares regressions with standard errors adjusted for clustering at the country level for a panel of 66 countries from 1986-2011. Selected country and/or regional dummies are included.
3/ The FE regression estimates country fixed effects for all countries in the sample; only LA7 results are reported.
4/ The investment profile subcomponent of the International Country Risk Guide political risk index is used to gauge institutional quality.
5/ Reinhart and Rogoff indicator of past banking crises.
6/ Demeaned estimates: fixed effect estimates minus a sample average of fixed effects.
Robust T-statistics are in italics. *** p<0.01, ** p<0.05, * p<0.1
Table 6. Financial Market Integration: Composite Financial Integration Index with Three Components

<table>
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<tr>
<td>Panama dummy 5/</td>
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<td>-0.22**</td>
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Notes: Time dummies have been incorporated in all specifications.

1/ Principle component from 3 variables: global openness, regional convergence and regional integration based on 8 regions.
2/ The OLS regressions are ordinary least squares regressions with standard errors adjusted for clustering at the country level for a panel of 172 countries from 1986-2011. Selected country and/or regional dummies are included.
3/ The FE regression estimates country fixed effects for all countries in the sample; only LA7 results are reported.
4/ The investment profile subcomponent of the International Country Risk Guide political risk index is used to gauge institutional quality.
5/ Demeaned estimates: fixed effect estimates minus a sample average of fixed effects.

Robust T-statistics are in italics. *** p<0.01, ** p<0.05, * p<0.1
B. Macroeconomic Gains from Regional Integration in Latin America

12. To quantify the benefits of further integration in LA, a model relating financial integration to economic growth is estimated. The specification, which follows Beck and Levine (2004) and Sahay and others (2015), includes the standard control variables of growth equations: initial income per capita, trade openness, inflation, the government expenditure-to-GDP ratio, investment-to-GDP ratio, population growth, and several measures of institutional framework quality (proxied by the ICRG indicators of country risk). The sample is similar to the one used in the previous exercise, and includes 76 countries between the mid-1980s and 2014. In light of the endogeneity of the integration variable with respect to growth, the baseline model uses an instrumental variable (IV) panel estimator with the following instruments: the first lag of the integration variable; the capital controls indicator by Fernández and others (2015); the occurrence of a banking crisis 10 years earlier; and a subcomponent of the ICRG political risk index, which describes the extent to which profits can be transferred or repatriated out of a country. All the instruments are assumed to impact integration directly but affect growth indirectly. The estimated equation is therefore:

$$y_{it} = \alpha_i + \beta_1 * FI_{it} + \beta_2 * X_{it} + \varepsilon_{it}$$

where $y_{it}$ denotes GDP growth, $FI_{it}$ the financial integration indicator defined in Box 2, $X_{it}$ the control variables, and $\alpha_i$ is the fixed effect. Time dummies are also included in some specifications.

13. Instrumental variables indicate that financial integration is found to be positively correlated with growth. In models without correction, integration is either statistically insignificant or has a negative effect on growth. IV estimates indicate that the elasticity is clearly positive regardless of the number of control variables (Table 7, columns 1–3), or when the equation is saturated with time dummies (column 4), or whether real growth or real growth per capita is used as a dependent variable (column 5). Results are also robust to removing the banking crisis instrument, which presents the disadvantage of reducing the sample size as the variable denotes the existence of a crisis 10 years earlier and is not available for some countries (column 6). The results of a dynamic model estimated by Arellano–Bond GMM with the lagged GDP growth as explanatory variable are also presented, and the financial integration variable coefficient is broadly unchanged (column 7).

14. Another potential issue is that the lagged GDP-per-capita level is endogenous in growth equations (Bond and others, 2001). To circumvent this problem, an equation is presented excluding the variable and finds that the integration coefficient is broadly unchanged (column 8). The endogeneity of both the integration variable and the lagged GDP level are corrected by rewriting the

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2 Admittedly, it is very difficult to find fully exogenous instruments in a macroeconomic setting. This appendix assumes that the institutional framework (capital controls, profit repatriation rules) is exogenous with respect to growth, which may be justified by the fact that these variables are slow-moving.

3 In this case, the elasticity of the financial integration variable cannot be directly compared to the other specifications because of the lagged dependent variable term. This coefficient should first be multiplied by one over one minus the coefficient of the lagged GDP growth to get the long-term elasticity.
growth regression as a dynamic model in levels\(^4\) and estimating it with the first-differenced GMM estimator of Arellano Bond (2001)— alongside the lagged (first-differenced) variables, the additional instruments mentioned above (capital controls indicator, occurrence of a banking crisis 10 years earlier, and profit repatriation rule) are included. The effect of financial integration is again positive and significant (column 9), but the regression suffers from the traditional GMM shortcomings, including a high sensitivity to the number of lags used for the instruments. Finally, the possibility of non-linear relationships was accounted for through interaction terms and a quadratic form of the integration indicator. However, the non-linear models did not produce robust results.

15. **Table 8 reports the results of specifications with alternative measures of integration.** The alternative indicators described in Box 2 are used: a two-component index with the ratio of external liabilities-to-GDP (column 1); a three-component index that adds a measure of financial depth (column 2); and variants of the three-component index including regional openness (column 3-6). Column 3 measures regional integration as the ratio of a country’s regional assets and liabilities to total foreign assets and liabilities in a 8-region framework. Column 4 replicates the indicator with a 4-region split. Column 5 (resp. 6) measures regional integration by weighting the sum of assets and liabilities (resp. liabilities only) with the distance between countries. In all these specifications, the effect of integration remains positive and significant.

16. **Using the measure of under-integration calculated in the previous section, the econometric analysis suggests that closing the integration gap in LA-7 countries may raise GDP growth by 0.25 to 0.75 percentage point.** The various specifications return integration elasticities of 0.01-0.02. Using the fixed effects estimates of the previous section\(^5\), the equations would therefore predict a growth effect in the range of 0.25 to 0.75 percentage point on average, if the gap were to be fully closed. The growth dividend will be lower if progress is partial. These results should be treated with caution, as most variables in growth regressions are endogenous, creating potential estimation biases that IV and GMM estimators cannot always correct.

\(^4\) See Bond and others (2001), equation 16. By rewriting a growth model as a dynamic model in level (with the GDP level on the left-hand side), the control variable on the right-hand side becomes the lagged level of GDP rather than the lagged level of GDP per capita.

\(^5\) More precisely, the difference between the country fixed effect and the sample average is used. In the fixed effect models, this gap averages 0.3-0.4 in LA7 countries. With an elasticity of 0.01–0.02, the growth effect is therefore 0.3–0.8 percentage points.
Table 7. Relationship of Financial Integration to GDP Growth (Baseline Results)

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<th>VARIABLES</th>
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<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
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<td>0.02**</td>
<td>0.02**</td>
<td>0.01*</td>
<td>0.02**</td>
<td>0.01*</td>
<td>0.01**</td>
<td>0.02**</td>
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<tr>
<td>Real GDP growth</td>
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<td>(0.01)</td>
<td>(0.01)</td>
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<tr>
<td>Real GDP growth per capita growth</td>
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<td>0.03**</td>
<td>0.03***</td>
<td>0.05***</td>
<td>0.01**</td>
<td>0.04***</td>
</tr>
<tr>
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<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
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<tr>
<td>Real GDP growth</td>
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<td>0.02</td>
<td>0.04***</td>
<td>0.02</td>
<td>0.07***</td>
<td>0.09***</td>
<td>0.01***</td>
<td>0.04***</td>
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<td>-0.02**</td>
<td>-0.09***</td>
<td>-0.01**</td>
<td>-0.04***</td>
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<tr>
<td>Log of investment to GDP ratio 3/</td>
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<td>0.14***</td>
<td>0.08***</td>
<td>0.09***</td>
<td>0.08***</td>
<td>0.07***</td>
<td>0.02***</td>
<td>0.07***</td>
<td>0.09***</td>
</tr>
<tr>
<td>Log of public expenditures to GDP ratio 4/</td>
<td>-0.08***</td>
<td>-0.05**</td>
<td>-0.05**</td>
<td>-0.05**</td>
<td>-0.06**</td>
<td>-0.05**</td>
<td>-0.06**</td>
<td>-0.03***</td>
<td>-0.03***</td>
</tr>
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<td>-0.51*</td>
<td>-1.62***</td>
<td>-0.33</td>
<td>0.51***</td>
<td>-0.61*</td>
<td>-0.90***</td>
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</tr>
<tr>
<td>Log change in population</td>
<td>(0.39)</td>
<td>(0.36)</td>
<td>(0.28)</td>
<td>(0.36)</td>
<td>(0.23)</td>
<td>(0.13)</td>
<td>(0.33)</td>
<td>(0.25)</td>
<td></td>
</tr>
<tr>
<td>CPI inflation rate</td>
<td>-0.08*</td>
<td>-0.02</td>
<td>0.03</td>
<td>-0.02</td>
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<td>0</td>
<td>-0.01</td>
<td>-0.03*</td>
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<td>CPI inflation rate</td>
<td>(0.05)</td>
<td>(0.04)</td>
<td>(0.03)</td>
<td>(0.04)</td>
<td>(0.03)</td>
<td>(0.00)</td>
<td>(0.04)</td>
<td>(0.02)</td>
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<tr>
<td>ICRG composite index 5/</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
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<tr>
<td>ICRG composite index 5/</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
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<tr>
<td>Real GDP growth (t-1)</td>
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<td>Real GDP growth (t-1)</td>
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<td></td>
<td></td>
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<td>Log of real GDP (t-1)</td>
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<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Constant</td>
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<td>(0.10)</td>
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<tr>
<td>Observations</td>
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<td>678</td>
<td>678</td>
<td>678</td>
<td>864</td>
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<tr>
<td>R-squared</td>
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<td>0.32</td>
<td>0.44</td>
<td>0.58</td>
<td>0.44</td>
<td>0.47</td>
<td>0.44</td>
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<tr>
<td>Number of ifscodes</td>
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<td>59</td>
<td>59</td>
<td>59</td>
<td>59</td>
<td>76</td>
<td>124</td>
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<tr>
<td>Robust standard errors in parentheses</td>
<td>*** p&lt;0.01, ** p&lt;0.05, * p&lt;0.1</td>
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</tbody>
</table>

Notes: all specifications estimated with panel IV estimator except for specifications 7 and 9 that use GMM.

1/ Principle component of 2 variables: global openness and regional asset price convergence.
2/ Exports plus imports, ratio to GDP
3/ Private and public investment, ratio to GDP
4/ Current and capital expenditures of the general government, ratio to GDP
5/ ICRG composite index of political, economic and financial country risks.
6/ This specification is saturated with time dummies, which are not presented in the table.
Table 8. Impact of Financial Integration on Growth Using Alternative Financial Integration Indicators

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>Real GDP growth</th>
<th>Real GDP growth</th>
<th>Real GDP growth</th>
<th>Real GDP growth</th>
<th>Real GDP growth</th>
<th>Real GDP growth</th>
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<td></td>
<td></td>
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<tr>
<td>FI: Alternate 1 1/</td>
<td>0.02**</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>(0.01)</td>
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<td></td>
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</tr>
<tr>
<td>FI: Alternate 2 2/</td>
<td></td>
<td>0.01***</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>(0.00)</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>FI: Alternate 3.1 3/</td>
<td></td>
<td>0.03*</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>(0.01)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FI: Alternate 3.2 4/</td>
<td></td>
<td>0.02*</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>(0.01)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FI: Alternate 3.3 5/</td>
<td></td>
<td>0.09*</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td>(0.05)</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>FI: Alternate 3.4 6/</td>
<td></td>
<td></td>
<td>0.06**</td>
<td></td>
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<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.03)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Log of trade openness to GDP ratio 7/</td>
<td>0.03**</td>
<td>0.05***</td>
<td>0.06***</td>
<td>0.03**</td>
<td>0.02</td>
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<tr>
<td></td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.03)</td>
<td>(0.02)</td>
</tr>
<tr>
<td>Log of PPP-GDP per capita (t-1)</td>
<td>-0.02**</td>
<td>-0.03**</td>
<td>-0.04**</td>
<td>-0.03***</td>
<td>-0.04**</td>
<td>-0.04***</td>
</tr>
<tr>
<td></td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.03)</td>
<td>(0.02)</td>
</tr>
<tr>
<td>Log of investment to GDP ratio 8/</td>
<td>0.08***</td>
<td>0.07***</td>
<td>0.09***</td>
<td>0.11***</td>
<td>0.11***</td>
<td>0.11***</td>
</tr>
<tr>
<td></td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.03)</td>
<td>(0.02)</td>
</tr>
<tr>
<td>Log of fiscal expenditures to GDP ratio 9/</td>
<td>-0.05**</td>
<td>-0.08***</td>
<td>-0.07***</td>
<td>-0.06***</td>
<td>-0.01</td>
<td>-0.03</td>
</tr>
<tr>
<td></td>
<td>(0.02)</td>
<td>(0.02)</td>
<td>(0.02)</td>
<td>(0.02)</td>
<td>(0.03)</td>
<td>(0.02)</td>
</tr>
<tr>
<td>Log change of population</td>
<td>-0.57*</td>
<td>-0.52</td>
<td>-0.73*</td>
<td>-0.67**</td>
<td>-0.50</td>
<td>-0.42</td>
</tr>
<tr>
<td></td>
<td>(0.32)</td>
<td>(0.33)</td>
<td>(0.44)</td>
<td>(0.30)</td>
<td>(0.67)</td>
<td>(0.44)</td>
</tr>
<tr>
<td>CPI inflation rate</td>
<td>-0.03</td>
<td>-0.01</td>
<td>-0.31*</td>
<td>-0.32***</td>
<td>0.03</td>
<td>-0.01</td>
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<tr>
<td></td>
<td>(0.04)</td>
<td>(0.03)</td>
<td>(0.17)</td>
<td>(0.11)</td>
<td>(0.09)</td>
<td>(0.08)</td>
</tr>
<tr>
<td>ICRG Composite 10/</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.00***</td>
<td>0.01***</td>
<td>0.01***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Year 2009 dummy</td>
<td>-0.03***</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Observations | 678 | 601 | 624 | 634 | 624 | 624 |
R-squared | 0.45 | 0.41 | 0.23 | 0.40 | -1.09 | -0.09 |
Number of ifscode | 59 | 59 | 59 | 59 | 59 | 59 |

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Notes: all specification estimated with panel IV estimator except for final 3 specifications that use GMM.
1/ Principle component of 2 variables: global integration of external liabilities and (narrow) regional asset price convergence. See box A1.
2/ Principle component of 3 variables: global integration of external assets and liabilities, banking system credit to the private sector, and (narrow) regional asset price convergence. See box A1.
3/ Principle component of 3 variables: global integration of external assets and liabilities, (narrow) regional asset price convergence, and (narrow) regional integration of external assets and liabilities. See box A1.
4/ Principle component of 3 variables: global integration of external assets and liabilities, (broad) regional asset price convergence, and (broad) regional integration of external assets and liabilities. See box A1.
7/ Exports plus imports, ratio to GDP
8/ Private and public investment, ratio to GDP
9/ Current and capital expenditures of the general government, ratio to GDP
10/ ICRG composite index of political, economic and financial country risks.
17. Financial linkages among financial or banking institutions can be broadly split in two categories: direct and indirect linkages. Direct financial linkages denote explicit balance sheet positions from one financial institution onto another; essentially these are assets or liabilities of financial institutions vis-à-vis each other. Indirect linkages arise when there are no explicit direct linkages among financial institutions, yet market indicators of these financial institutions (for instance, stock prices) tend to exhibit some degree of co-movement or synchronicity. These indirect linkages could be the consequence of having similar business models, or common exposures to related economic sectors, or simply being perceived by the markets as being vulnerable to the same type of shocks (e.g. a change in legislation affecting most banks in one country).

18. The aim of the market-implied interlinkage analysis is to quantify both direct and indirect linkages among different financial institutions in Latin America. The sample includes the largest listed banks from Argentina, Brazil, Chile, Colombia, Mexico, and Peru, over the period 2005–2015, and relies on publically available daily time series of financial variables (e.g. stock prices, CDS spreads, etc).

19. The methodology relies on the computation of empirical distributions characterizing the joint and conditional probabilities of distress among financial institutions. This is largely based on the CIMDO methodology developed by Segoviano (2006). In particular, two synthetic measures are used:

(i) The vulnerability index (VI), which measures the susceptibility of a particular institution to fall in distress given distress in other financial institutions (loosely speaking, it measures an institution’s “vulnerability to contagion from other financial institutions”). Algebraically, the vulnerability index of a given financial institution $i$ is given by:

$$VI(A_i) = \sum_{j=1}^{n} \alpha_j \cdot P(A_i|A_j)$$

Where the weight $\alpha_j = \frac{1}{N} \cdot P(A_j)$, $N$ denotes the number of financial institutions in the sample, and $P(A_j)$ is the probability that institution $j$ falls in distress.

(ii) The contribution to systemic risk, which measures the contribution of a given institution to changes in the vulnerability to contagion of other institutions (i.e. its role as a “source

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6 Extensions of the methodology are described in Segoviano and Goodhart (2009), and a description of the main quantitative indicators used in this analysis can be found in Caceres et al (2010). The Spring 2010 GFSR includes examples of practical applications of this methodology.

7 Marginal probabilities of distress for the different individual financial institutions in the sample are obtained from the Moodys KMV’s Expected Default Frequencies (EDFs) database.
of contagion”). In other words, it is the percent share that a given financial institution represents in the changes in the vulnerability index of all other institutions in the sample.

20. In order to analyze the dynamics of the above two market-based measures in Latin America, both of them are computed for a sample of five Brazilian banks (as Brazil is by far the largest banking sector in the region) (Figure 6); and then separately for a sample of 15 banks from the six LA countries in the country sample (Figure 7).\(^8\)

21. Figure 6 presents the evolution of the vulnerability index of the five large Brazilian banks (left panel), and it also exhibits the percent contribution of each of these banks to the system’s change in vulnerability during three selected periods (right panel). Interestingly, it appears that foreign banks such as Santander (SAN) were perceived by the markets to be relatively safe compared to domestic banks during the CFC (“Period I”). However, in the recent period of falling economic activity, lower commodity prices and heightened political tensions in Brazil (“Period III”), public banks (BDB, RSU) are perceived to be a larger source of risk for the banking system compared to privately owned banks such as Itau (ITA) and Bradesco (BRA). Public banks in Brazil are an important part of the banking system co-movement of their market indicators may reflect more wider economic concerns for Brazil and thus are significant source of risk for the banking system.

22. Regarding the sample of the financial institutions for the six Latin American countries together, Figure 7 presents the evolution of the vulnerability index for the 15 banks included in the sample (top two panels and bottom-left panel). Likewise, Figure 7 also exhibits the percent contribution of each of these banks to the rest of the system’s change in vulnerability during three selected periods (bottom-right panel). In this case, Argentinean banks and Banorte (from Mexico) appear to be the most “vulnerable to contagion” during the GFC (“Period I”). However, these relatively high market-implied interlinkages during that period appear to be important mainly among themselves (Figure 7).

23. In the most recent period (“Period III”), Banco do Brazil (BDOBR) appears to be driving most of the market-implied contagion (Figure 7, bottom-right panel). However, the actual spillovers outside of Brazil appear to be rather small, for instance when comparing the levels of the vulnerability index to those observed during the GFC. In other words, large domestic public banks in Brazil might be very important for the domestic market (in Brazil), but not really for the rest of region. These market-based measures seem to be in line with the limited actual cross-border balance sheet exposures of the banking sectors in LA.

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\(^8\) The country coverage and the sample are determined by data availability and are not the same as in the rest of this study. In general, any financial institution included in the sample needs to be listed and actively traded in the stock market. This is also a requirement for individual domestic subsidiaries of foreign banks.
Source: Moody’s KMV, Datastream, and IMF staff calculations.

### List of Latin-American Banks Included in the Market-Implied Interlinkages Analysis

<table>
<thead>
<tr>
<th>Bank acronym</th>
<th>Bank name</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>BGALI</td>
<td>Banco de Galicia</td>
<td>Argentina</td>
</tr>
<tr>
<td>BVAAR</td>
<td>BBVA-Argentina</td>
<td>Argentina</td>
</tr>
<tr>
<td>BMACR</td>
<td>Banco Macro</td>
<td>Argentina</td>
</tr>
<tr>
<td>BDOBR</td>
<td>Banco do Brasil (BB)</td>
<td>Brazil</td>
</tr>
<tr>
<td>ITAUB</td>
<td>Itau</td>
<td>Brazil</td>
</tr>
<tr>
<td>SANBR</td>
<td>Santander-Brazil</td>
<td>Brazil</td>
</tr>
<tr>
<td>SANCL</td>
<td>Santander-Chile</td>
<td>Chile</td>
</tr>
<tr>
<td>BDCHL</td>
<td>Banco de Chile</td>
<td>Chile</td>
</tr>
<tr>
<td>CORPB</td>
<td>Corpbanca</td>
<td>Chile</td>
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<tr>
<td>BCOLO</td>
<td>Bancolombia</td>
<td>Colombia</td>
</tr>
<tr>
<td>BDBOG</td>
<td>Banco de Bogota</td>
<td>Colombia</td>
</tr>
<tr>
<td>BANOR</td>
<td>Banorte</td>
<td>Mexico</td>
</tr>
<tr>
<td>INBUR</td>
<td>Inbursa, grupo financiero</td>
<td>Mexico</td>
</tr>
<tr>
<td>SCOPE</td>
<td>Scotiabank-Peru</td>
<td>Peru</td>
</tr>
<tr>
<td>BCREP</td>
<td>Banco de Credito del Peru</td>
<td>Peru</td>
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</table>
Figure 7. Market-based Interlinkages in Selected Latin American Banks

Sources: Moody’s KMV, Datastream and IMF staff calculations.

Table 9. Contribution to Systemic Risk During Global Financial Crisis
(Period: October 31, 2007 to March 2, 2009)

<table>
<thead>
<tr>
<th>Bank</th>
<th>BGALI</th>
<th>BVAAR</th>
<th>BMACR</th>
<th>BDOBR</th>
<th>ITAUB</th>
<th>SANBR</th>
<th>SANCL</th>
<th>BDCBR</th>
<th>CORPB</th>
<th>BCOLO</th>
<th>BDOBR</th>
<th>BANOR</th>
<th>INBUR</th>
<th>SCOPE</th>
<th>BCREP</th>
<th>STD</th>
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<td>1.2</td>
<td>0.7</td>
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<td>0.1</td>
<td>0.2</td>
<td>0.7</td>
<td>0.9</td>
<td>0.3</td>
<td>3.7</td>
<td>0.4</td>
<td>0.2</td>
<td>0.4</td>
<td>2.7</td>
<td>0.2</td>
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<tr>
<td>BVAAR</td>
<td>3.2</td>
<td>1.0</td>
<td>0.9</td>
<td>0.7</td>
<td>0.1</td>
<td>0.1</td>
<td>0.2</td>
<td>0.7</td>
<td>0.3</td>
<td>0.8</td>
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<td>0.2</td>
<td>0.6</td>
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</tr>
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<td>3.3</td>
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<td>0.1</td>
<td>0.2</td>
<td>0.4</td>
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<td>0.3</td>
<td>2.7</td>
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<td>1.0</td>
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<td>1.9</td>
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<td>0.1</td>
<td>0.4</td>
<td>1.0</td>
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<td>1.0</td>
<td>0.3</td>
<td>4.0</td>
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<td>0.3</td>
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<td>0.1</td>
<td>0.1</td>
<td>2.7</td>
<td>0.1</td>
<td>1.0</td>
<td>0.1</td>
<td>2.7</td>
<td>0.2</td>
</tr>
<tr>
<td>SANBR</td>
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<td>2.4</td>
<td>1.0</td>
<td>0.1</td>
<td>0.1</td>
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Sources: Moody’s KMV, Datastream, and IMF staff calculations.
IMF Research Department (RES) Bank Contagion Module

24. Direct linkages (through cross-border lending and purchases of debt securities) among financial institutions can lead to increased spillover risks among countries. These risks may take the form of losses on risk exposures that may cascade across borders through interlinked financial systems.

25. The aim of RES’ Bank Contagion Module is to analyze potential spillover effects arising from the international lending operations of global banks. The main exposure metric in this analysis assesses lender banking systems’ exposure to shocks in borrower countries. Essentially, the framework simulates the propagation of financial shocks across borders through bank losses and deleveraging. The module utilizes the BIS bilateral banking statistics—representing claims of banking systems in BIS reporting countries vis-à-vis all residents (banks, non-banks, and public sector) in reporting and non-reporting countries. There are four BIS reporting countries in Latin America: Brazil, Chile, Mexico, and Panama.

26. Latin American banking systems are not strongly integrated among themselves but have tight links with advanced economy banking systems, from where shocks may emanate. Bank linkages with advanced economies outside the region—in particular, Canada, Spain, UK, and the United States—are relatively important. Results from the RES Bank Contagion Module suggest that an asset-side shock to these advanced economies’ banking systems could have a sizeable impact on the availability of foreign credit to Latin American countries (Table 10). A shock to any of the Latin American banking systems would likely have small direct spillovers onto other countries in the region due to limited intraregional cross-border banking exposures.

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9 Prepared by WHD, based on inputs from Camelia Minoiu (RES) and Paola Ganum (RES).
Table 10. Simulated Spillovers in Selected Latin American Countries

<table>
<thead>
<tr>
<th>Creditor banking system</th>
<th>Impact on Credit Availability (% GDP) 10</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Panama</td>
</tr>
<tr>
<td>USA</td>
<td>-10</td>
</tr>
<tr>
<td>Canada</td>
<td>-10</td>
</tr>
<tr>
<td>USA and Canada</td>
<td>-10</td>
</tr>
<tr>
<td>UK</td>
<td>-10</td>
</tr>
<tr>
<td>Spain</td>
<td>-10</td>
</tr>
<tr>
<td>UK and Spain</td>
<td>-10</td>
</tr>
</tbody>
</table>

1/ Magnitude denotes the percent of on-balance sheet claims (all borrowing sectors) that default.
2/ Reduction in foreign banks’ credit due to the impact of the shock on their balance sheet, assuming uniform deleveraging across domestic and external claims. All simulations are based on 2014Q3 data.

Source: BIS bilateral banking statistics, European Central Bank, IFS, Bankscope, and IMF staff calculations.

LA-7 COUNTRY PROFILES

A. Brazil

27. **Brazil’s financial system is by far the largest in LA.** Commensurate to the size of its overall economy, Brazil’s total financial sector assets dwarf those of the other countries in the region. Brazil’s nominal GDP amounted to about US$2.35 trillion in 2014 (Figure 8), comparable to that of the largest 5 other economies in LA together. Brazil’s financial sector is not only large in absolute terms, but also relative to its economy.

28. **Accordingly, Brazil’s banking system is the largest in absolute terms.** Furthermore, with total assets close to US$2.4 trillion, the banking sector is also one of the largest in percent of GDP, representing close to 117 percent (Figure 9).

29. **The Brazilian banking system remains dominated by large public banks.** Publicly owned banks represent about half of the banking system (Figure 10). Furthermore, the banking sector remains highly concentrated, with the 8 largest banks accounting for about 85 percent of the banking sector (Figure 11). The financial system is characterized by a high degree of conglomereration. Interest margins are high, which is partly reflected in high profitability, particularly for the large banks (c.f. FSI’s chart). However, the system appears to be stuck in a “high interest rate and short duration” equilibrium, which limits capital market development, and thus potential growth.

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10 For emerging markets, the model assumes that spillovers are through their common exposure to advanced economies’ financial systems, which might lead to some underestimation of the impact of some emerging markets onto other emerging markets.
30. Regarding non-banks, the insurance sector is performing well. Profitability in the insurance sector has been relatively high over the past few years, likely benefiting from high interest rates, which have translated into solid solvency ratios. Mutual funds and banks are highly interconnected through repo operations and the holding of deposits and bank-issued bonds by the funds. Pension funds are sizeable in Brazil, with assets under management close to US$280 billion. Essentially all these assets are invested domestically (Figure 12).

31. Itau is the only universal Brazilian bank with a significant presence across the region. Most Brazilian banks tend to be inward looking. This reflects in large part the significant share of publically-owned banks, as well as the large domestic market. Itau, which is the largest privately-owned bank in Brazil, has nevertheless sizeable stakes in the region, representing almost 10 percent of the banks’ total assets. The bank is present in Argentina, Chile, Colombia, Mexico, Paraguay, and Uruguay. BTG Pactual is trying to position itself as a regional investment bank. Investment banks have the advantage of operating with smaller balance sheets, hence the potential ability to be profitable without the need for large scale. This is also reflected in terms of their capital costs.

32. Brazilian foreign claims remain concentrated in a few advanced economies. Brazilian claims on countries such as the U.S. and the U.K. dwarf those on other LA countries (Figure 13). The only exception is Chile, where Itau has a significant presence. Cayman Island has a notable share of Brazilian foreign claims; most Brazilian banks establish operations there in order to offer their Brazilian clients investments denominated in foreign currencies.

33. Foreign financial claims on Brazil have been growing rapidly for most of the past 15 years. Indeed, foreign claims have more than quadrupled since 2005 (Figure 13), and stand at about US$442 billion (roughly 18 percent of GDP). Spain has the highest foreign claims, representing close to 7.5 percent of GDP, reflecting the significant presence of Spanish banks, most notably Santander. In the last couple of years, however, the total amount of foreign claims has stabilized. This is consistent with the slowdown in the domestic economy. Furthermore, Brazilian financial institutions have a relatively low ratio of foreign liabilities to credit to the economy (around 10 percent). This suggests a relatively low reliance on foreign funds as a source of funding, limiting the effects of any potential global liquid squeeze.

34. Banking sector flows appear geographically related to real sector activity. There are likely a large number of drivers behind Brazilian cross-border financial flows. There is some evidence that cross-border banking sector flows in Brazil tend to be associated with trade linkages as well as FDI (Figure 15). Furthermore, there has been a noticeable increase in bank as well as non-bank issuance abroad by Brazilian corporations (Figure 16), through 2014. Issuance abroad has contracted as risk appetite for Brazilian securities has subsided.

35. Brazil’s regulatory framework is broadly adequate. The 2012 FSAP characterized financial sector oversight as strong, but noted that efforts were needed in some areas in order
to stay abreast of a rapidly evolving system. Compliance of banking supervision vis-à-vis Basel Core Principles (BCP) is one of the highest in the region.\textsuperscript{11}

36. **Significant regulatory barriers exist.** For instance, foreign banks need special presidential approval in order to operate in the country, even under the subsidiary model. Furthermore, Brazilian banks are not allowed any significant position in their balance sheet (loans or deposits) denominated in foreign currencies. Although this clearly minimizes potential FX-associated risks (both market and credit risks), most countries tend to allow some small open FX position on banks' balance sheets. Barriers such as Brazil’s large size and the degree of market concentration reportedly represent further hurdles for regional players to enter the domestic market.

\textsuperscript{11} 100 percent of principles were found to be “Compliant” or “Largely Compliant”.
Figure 8. Brazil: Indicators of Regional Size

Sources: National authorities; United Nations; Haver; and IMF staff calculations.

Figure 9. Brazil: Banking Sector Assets Relative to Regional Peers

Sources: National authorities; Bankscope; and IMF staff calculations.
Figure 10. Brazil: Assets and Deposits by Nationality of Bank Ownership

Figure 11. Brazil: Ownership of Major Banks

Note: In 2015, Bradesco purchased HSBC’s operations in Brazil to increase their market share to about 14%.

Sources: National authorities; Bureau van Dijk, Bankscope; and IMF staff calculations.
Figure 12. LA-7: Pension Fund Assets Under Management¹

(Billions of US dollars)

Figure 13. Claims of Brazilian Banks on the Rest of the World

Sources: National authorities; Bureau van Dijk; and IMF staff calculations.
¹ Year-end 2014 or latest available.

Sources: Bank for International Settlements; and IMF staff calculations.
Figure 14. Claims on Brazil by BIS Reporting Banks

International bank claims of top 7 on Brazil
(Millions of $, consolidated - ultimate risk basis)

International bank claims on Brazil, by Sector
(Millions of $, consolidated - ultimate risk basis)

Sources: Bank for International Settlements; and IMF staff calculations.

Figure 15. Brazil: Relationship Between Banking Sector Flows and Exports and FDI

BRA: Financial Claims against Exports

BRA: Financial Claims against Outward FDI

Sources: National authorities; IMF, Direction of Trade Statistics; and IMF staff calculations.
Figure 16. Brazil: Securities Issued Abroad
(Amounts outstanding in billions of US dollars)

Sources: National authorities and IMF staff calculations.
B. CHILE

37. **Chile has a deep financial system with a large presence of institutional investors.**

Assets of the banking system amount to about 125 percent of GDP. Pension funds account for about 75 percent of GDP, while mutual funds and insurance companies are significantly smaller (20–25 percent of GDP). All institutions combined, the financial sector is close to 250 percent of GDP.

<table>
<thead>
<tr>
<th>Table 11. Chile: Financial System Structure, June 2015</th>
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</thead>
<tbody>
<tr>
<td><strong>Assets</strong> (%)</td>
</tr>
<tr>
<td>of total</td>
</tr>
<tr>
<td>Banks</td>
</tr>
<tr>
<td>Insurance companies</td>
</tr>
<tr>
<td>Pension fund administrators 1/</td>
</tr>
<tr>
<td>Other fund administrators 1/ 2/</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
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</table>

Sources: Superintendent of Banks and Financial Institutions, Superintendent of Pension Funds, and Superintendent of Securities and Insurance.

1/ Assets under management

2/ Includes mutual funds and investment funds

* 2014 GDP.
38. **Chile is a very open economy with large cross-border financial linkages.** Chile’s net has hovered around -15 percent of GDP since 2008, and is stronger than that of other countries in the region. Chile has a net negative FDI position reflecting large inflows in the mining sector, and a net positive equity position, with the financial sector (pension funds, mutual funds, and insurance companies) being the main holders of foreign assets. FDI inflows are an important source of investment in Chile, in particular for the mining, financial and utilities sectors. They have increased from an annual average of 6 percent of GDP in the early 2000s to 8½ percent in recent years. The United States, the Netherlands, and Spain represent the main source markets. Portfolio investment amounted to 30 percent of GDP in 2014 (based on IIP stock data). U.S. residents hold nearly half of total portfolio investment assets (both equity and debt) vis-à-vis Chile, followed by Luxembourg and the United Kingdom (each 10 percent). Non-residents hold about 5 percent of Chile’s sovereign bonds.

39. **The Ministry of Finance (MoF), the Central Bank of Chile (BCCh), and the three supervisory agencies are responsible for the financial regulation and supervision.** In addition to their responsibilities for the issuance of norms, particularly concerning corporate governance, credit classification and provisioning, the three supervisory agencies are responsible for the supervision of financial entities: the SBIF supervises banks, the SVS supervises insurance companies and security companies, and the SP supervises pension funds. The MoF is responsible for the preparation of financial sector laws. In addition to having an advisory role regarding the preparation of laws, the BCCh is directly responsible for the determination of liquidity requirements, regulation and supervision of derivative operations, and the payments system. The BCCh conducts twice-a-year top down stress tests that focus on both credit and market risk for the banking sector, and shares these results with the supervisory agencies. Coordination between all these entities has been improved through the creation of a Financial Stability Council in 2011.

**Banking sector**

40. **There is a large foreign presence in the banking sector in Chile.** Foreign banks account for 35 percent of total banking sector assets, including Chile’s largest bank Banco Santander-Chile, which is a subsidiary of the Spanish banking group. BBVA, Itau, and Scotiabank are also subsidiaries of foreign banks. Banco de Chile is a domestic bank but it is jointly owned by US Citigroup and a Chilean Conglomerate. The share of foreign banks, however, is not unusually high and is close to the average of LA-5 countries. Itau-Corpbanca (whose merger is expected to be finalized in 2016) has become a regional bank with a presence in Brazil, Colombia and Chile.
41. **Conversely, Chilean banks do not have a large presence abroad.** Corpbanca was an exception with its acquisition of two Columbian banks a few years ago. One explanation is the small size of the financial sector relative to Chile’s neighbors. Chilean banks are too small to compete with Brazilian banks, for instance, particularly since Chilean banks are not allowed to invest more than 40 percent of common equity in a single market (in shares of a foreign bank). There are anyway few potential candidates (only four large domestic banks, of which one is public). In addition, if subsidiaries of foreign banks are willing to expand outside Chile, they will proceed from their headquarters, not from Chile.

42. **The banking sector appears generally healthy.** Bank capitalization is adequate. Banks’ profitability remained strong in 2014, although it declined in 2015 mainly due to a smaller positive impact of inflation. Banks’ NPLs have decreased slightly from already low levels, and capital ratios are above regulatory thresholds. Domestic deposits are the main funding source; the banks’ reliance on external funding sources is relatively moderate (at 12¼ percent of their total funding needs, up from about 9½ in August 2012).

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12 The 40 percent limit applies to each country, meaning that a bank could invest up to 80 percent of its regulatory capital in two countries, for instance.
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<td><strong>Table 12. Chile: Financial Soundness Indicators, 2009–15</strong>&lt;br&gt;<em>(Percent, unless otherwise indicated)</em></td>
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<td>Return on Assets</td>
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<td>21.4</td>
<td>24.3</td>
<td>25.5</td>
<td>26.1</td>
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</table>

Sources: IMF FSI database and Fund staff calculations.
1/ September 2015 data.
2/ In billions of Chilean pesos.
43. The authorities are in the process of adapting Basel III standards to the Chilean banking system. Currently, banks operate under an amended Basel I framework with additional capital requirements for market risk. A leverage ratio is already imposed, but there is no capital charge for operational risk. A new Banking Law will be submitted in March 2016. The new law will adapt Basel III capital standards to Chilean banks on a transitional basis and introduce a capital surcharge for domestic systemically important banks. Basel III capital guidelines should be published in 2016 in order to assure compliance by the 2019 deadline. In addition, a new liquidity regulation became effective from August 2015. It improves the quality and frequency of information provided to regulators and specifies the minimum requirements for monitoring the liquidity coverage ratio and net-funding stable ratio.

Pension funds

44. Pension funds, with total assets above 70 percent of GDP, are key players in Chile’s financial system. Chile has a three-pillar defined contribution system. Under the mandatory contribution pillar, employees are required to contribute 10 percent of their wage or salary to an individual account and choose one of the six private pension funds (AFPs) to manage their account. Employees also chose between five portfolios (A-E) depending on their desired level of risk. Two pension funds were bought by US groups in 2013. Today, four AFPs are foreign-owned and two are Chilean. AFP assets are managed by international and domestic fund managers, who invest mainly in mutual and exchange traded funds, with a strong focus on EMs. The authorities plan to establish a new public pension fund to increase competition and coverage.

45. In recent years, pension funds pressured by the low-yield environment have been restructuring their portfolios towards riskier, foreign, and/or less liquid assets. Expansion abroad has mainly been in response to the lack of investment opportunities in the domestic market. Most foreign investment is in mutual funds and equities, mainly in the United States and Emerging Asia assets.

46. AFPs are subject to a number of limits on their risky assets allocations. These limits are in place to encourage diversification and protect pensions from contagion and spillover problems. In the past AFPs could only invest in fixed income securities, but limits have been relaxed over time, and gradually the scope was extended to riskier and more diversified instruments.
• For each type of portfolio (A to E), there are limits on how much the AFP can invest in "restricted instruments" (non-investment grade fixed income and stocks that exchange in a market with a rating lower than AA). For instance, for the riskiest portfolio (type A), the limit is 20 percent of assets under management. The assessed risk of direct equity holdings is assigned to the sovereign risk rating of the country where the firm is domiciled; however, this can be somewhat circumvented by purchasing Mutual Funds or ETFs through investment grade financial centers like New York or Luxembourg. For alternative assets (such as private equity, or real estate). AFPs are not allowed to invest directly but have to invest through a mutual fund.

• In addition, AFPs are subject to two types of limits on their foreign investment. The first limit is specific to each portfolio (for instance, 90 percent of portfolio B can be invested in foreign assets). The second limit concerns the aggregate portfolio: AFPs are allowed to allocate up to 80 percent of their total assets under management abroad; currently, the actual share is 45 percent on average, up from 35 percent at end-2011.

Insurance and mutual funds

47. The insurance sector is the largest sector after banks and pension funds. This competitive market (60 companies) is dominated by life insurance companies, which represent 90 percent of assets. Its growth has been spurred by the pension system. In life insurance about a third of the market share is held by foreign companies. International companies need to be based in Chile to operate in the domestic market, and their risk rating needs to be equal to or above BBB. Most insurance companies are part of conglomerates.

13 At retirement, a retiree has the choice between either buying an annuity from an assurance company or leaving the money in the pension fund and drawing it on a monthly basis. In most cases, retirees chose the first option and pension funds are converted into annuities.
48. **Pressed by the low yield environment, like pension funds, insurance companies have increased their asset allocations in real estate, lower rating domestic and foreign corporate bonds.** Insurance companies cannot invest more than 20 percent of their assets abroad (and 5 percent for foreign high-yield bonds), which makes the limit significantly more binding than that applied to pension funds. The 20 percent limit has recently become binding for several life insurers and is an active constraint on portfolio management. A new regulation introduced in 2015 requires insurance companies to define their risk appetite and introduces “own risk and solvency assessment” (internal procedure of risk assessment). The draft law that introduces risk-based supervision for insurance companies (and risk-based capital requirements) is still in Congress.

49. **The mutual fund sector has grown very rapidly in recent years.** Its share of GDP has tripled since the early 2000s. Mutual funds are often affiliates of banks, such as Banco de Chile, Santander or BCI. Investment abroad is relatively low: about 10 percent of assets under management are foreign (mostly in the US). Mutual funds invest mostly in money market funds, although the share of bonds in their asset portfolios is increasing. Mutual funds do not have to comply with standardized liquidity requirement but they are subject to restrictions on foreign investment abroad (depending on the quality of the foreign market’s supervision and regulation).

**Stock market**

50. **Market capitalization is quite large at around 90 percent of GDP.**¹⁴ This is partly due to the role and importance of pension funds in Chile. Since the mid-1990s, the stock market has gone through several rounds of modernization via the adoption of “MK laws”. The last round in 2010 (MK III) included numerous provisions to foster the openness of capital market to international investors. It exempted capital gains obtained by foreign institutional investors on the sale or transfer of some securities (which was previously seen as a factor behind the low participation of foreign investors in the fixed-income market in Chile). The law authorized representative offices of foreign banks to advertise in Chile the products or credit services offered by the parent company. The law also promoted the local trading of

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¹⁴ As measured by the World Federation of Exchanges.
registered foreign securities by allowing their denomination in Chilean pesos (such peso-denominated foreign securities are now payable in an authorized foreign currency or in Chilean pesos).

51. The liquidity of the Chilean stock market has declined over the last few years and is relatively low compared to other economies. Compared to other EMs, Chile’s stock market has gone from one of the most liquid to one of the least liquid since the GFC. This is reducing the attractiveness of the Chilean market for foreign investors. Several reasons have been provided. Pension funds, which are large market players in Chile, are to a large extent buy-and-hold investors. Large conglomerates also reduce the amount of float (due to the large intro-group debt). The tax system may have encouraged companies to issue debt rather than equity. Another factor is the poor corporate governance: informational asymmetries (corporate insiders using private information to extract rents from other market participants) may discourage trading activities.

Financial conglomerates

52. Both financial and mixed conglomerates have a strong presence in the financial sector. According to the Chilean authorities, conglomerates comprise 16 systemically important domestic institutions, with assets totaling 125 percent of GDP as of end-December 2011 (the last time the authorities measured these assets on a consolidated basis). As a sign of the concentrated holdings among these conglomerates, conglomerates held more than one-third of the assets of local pension funds and life insurers, which total some 60 percent of GDP at end-December 2011.

53. Most conglomerates operate in the financial sector. Out of the 16 conglomerates, as measured by their asset holdings with respect to total assets, five conglomerates focus on banking activities, four concentrate in the insurance and pension sectors, and four focus on both the banking and insurance sectors. Many banks operate within conglomerates, perhaps because of the required separation of financial activities.

54. Conglomerates are well integrated into international financial markets. Out of the 16 conglomerates, two are led by major international banks and four by major international insurance companies. In addition, four local mixed conglomerates have significant operations both in the financial and non-financial sectors of neighboring countries, underlining the importance of establishing coordination with other regulators in the region.

55. Improving the supervision of conglomerates is on the authorities’ agenda. Currently, the supervision of conglomerates relies on a sector or silo approach, with each type of financial institution (banks, pension funds, insurance companies) being supervised by a separate superintendency. Nonetheless, the Financial Stability Council law has recently strengthened consolidated supervision of financial conglomerates. The law removed all barriers to information-sharing among supervisors; expanded their power to request information from the final owners of financial institutions within the conglomerate; and established solvency
requirements for the controlling shareholders of banks and insurance companies. However, supervisors still lack the powers and authority to conduct comprehensive group-wide supervision (including setting risk-based minimum prudential standards and monitoring conglomerates’ compliance with limits on risk exposure). The 2011 FSAP recommended stronger coordination among supervisors and the identification of a group-level supervisor with enhanced powers, including that of establishing risk-based minimum prudential standards for financial conglomerates.

C. Colombia

56. Colombia has a concentrated financial system, dominated by complex financial conglomerates. Assets of the banking system are about US$200 billion, or 55 percent of GDP at end-2014. Nonbank financial intermediaries (largely private pension funds, trust companies and insurance companies) account for another 60 percent of GDP. Large domestic complex conglomerates dominate the financial landscape, with ten holding about 80 percent of total financial sector assets. Many bank and nonbank entities are part of the same conglomerate.

57. In the banking sector, the top 3 banks (Bancolombia, Banco de Bogota, and Davivienda) hold about 50 percent of banking system assets, and banks extend 90 percent of their commercial loans to 7 percent of borrowers. Foreign banks hold only 24 percent of banking system assets (one of the smallest shares in the LA-7), of which regional banks hold 8 percent. In terms of access to the banking system and financial intermediation, credit to the private sector and bank deposits relative to GDP, and ATMs are among the lowest in the LA-7, reflecting in part the large informal sector.

58. Colombia’s capital markets reflect mainly activity in government debt and equity markets, with capitalization reaching 45 percent of GDP at end-2014. Non-government fixed income remains undeveloped (4 percent of GDP). The investor base for government debt comprises mainly domestic investors—banks (20 percent of GDP), pension funds (20 percent of GDP), insurance companies (6 percent of GDP) and mutual funds (5 percent of GDP). Foreign investors’ ownership of government debt rose to 14 percent of the total at end-2014, up from 3 percent at end-2012, fuelled by a reduction in early 2013 from 33 to 14 percent in the withholding tax charged on foreign investors’ income and capital gains tax. The authorities intend to raise foreign investors’ participation in the government debt market to 15–20 percent to diversify the investor base.

59. The main nonbank financial intermediaries are the private pension funds, which manage IRA-type pensions, while insurance companies are much smaller. Since 2008, assets under pension funds’ management increased by about half through a combination of
healthy returns and rising contributions. Industry concentration is high, as the two largest private pension funds in Colombia, Porvenir and Proteccion, manage more than 70 percent of industry assets. Pension funds remain under the sole stewardship of domestic asset managers, and foreign pension funds are non-existent due to legal restrictions. In the insurance sector, premium growth, one of the highest in the LA-7, was 24 percent for the life segment, and 4 percent for the non-life segment in 2012-13. Premiums per capita and insurance penetration are below other LA countries, but similar to Mexico’s premiums per capita are US$200 and premiums amount to about 3 percent of GDP. The insurance sector is relatively concentrated. The ten largest companies account for almost 80 percent of the market. Foreign insurance companies are virtually non-existent.

60. **Colombia has important and growing financial linkages with the rest of the world, including recently with Chile.** According to data from the Bank of International Settlements (BIS), international banks have significant claims on Colombian borrowers. Foreign claims (ultimate risk basis) on Colombia have increased nine times since 2005 and twice since 2008, when they experienced a dip, and are now US$45 billion (11% of GDP). These foreign claims originate mostly from European banks (US$21 billion or 46 percent of the total)—of which US$18 billion are from Spanish banks—, U.S. banks (US$10 billion or 22 percent of the total), and Japanese banks. Most foreign claims are on the non-bank private sector.

61. **High bank concentration made it hard for regional banks to break into the Colombian market when foreign banks withdrew.** High bank concentration, with 50 percent of assets held by the three largest banks (if the largest conglomerate, which comprises four banks, is taken into account, concentration rises to 65 percent), and tight linkages of conglomerates to the private sector hinder entry of big foreign players. A Colombian bank, GNB Sudameris, acquired HSBC’s assets in 2014, which resulted in a consolidation of the market. However, efforts were made to open up, and Chilean Corpbanca acquired the business of Banco Santander, as well as Helm Bank in 2012–13., Currently Bank Itau is merging with Corpbanca, which will place it 5th in terms of market share.

62. **Beyond banking, regional financial integration could be fostered through MILA and started through broker dealer acquisitions.** Brokerage firms are less concentrated than banks or pension funds, allowing entrance of new players more easily. A Peruvian broker bought Correval, as the two countries integrate their securities markets, and a Chilean broker is planning to enter the market. However, concentration in terms of issuers and the investor base is high in each of the four MILA capital markets (2–3 conglomerates are the main issuers, and
they are the same buyers), which will be hard to break to allow more players on both sides.

BTG Pactual, a Brazilian investment bank, acquired Bolsa y Renta, Colombia’s biggest brokerage, seeing opportunities in Colombia, given a high return on equity and underdeveloped capital markets, including the need to develop/structure instruments to support financing for large projects in energy/oil business and infrastructure/real estate sector.

63. In terms of outward regional expansion, Colombian financial institutions have a significant presence in Central America (and to a lesser extent South America). The expansion was due to a combination of factors: withdrawal of foreign banks since 2008, increased economic integration with Central America and countries of the PA, as well as similarities in culture and language that fit with Colombian banks’ business plans to expand in geographically proximate regions. Assets of Colombian banks’ subsidiaries abroad account for 2 percent of the total assets of the Colombian banking system. Colombian banks have attained a significant market position in Central America (on average: 22 percent). Banco de Bogota acquired Panama-based conglomerate BAC International and Guatemala-based Grupo Reformador, and focuses on consumer credit and mortgage lending in these markets. Bancolombia bought El Salvadoran-based Banco Agrícola and HSBC’s assets in Panama, and a minority stake in Guatemala-based Grupo Agromercantil, and its portfolio comprises corporate lending, as well as consumer credit and mortgage lending. Banco Davivienda acquired most of HSBC’s operations in the region, notably, those in Costa Rica, El Salvador, and Honduras, and provides consumer lending. Banco GNB Sudameris bought HSBC’s remaining operations in Latin America, specifically in Paraguay and Peru, and focuses on corporate lending. There has also been expansion by Grupo Sura, which is the largest shareholder of insurance company Suramericana (8 percent of the revenues come from Central America) and asset management company Sura Asset Management (76 percent of assets are in LA).

64. Going forward, Colombian banks are planning to consolidate their acquisitions in Central America, while seeing limited scope for going elsewhere, at least in the short run. They cite consolidation and size of the market, as well as language, as significant impediments to establishing in Brazil. While considering Peru and Chile as attractive markets, they see prices of assets prohibitive and markets extremely concentrated.

65. Financial integration through foreign investment by pension funds is picking up. Pension funds hold the largest share of their assets in government securities, followed by equity, and foreign assets. The share of foreign assets held by pension funds in their portfolios in Colombia is still less than half of that in Chile and Peru, but comparable to that in Mexico,
and has been picking up in recent years. An easing of regulatory restrictions allowed, for instance a multi-fund system which allows risk profile differentiation, and thus larger shares of investments in variable rate instruments and higher limits on foreign securities investments. Investments abroad are about 30 percent of total assets, close to the 40 percent statutory limit for the Conservative Fund. Insurance companies largely choose to invest in debt securities, where about ¾ of investment portfolio allocations of life insurers are held in bonds, and not at all in foreign assets.

66. **Colombian banks remain adequately capitalized and profitable.** Tier 1 capital is 12.4 percent, lower than the average for LA, and systemic Colombian banks have lower Tier 1 capital: Bancolombia has 8.9 percent, Banco de Bogota 7.4 percent, and Davivienda 7.1 percent in 2014. Moreover, Standard and Poor’s risk-adjusted capital (RAC) measure (which deducts goodwill) indicates that Colombian banks have lower levels of capital compared to other banks in the LA-7. NPLs remain moderate, even though higher than the average for LA. NPLs vary by portfolio, with consumer and microfinance loans at 4.8 and 4.5 percent, respectively, and commercial and housing at 1.8 and 2.5 percent, respectively. Provisions appear adequate, covering 163 percent of total NPLs (one fifth of the provisions come from the countercyclical loan loss provisioning system adopted in 2007). The return on assets is high at 3.5 percent (higher than the average in LA), and the return on equity has stayed near 24 percent, with profits arising mostly from a wide net intermediation margin. This strong profitability may reflect in part the concentration of the banking system.
Figure 23: Colombia: Financial Soundness Indicators

- **Regulatory Tier 1 Capital to Risk-Weighted Assets (in percent)**
- **Non-performing Loans to Total Gross Loans (in percent)**
- **Return on Assets (in percent)**
- **Return on Equity (in percent)**
- **Interest Margin to Gross Income (in percent)**
- **Non-Interest Expenses to Gross Income (percent)**
- **Liquid Assets to Total Assets (percent)**
- **Liquid Assets to Short Term Liabilities (in percent)**
D. Mexico

67. Mexico responded to its financial crises of the 1990s by opening its financial system to foreign participation, in order to gain capital, and management expertise, and to protect itself from economic volatility. Financial services industry liberalization, including through a number of trade agreements, starting with NAFTA in the early 1990s, precipitated the influx of foreign banks into Mexico.

68. Mexico’s financial system remains small relative to its size and the level of economic development, but it continues to expand robustly. Over the period 2010–14, the Mexican financial system increased on average by 2.5 percentage points of GDP annually, with total assets accounting for about 83% of GDP in 2014. Much of the growth appears to have been generated by the non-bank financial sector, owing largely to the sustained rise of mutual funds and private pension funds, as non-bank asset accumulation continues to outperform the banking industry.

69. The banking sector has the highest share of foreign ownership about 70% of total assets. A large foreign presence is also registered in the insurance industry, and to a lesser extent in pension funds and brokerage firms.

Banking Sector

70. Foreign bank ownership remains broadly diversified by the country of origin. Among foreign banks, Spanish banks represent about 37% of market share, followed by US banks, at 18% of total assets, UK 9%, and Canada 4%. BBVA Bancomer and Santander represent about 22 and 14 percent of the banking system assets, respectively. The market share of US banks comprised of Citibank’s subsidiary Banamex (15% market share), and a
number of smaller banks. HSBC represents the majority of assets of UK banks, with about 8% market share. Banco Azteca is the only Mexican banking entity with subsidiaries in other LA countries, including Panama, Guatemala, Peru, and Brazil.

71. **Foreign banks in Mexico historically have maintained operational autonomy from headquarters, and have followed a largely domestically financed credit model.** Foreign banks’ subsidiaries in Mexico largely operate as autonomous financial institutions, mostly funding themselves through the domestic customer base. Similarly to the domestic banks, foreign banks report sufficient levels of profitability and capitalization, despite the fact that Mexican lending and deposit interest spreads are the lowest within LA-7.

72. **Elevated banking sector concentration and high equity prices are often cited as major barriers to entry.** Given the open regulatory and legal regime, as well as the reported equal treatment of foreign and domestic banks, there are no explicit barriers to entry. Banking sector concentration, however, is often cited as a major barrier; due to high concentration, reaching the reported minimum market share of 7–10 percent through greenfield investment would be difficult. Of the 47 commercial banks, the largest 10 account for 86% of the market share, 5 of which are foreign subsidiaries, representing about three quarters of the subgroup assets. Cross-border entry of foreign banks, including regional, into Mexico is also often discouraged by high equity prices. On the other side, the expansion of domestic banks into other countries, so far, has been limited, largely since banks recognize the growth potential domestically, also given the fact that few domestic banks in Mexico possess the necessary size to make substantial acquisitions abroad.
Changes in the regulatory environments of advanced economies, precipitated by the GFC, have led to the withdrawal from, or downsizing of, global banks from EMs including Mexico. Higher capital and other regulatory requirements have increased the cost of doing business. With global banks weakened by the GFC, a number have retrenched to their core businesses, regarded often as domestic rather than cross-border. Significantly also, US authorities have started enhanced enforcement, including exemplary fines, for banks that violate AML/CFT and other US regulations. Overall, this has led a number of global banks to rethink their strategies. Mexico, with one of the highest penetrations of global banks, is potentially particularly heavily affected. Additional regulatory costs, such as the requirement that systemic banks establish minimum loss absorption capacity, may lead this process to continue.

US regulations, and comparable provisions elsewhere, have the effect of increasing the cost of doing business in EMs such as Mexico compared to conducting business at home. Mexican deposit insurance is not recognized by the US regulators for LCR calculation purposes in the same manner as FDIC insurance, for example, which calls for more liquidity when foreign subsidiaries consolidate with their parent jurisdictions. Even more importantly, while the Basel Standardized approach, used in Mexico, allows supervisors to assign a zero-risk weight to banks’ exposures to sovereign debt denominated in domestic currency, the advanced approach (IRB)—which is used in the US—requires banks to estimate risk parameters that lead to positive capital charges when global banks consolidate their balance sheets. While the banks’ costs may be at least partially offset by potentially lower capital requirements generated by the advanced approach used in the US on other asset classes such as real estate investment, for example, higher capital requirements on Mexican government debt may have a deeper implication for the Mexican sovereign bond market.
Pension Funds

75. **Mexican pension funds represent the second largest segment of the financial system.** Assets under management have well outpaced the growth of the capital markets, more than doubling in size since 2008. This is largely a result of the increasing number of participants since the establishment of the pension scheme in 1997 and the introduction of the reform to the participation of public sector employees in 2007. Assets under afores (pension fund managers) management now constitute about 14% of GDP, and have continued to climb rapidly over the last decade.

76. **Vibrant M&A activity in the pension fund industry has led to higher industry concentration.** Until now the industry has been following a consolidation path, as the number of administrators peaked at 21 at end-2007 and declined to 11 as of mid-2015. This was largely caused by a sequence of M&As, including with foreign players. The acquisition of ING Afore in 2012 by a Colombian asset manager –Grupo Sura – signified the entrance of a regional player into the Mexican pension fund market. As of mid-2015, Sura Afore held 15% of the industry assets and ranked as the third largest pension fund in Mexico. The three afores managed by the US entities constituted about 26% of the market share, while the remaining 60% of the assets fell under the management of domestic pension funds.

77. **Investment regime liberalization over the last decade has allowed greater diversification of pension fund assets, including through higher foreign asset holdings.** The Mexican pension fund regulator – CONSAR – has followed a path of gradual adjustments to the investment regime since the scheme’s inception in 1997, more so in recent years. In addition to asset allocation in debt securities, the regulatory framework allows pension funds to invest their assets in currencies, equities, Mexican private equity funds and real estate trusts, structured assets, and more recently swaptions and REITS. Mexican regulation also permits diversification through foreign securities holdings.
78. **Regulatory limits on certain types of investments, such as foreign securities, have become binding.** Portfolio allocation decisions of pension funds continue to be curbed by regulatory limits, originally instituted to stimulate financial market deepening and protect contributors from excessive risk concentration (Table 14). In addition to risk minimization, foreign investment limit implementation was also driven by the wish to direct savings towards domestic capital markets. The tiered-risk model – based on the contributor’s age – allows greater risk diversification for the younger cohort (SB4 fund), given the significant variation of limits by type of fund. For the system overall, loosening of regulatory limits over time has allowed greater diversification away from bonds into a broader range of instruments. While some limits continue to be set well above the actual holdings, others have become particularly binding, thus complicating the optimal portfolio allocation decisions of asset managers. Foreign security holdings, for example, have long reached the allowed limit, given the fact that Mexican pension funds have outpaced the growth and the supply of instruments in the domestic capital market. While both pension fund regulators and pension fund managers agree on the urgency of increasing in the foreign security holding limit, the process is complicated by the required approval of Congress.

79. **Foreign asset holdings are largely concentrated in equities, invested mainly in advanced economies and emerging markets outside of LA.** Given the vibrant domestic debt market and the stalled Mexican equities market, afores report a greater need for diversification of equities, rather than debt instruments, through foreign holdings. The current shares of debt instrument holdings remain significantly larger than in other OECD countries, while domestic holdings of equity remain relatively low, given the small size of the equity market in Mexico. The problem is further exacerbated as the growth of afores’ demand for assets may have inflated bubbles in the domestic capital markets. Thus, the anticipated increase in the foreign security holding limit is expected to be largely used for equity diversification. Currently, holdings of securities from other Latin American markets are reported to be limited. While investments in Brazil are stalled due to the perceived excess volatility in the market, investments in Chile, Colombia, and Peru are restrained by the relatively small size of these markets. Investments in individual markets, and particularly other LA countries, are reportedly discouraged by the need to employ specialists for stock picking due to insufficient familiarity with these markets, thus, encouraging investment in mutual funds. The Mexican market, on the other hand, provides an attractive opportunity for the Chilean and Peruvian pension funds, among others, for diversification purposes, given the disparate business cycles between Mexico and Latin American commodity exporters.
80. **Infrastructure products constitute a promising tool for diversification.** The current investment regime allows afores to invest in infrastructure, housing, and private equity through a number of vehicles. So far, the supply of infrastructure products has been limited, largely since they are still at an early stage of development. The anticipated energy reform is likely to promote energy product development in the market.

**Insurance Companies**

81. **The Mexican insurance sector remains fragmented and underdeveloped.** About 200 insurance companies operate in the market, jointly capturing about 2.1 percent of GDP\(^{15}\) and holding nearly 6 percent of GDP in assets. Insurance penetration remains well below the OECD countries’ average, and among the lowest in LA. Life insurance represents the largest segment, accounting for about 40 percent of the market. Damages insurance constitutes about 19 percent of the premia, and, given the country’s susceptibility to natural disasters, offers scope for growth. Auto insurance, at 19% of premia, remains depressed by the absence of the mandatory third-party motor insurance requirement in many states.

82. **Commercial and trade agreements have helped liberalize the industry and remove legal and regulatory barriers to entry.** Largely through various commercial and trade agreements, Mexico liberalized the financial services industry allowing foreign subsidiary ownership in the domestic market, resulting in a considerable foreign presence. As a result, insurance market is very open. The unrealized potential of the domestic insurance market, along with a strong regulatory framework—Mexico implemented the Solvency II-type standard in April 2015—constitute the main drivers of entry, including cross-border. Nevertheless, some implicit barriers exist, generated by the structure of the distribution channels. Life insurance products are mainly distributed through agents (nearly half of the market), and developing a sound agent base can be expensive and lengthy and serve as a deterrent for market entry.

83. **The foreign presence in the Mexican insurance market is considerable, closely trailing banks.** Most insurance companies in Mexico have ties to foreign institutions, mostly in the United States and Europe. Thus, among the largest 10 institutions, which comprise about 70 percent of the market, 60 percent of premia are captured by foreign-owned entities. The five largest institutions-- MetLife Mexico (US), Grupo Nacional Provincial (domestic), AXA Seguros (France), Seguros Banamex (US), and Seguros Banorte Generali (domestic)—control nearly half of direct premia, . The expansion of the Mexican insurance companies abroad, on the other hand, has been limited, possibly because of the sizable unrealized potential for growth of the domestic market. Expansion to other LA countries is also dampened by the elevated levels of market concentration of the insurance industry in LA-7 countries.

84. **Similarly to many other Latin American countries, financial integration through foreign investment remains limited.** The investment strategy of the Mexican insurance

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\(^{15}\) End-2014 CNSF data.
companies is only marginally influenced by the regulatory limits on different types of investments, including corporate debt, equity, structured notes, foreign financing vehicles and foreign securities, among others. Instead, it is largely dictated by the structure of the offered insurance products. Insurance companies at present invest the majority of their assets in domestic government securities. Given the small size and the low turnover and liquidity of the domestic equity market, access to domestic equities remains limited. The absence of a mandatory limit in holdings of government securities also provides an incentive for heavy reliance on that sector.

85. The growing importance of life and pension insurance products shifts the demand toward longer term financial assets denominated in local currency. Since annuities and life insurance products require long-term Mexican peso asset matching, insurance companies’ demand for instruments is moving toward longer-term domestic currency assets, up to 30 years of maturity. Since the local market can only offer instruments of much shorter durability, this creates a maturity mismatch. To avoid a currency mismatch, insurance companies seek Mexican peso-denominated assets, thus, resulting in foreign investments well below the regulatory limits. However, Solvency II-type regulation is expected to increase the foreign asset holding limit to 20% in the anticipation of more foreign asset investments going forward, the rising popularity of non-life insurance products denominated in foreign currency.

**Capital Markets**

86. Mexican capital markets have shown considerable heterogeneity in their speed of development. While the foreign exchange and debt markets have gained volumes and liquidity in the last few years, the domestic equity market has continued to stall. Family-based ownership of many Mexican firms, as well as informality, has hindered its growth. The largest banks, many of which are foreign-owned, and pension funds constitute the most important domestic institutional investors in the sovereign and corporate debt markets.

87. The Mexican peso has been amongst the ten most traded currencies since 2013, largely against the US dollar and in the form of foreign exchange swaps and spot transactions\(^\text{16}\). The Mexican peso is fully convertible, free-floating, without any exchange controls, with turnover reaching US$135 billion in 2013, raising its market share in the global FX trading to 2.5%\(^\text{17}\), from 1.3% in 2010. The US dollar vis-à-vis Mexican peso currency pair trading comprises the majority of Mexican peso trading, and constitutes about 2.4% of the global FX market transactions. Since the vast majority of these transactions take place offshore, the Mexican domestic market only manages about 0.5% of global foreign exchange market turnover.

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\(^{16}\) Based on BIS Triennial Central Bank Survey.

\(^{17}\) Because two currencies are involved in each outstanding contract, the sum of the percentage shares of individual currencies total 200%.
88. **Mexican sovereign debt securities are largely held by institutional investors.** About 31 percent of government debt bonds were held by foreigners as of May 2015, well exceeding Brazil and Colombia, but trailing behind Peru’s 40% foreign ownership of government debt. US and European funds, and Japanese pension funds, are among the largest foreign institutional investors. The corporate debt market has also displayed robust trends in the last few years, as foreign currency corporate bond issuances continue to be an important source of funding for the Mexican corporate sector. Estimates suggest that Mexico and Brazil jointly accounted for more than half of Latin American issuance of corporate debt in foreign currency in 2014.

89. **The development of the equity market has been stalled mainly at least in part by the structural characteristics of the private sector.** The Mexican stock exchange—La Bolsa Mexicana de Valores (BMV)—which is a shareholder-owned company, remains the second largest stock exchange in LA, trailing only Brazilian BM&F Bovespa. Despite the fair number of new IPOs that were launched in the last few years, the Mexican stock exchange remains small given the size of the economy, largely explained by the family-owned structure of many Mexican firms, the level of economic informality, and the alternative sources of funding, particularly in the United States. The number of listed companies on the stock exchange has been stagnant over the last decade. At end-2014, 147 companies were listed on the stock exchange, well below the levels in Peru, Chile, and Brazil. Only a few stocks dominate the IPC index (Indice de Precios y Cotizaciones), which is a capitalization weighted index of the leading stocks traded on the Mexican Stock Exchange.

90. **Mexico’s interest rate derivatives market remains active, with the majority of transactions taking place through over-the-counter (OTC) market, while the share of exchange-traded derivatives remains limited.** Exchange-traded derivatives are traded on the Mercado Mexicano de Derivados (MexDer, the Mexican derivatives exchange platform) and are
cleared through a central counterparty clearing house (CCP) ASIGNA, both of which are subsidiaries of the BMV. MexDer’s turnover remains small, with a reported market share in the low single digits. The establishment of MexDer has not resulted in a significant shift of OTC transactions to the Mexican electronic platform, largely because the OTC market is more competitive than MexDer, which charges considerable fees to cover its technical and technological costs. And the high foreign presence in the Mexican markets, the close trade and financial ties of Mexican companies to the US, and regulatory bias towards trading on recognized exchanges, have also pushed the derivatives market outside of Mexico, mainly to the US, UK, and Europe.

91. In the interest rate derivatives market, interest rate swaps, largely TIIE swaps (Tasa de Interes Interbancaria de Equilibrio, the equilibrium interbank interest rate) represent the majority of trading, as the volume of forward rate agreements, options, and other products remains rather limited. The OTC single currency interest rate derivatives turnover in Mexico stood at US$2.4 billion as of April 2013, representing about 0.1% of the global interest rate derivatives market. This is the second largest market in Latin America, trailing only Brazil. Most OTC single currency interest rate derivatives trading denominated in Mexican pesos, however, occurs in the US markets, with only 18% executed domestically. This is not unusual in Latin America (Panel 1), as OTC derivatives of other LA-7 countries are largely traded on the US and UK markets as well.

92. The GFC prompted changes in the regulatory frameworks in many countries, including Mexico, aimed to provide transparency and reduce counterparty risk. Regulatory adjustments to the G-20 frameworks, the Dodd-Frank law in the US, and EMIR in the EU, in line with the Basel III standards, introduced largely comparable regulatory modifications aimed to eliminate counterparty risk, increase price and valuation transparency, and collect information. The new regulations call for all standardized OTC derivative contracts to be traded on exchanges or electronic trading platforms and cleared through CCPs, while non-centrally cleared contracts would be subject to higher capital requirements. In the spirit of improving transparency and strengthening the derivatives market, and largely in line with the global regulatory changes, the Mexican authorities introduced a new regulation, scheduled for gradual implementation. 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. The new Mexican regulation will require derivative trades to take place on exchanges or through inter-dealer brokers, and call for a mandatory clearance of standardized derivatives through a CCP—Mexican (established in Mexico and authorized by the SHCP) or foreign (if recognized by Banco de Mexico).

93. The new regulation will bring more transparency and reduce counterparty risk, and may increase competition between ASIGNA and foreign CCPs. Higher CCP clearance volumes will also generate competition between ASIGNA and global CCPs, such as CME (Chicago Mercantile Exchange). While the volume on ASIGNA is expected to be driven largely by Mexican pension funds, clearance through CME is likely to remain significant given the large share of transactions involving multinational institutions headquartered in the US. A large share of
counterparties involved in derivatives trading are subsidiaries of foreign entities or have ties to other countries, as testified by the overwhelming majority of foreign subsidiaries among the “eight market makers” – the most active participants in the Mexican capital market. By clearing through a CCP in the parent country, foreign multinationals are able to consolidate operations through netting their derivative positions, thereby decreasing capital requirements. Thus, ASIGNA may maintain its domestic market share, and could become the primary vehicle for trading with regional participants, including through MILA, while foreign CCPs, such as CME, would largely handle the business involving the global multinationals.
Table 14. Mexico: Pension Funds’ Regulatory Investment Regime

<table>
<thead>
<tr>
<th>Markets and Liquidity Risks</th>
<th>Limits by type of Basic SIEFORE (fund)</th>
<th>SB1</th>
<th>SB2</th>
<th>SB3</th>
<th>SB4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value at Risk</strong> (^1)</td>
<td></td>
<td>0.70%</td>
<td>1.10%</td>
<td>1.40%</td>
<td>2.10%</td>
</tr>
<tr>
<td><strong>Difference of the Conditional Value Risk</strong> (^2)</td>
<td></td>
<td>0.30%</td>
<td>0.45%</td>
<td>0.70%</td>
<td>1.00%</td>
</tr>
<tr>
<td><strong>Liquidity coverage ratio</strong> (^3)</td>
<td></td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
</tr>
</tbody>
</table>

| Risk by issuer and/or counterparty \(^4\) | Debt from mxBBB to mxAAA or int'l currencies BB to AAA | 5% | 5% | 5% | 5% |
|                                          | Subordinated Debt mxBBB+ to mxBBB- or int'l currencies B+ to BB- | 1% | 1% | 1% | 1% |

| Assets Class limits                   | Foreign Securities \(^5\) | 20% | 20% | 20% | 20% |
|                                       | Equity \(^6\)             | 5%  | 25% | 30% | 40% |
|                                       | Foreign Currency \(^7\)   | 30% | 30% | 30% | 30% |
|                                       | Securitizations \(^8\)    | 10% | 15% | 20% | 30% |
|                                       | Structured securities \(^9\) | 5% | 15% | 20% | 20% |
|                                       | Infrastructure or Housing | Not applicable | 10% | 13% | 13% |
|                                       | Others \(^{10}\)          | Not applicable | 5% | 7% | 7% |
|                                       | Inflation protected securities \(^11\) | Ye\(\text{es}^{(1)}\), Max | No | No | No |
|                                       | Commodities \(^{12}\)     | 0%  | 5%  | 10% | 10% |

| Conflicts of Interest \(^{13}\)       | Securities by related entities | 15% | 15% | 15% | 15% |
|                                       | Securities by entities with patrimonial affiliation with the AFORE \(^{14}\) | 5%  | 5%  | 5%  | 5%  |

| Vehicles and Derivatives             | Investment Mandates | Yes | Yes | Yes | Yes |
|                                       | Derivatives \(^{15}\) | Yes | Yes | Yes | Yes |

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Source: CONSAR.

1/ As of June, 2015. All the limits are maximum percentages, with the exception of the inflation protection limit.

2/ As a percentage of the Assets Under Management (AUM directly managed by the SIEFORE).

3/ As a percentage of the High Liquid Assets of the SIEFORE.

4/ As a percentage of the Total AUM of the SIEFORE, including the assets managed by the Specialized Investment manager.

5/ Rating of medium- and long-term issuances, as well as the issuer and/or endorser, in the corresponding proportion. Repos and derivatives are computed in these limits as well.

6/ The regulation permits investments in foreign securities with a credit rating below A- and equal or greater than BBB-, nevertheless the AFORE must abide by the investment Regime Provisions and Financial Provisions (CUF).

7/ Applies to the asset holdings of all the pension funds by the same fund manager (AFORE), and for debt and structured securities. A CKD may exceed this limit if the issuance meets certain conditions.

8/ Includes individual stocks, IPOs, Domestic and international equity indexes listed in the Index Lists, and mandatory convertible debt into share for Mexican issuers.

9/ Securitization fulfilling the Eighth Transitory Provision of the Investment Regime Provisions are computed in this limits and are considered as being issued by an independent issuer.

10/ Includes CKDs, REITs, Mexican REITs (FIBRAS) and Debt in which the income sources comes from real assets. The regulation prohibits the investment in CKDs for the Basic Siefore 1.

11/ Minimum investment limit in securities that ensures a return equal or greater than the inflation rate in Mexico.

12/ The limits are written down in the SAR Law, Art 48. In exceptional cases it could be increased up to 10%. The limit is 0% for financial entities with patrimonial affiliations.
E. Panama

94. Panama is an important regional financial center, especially for Central America and part of South America. Banking assets are US$90 billion, or 200 percent of GDP at end-2014, with over 30 percent held by regional banks (and another 20 percent held by other foreign banks). Panama’s banking center includes a sizeable offshore sector. Of the 76 banks licensed in Panama, 49 operate with a general license (onshore; includes 2 state-owned), 27 have an international license (offshore). Offshore banks’ assets are 40 percent of GDP. The offshore sector is largely disconnected from the rest of the Panamanian financial system, and serves for such operations as foreign currency lending to Latin American or international corporates by banks outside their home jurisdiction. Domestic capital markets are the smallest in the LA-7 (bonds outstanding are 12 percent of GDP), compared to 33 percent of GDP for international bonds outstanding, and the domestic stock market capitalization is 33 percent of GDP. The range of activities undertaken by Panamanian financial institutions is relatively narrow: there is no significant activity on derivatives, structured products, or foreign exchange.

95. Both insurance companies and pension funds are small compared to the size of the banking sector, but expanding rapidly. Insurance companies’ assets account for roughly 5 percent of GDP, and foreign insurance companies own about half of the assets. Premium growth has been 12 percent for the life segment annually, and 8 percent for the non-life segment. Premiums per capita and insurance penetration figures are high relative to other LA countries (premiums per capita are US$320 and premiums amount to about 3 percent of GDP). The insurance sector is relatively concentrated. There are 33 companies, of which the 3 leading companies are of similar size and jointly account for 49 percent of total premiums, while 19 companies receive less than 3 percent. Insurance brokers monopolize the distribution of insurance products, and commissions are relatively high, making micro insurance and other low cost products unattractive. The two local pension funds, one public and the other private, account for about 0.7 percent of GDP. Since 2008, assets under pension funds’ management increased by about half.

96. Panama has important and growing financial linkages with the region and the rest of the world. According to the BIS, international banks have significant claims on Panamanian borrowers. Foreign claims (ultimate risk basis) on Panama have doubled since 2005 and were US$40 billion in 2014 (90% of GDP). Claims by the UK, which were among the highest until 2013, have dropped (likely due to the exit of HSBC), and foreign claims by
Germany and Spain (likely due to the exit of BBVA) also fell that year. Most foreign claims are on the non-bank private sector. Foreign claims of Panamanian banks on other countries have more than doubled since 2002 (US$21 billion in 2014), with lending to the remaining LA-6 representing 30 percent of total claims on others.

97. The withdrawal of global banks starting in the 1990s first led to a consolidation of the market and more recently, to M&As by LA banks. Foreign banks (i.e. Bank of America, Societe General, 7 Japanese banks, as well as some Swiss, Dutch and Spanish banks), controlling 70 percent of assets in the 1970s and 80s, withdrew in the 1990s. Their assets were mostly acquired by domestic banks, which led to a consolidation of the market (e.g. Primer Banco del Istmo doubled its market share to 12 percent of total assets between 2000 and 2008). Since 2008, banks from Colombia acquired assets of withdrawing banks and institutions (i.e. HSBC, BBVA, and GE). In 2010, Colombian Grupo Aval, through Banco de Bogota, bought GE’s 75 percent share in BAC International. In turn, BAC International, acquired BBVA in 2013. The same year, the largest Colombian bank – Bancolombia - acquired HSBC’s assets. Colombian banks own 22 percent of assets in Panama.

98. Cross-border credit to the region is important. Credit to GDP is 90 percent (one of the highest in the LA-7), but credit growth has remained in line with nominal GDP growth in the past four years. Credit to non-residents is 30 percent of total credit (US$15 billion) and 30 percent of GDP, and has recovered following a sharp deceleration associated with HSBC’s departure. Costa Rica, Brazil, Mexico, and Colombia are among the largest borrowers, and receive 45 percent of foreign credit. Foreign investments, foreign loans, and deposits in foreign banks (as many banks hold sizeable deposits at their parent banks or other banks abroad) are about 40 percent of total bank assets. Half of the securities bought are foreign (US$7.5 billion), and most investments are made in securities in the U.S. (30 percent of total foreign securities), Costa Rica, Mexico, Colombia, and Brazil.

99. Acquisitions by regional insurance companies and pension funds remain limited. Only the Colombian insurance company Suramericana has expanded to Panama, and several other Central American countries, and has a strategy of expansion to LA. Foreign investments by insurance companies and pension funds are very small. Investments by pension funds are concentrated in local bank deposits (50 percent) and domestic fixed income securities (less than 10 percent). Only 2 percent of total investments are investment abroad (most in LA). The rest is invested in equity and non-financial institutions. Investments by insurance companies are concentrated in equities (80 percent), while 20 percent is invested in bonds, and similarly only about 2 percent abroad.

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18 Colombian banks, significant holders of important claims on Panama, do not report their foreign claims to the BIS.
100. **Banks are well capitalized and profitable.** Banks have significant capital buffers, and good asset quality. Tier 1 capital is 14.1 percent at end-2014, which is higher than the average for LA. NPLs are 1.3 percent at end-2014, have slightly increased since 2013, but are below the average for LA. Margins are low relative to other LA countries, and profitability has been declining, pointing to increased competition in the banking system. ROA and ROE are much lower than the average for LA. Credit risks are lower, given a declining trend in NPLs and a deceleration in credit growth, and market and liquidity risks have declined, as banks are less reliant on non-resident deposits and foreign liabilities.

101. **Banks rely in large part on a stable domestic deposit base.** Retail funding is about 85 percent of total funding. Local deposits represent 70 percent of total deposits (US$46 billion), and banks are less reliant on foreign deposits (they were 53 percent of total deposits in 2008), but local deposits are likely to be overestimated as they include as residents multinational corporations incorporated in Panama, as well as offshore companies, trusts, and foundations. Foreign deposits have been recovering after HSBC’s departure; the largest share of foreign deposits comes from Venezuela (22 percent), Ecuador (11 percent), Costa Rica and Colombia (about 8 percent each).

**Challenges for financial stability in the context of increased regional integration:**

102. **Complex conglomerates with cross-border operations raise important challenges for effective supervision and the assessment of macro-financial stability.** The conglomerates operating in Central America have complex corporate structures, including overlapping layers of holding companies (one of which could be in Panama) and entities (bank, non-bank, and real sector) in several financial sectors (including in Panama), and thus fall under different supervisory authorities which may not cooperate sufficiently. In Panama, there appeared in the past to be incentives to attract financial business through laxer regulation and requirements. This model is obsolete, with outside supervisors increasingly imposing home country requirements across the whole financial institution, and with the threat of large fines on the institution in the event of lack of full compliance with the requirements of the home country authorities. Coordination among supervisory agencies in the region has been improved through the establishment of a Council of Supervisors (FCC) for all supervisors in Central America and Colombia, and efforts are under way to further enhance supervisory capacity.

103. **Slow progress in implementing Basel III, including capital definitions, liquidity and leverage rules, and capital buffers, could lead to inadequate identification of cross border and interconnected risks and insufficient capital held against such risks.** The absence of a well articulated framework and available capital buffers (Pillar 2, D-SIB buffers) could result in lower levels of loss absorbency and risk mitigation exposing complex conglomerate structures to own risks, but given their size and the complexity of their cross border operations could lead to systemic risks as well.
Figure 33: Cross-Border Financial Linkages

International bank claims of largest countries on Panama
(Millions of $, consolidated - ultimate risk basis)

International bank claims on Panama, by Sector
(Millions of $, consolidated - ultimate risk basis)

Foreign claims of Panama on all countries, including on LA7
(Millions of $, consolidated - immediate borrower basis)

Consolidated Foreign Claims of Reporting Banks in Panama on Top 10 Individual Countries

Foreign credit by country, 2014 (%)

Foreign securities by country, 2014 (%)

Legend:
- JP: Japan
- CH: Switzerland
- DE: Germany
- GB: United Kingdom
- ES: Spain
- US: United States
- PA: Public Sector
- PA: Non-bank private sector
- All countries
- Rest of the World
- LA7

COUNTRY
- UNITED STATES
- COSTA RICA
- MEXICO
- COLOMBIA
- BRAZIL
- CAYMAN ISLANDS
- PERU
- CHILE
- OTHER

YEAR
- 2002
- 2003
- 2004
- 2005
- 2006
- 2007
- 2008
- 2009
- 2010
- 2011
- 2012
- 2013
Figure 34. Panama: Financial Soundness Indicators
F. Peru

104. The financial system in Peru is relatively small, but growing solidly. Between 2006 and 2014 the broad financial system including insurance and pension funds grew from US$52.3 billion (58.1% of GDP) to US$175.8 billion (90.8% of GDP). Most of the financial system (except for the stock exchange) is under the consolidated purview of the superintendent for banks, insurance and pensions (SBS). The banking system is assessed to be largely Basel II compliant with SBS reporting that Basel III compliance is expected in the next few years. Some of the larger, particularly foreign owned, banks have already adopted many Basel III principles. All firms traded on the Bolsa de Lima must file IFRS compliant annual reports to the securities regulator. Despite a high level of dollar deposits, the banking system maintains relatively low non-resident asset exposure and while the share of foreign liabilities is on the rise, it is still less than 10% of the system’s balance sheet. The importance of insurance and pension funds deposits in the banking system has declined markedly, but they still account for 11 percent of total deposits.

105. There are no legal impediments to foreign financial institutions entering, operating or exiting Peru. The legal regime provides for equal treatment of foreign and domestic entities. Foreign institutions are free to operate as either branches or subsidiaries, though currently there are no branch operations of foreign banks. Within the four largest banks, accounting for about 85% of total assets and credit, two (Banco del Credito and Interbank) are controlled by domestic conglomerates and two are foreign owned institutions. BBVA purchased half the controlling interest in Continental bank in 1995 to become the second largest bank by assets. Scotiabank purchased the operations of two smaller banks in 2006 and is now the fourth largest bank. The SBS supervisor reports strong interest from many foreign financial firms to obtain operating licenses. The insurance sector in particular has seen many new applications and entrants from abroad.

106. Highly concentrated market structures as well as tax and supervisory issues were identified as potential impediments to foreign investors. The dominance of a few firms in the banking, brokerage, and pension management sectors was the most commonly cited impediment to integration of the financial system with other countries, regional or otherwise.
As already noted in this report, the difficulty of building market share organically leads most international banks to target only the largest 3–4 institutions in a country for acquisition. The top 4 banks are sufficiently large and profitable that buying into Peru has become cost prohibitive, while the small market share of remaining banks would require significant business development to achieve critical mass. Also, the SBS’s exhaustive efforts to document ownership structures to ensure compliance with a prohibition against multiple licenses to subsidiaries of the same parent may draw out the licensing process, and thus may freeze out some potential purchasers. Moreover, the 30% tax on dividend repatriation may weaken the incentive for foreign institutions to operate in Peru.

107. **Divestiture of regional operations by global banks, and the special skills developed by Peruvian banks, may present expansionary opportunities for some Peruvian banks.** Banco del Credito del Peru (BCP), a subsidiary of the Creditcorp conglomerate, the largest bank by assets and deposits in Peru, already owns the fourth largest private bank in Bolivia, and an asset management/insurance company in Chile, and is likely seeking opportunities in other countries. Interbank, the fourth largest bank and its conglomerate parent, Intercorp, are focused on developing organic growth in Peru, though Interbank’s strength in retail banking and reaching underserved segments could be leveraged in other countries with high informality.

108. **Private pension funds have been successful at drawing out domestic savings and broadening the formal financial system.** About 5 million adults (out of nearly 20 million aged 15–64) are enrolled in Peru’s private pension fund system. The system caters to formal sector employees, who are required to contribute 10% of their salaries to funds administered by one of 4 fund managers (AFPs). Under each administrator there are 3 age-determined, risk-tolerant funds. Funds for the youngest workers have the highest risk tolerance, while the risk profile for funds reserved for people closer to retirement is less aggressive. Younger participants may elect to save in the more conservative pool, but older subscribers are prohibited from moving into riskier funds. Unlike pension funds in other LA-7 countries, upon retirement, a lump sum is not paid to the individual. Rather, the AFP is charged with a fiduciary responsibility to provide a stream of income for the remaining years of life proportionate to the accumulated savings of the individual. Strong domestic growth has increased both the number formal employees and their salaries such that contributions now grow by over US$230 million each month (US$130 million net of fees and paid benefits).

109. **The supervisors penalize funds that do not yield a minimum level of returns, and organize a competitive auction every 2 years to contain management fees.** Minimum financial returns are determined as the average systemic return less 2% over the previous 36 months. Fund managers must “top up” returns from their own capital if they fail to meet

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19 However it is estimated that only about half the 5 million contribute regularly as the others are independent or contract workers. Reforms are under consideration to facilitate contributions by independent, contract or other informal workers.
minimum returns. As in other countries with minimum return requirements, AFPs in Peru therefore mimic each other’s asset class holdings and have very similar risk/return profiles. Consequently it is considered that competition to attract competitors’ clients is based more on marketing than net returns. All new subscribers are enrolled with the same AFP, however, every two years, the SBS solicits proposals for this rate in which the winner is the one with the lowest proposed management fee. If the lowest fee is lower than the current rate, the new lower rate is then applied to all of its subscribers. After the initial two years, subscribers are free to move their savings to a different AFP.

110. The rapid growth of assets under management now exceeds the capacity of capital markets to provide sufficient portfolio securities. While about 180 shares and are over 350 bonds listed on the Lima exchange, the aggregate value of stocks and bonds traded in 2014 was about US$5.8 billion or 3.7 times annual net contributions. The universe of investable domestic securities for pension funds shrinks further once small cap and infrequently traded listings are excluded. Deposits in the banking system have also become less attractive as easier external financing conditions and solid fiscal and macro-management have combined to push down treasury and deposit yields. With increasingly limited domestic investment options, the supervisor has had to increase the limit on foreign asset holdings several times; it now stands at 50 percent\(^{20}\) and the limits are effectively binding on nearly all funds. Many financial market participants and regulators are calling for higher foreign asset limits, if implemented gradually to avoid abrupt sales of nuevo soles in the onshore market. Proposals to treat MILA country assets as domestic securities (and not count towards the foreign asset limit) or to create a special category for pension fund holdings of MILA country assets would (i) ease the demand for domestic assets while promoting regional integration, and (ii) lower the cost of access to regional securities, provided costs for hedging cross rates and market risk also come down.

111. As in other countries of the region, insurance markets in Peru are small, but developing steadily. In 2014, the industry collected about US$3.4 billion in premiums and held $11.1 billion in assets (1.8% and 5.8% of GDP respectively). The sector is fairly concentrated with 6 of 18 firms accounting for about 75% premiums and 72% of assets. While several foreign firms are active through local subsidiaries (Mapfre and Sura being the two largest foreign subsidiaries), most insurers are domestically owned. Premiums between life insurance and property/casualty policies segments are evenly split at about US$1.7 billion. Insurance policy issuance is largely concentrated among

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\(^{20}\) 50 percent is the statutory limit, though the regulator currently limits holdings to 42 percent as the effective cap is raised slowly to stem large capital outflows and volatility in the on-shore FX market.
formal, high wage earners, so macroeconomic development leading to higher incomes and greater employment formality are expected to drive deeper penetration going forward. Most policies are written in nuevo soles: thus for currency matching reasons firms generally have fewer foreign holdings than the statutory limit of 40% of assets. Insurance companies reportedly face difficulties finding sufficient long term local currency assets in domestic capital markets in order to match the long term liabilities in the life policy segment.

112. **Peruvian equity markets are modest in size; domestic bond markets are significantly smaller than in LA-7 counterparts (except Panama and Uruguay), and experience low liquidity.** In 2014, equity markets had a market capitalization of nearly 60% of GDP and 180 listed firms (both indicators larger than in Mexico); about 40% of the market capitalization is tied to firms that primarily trade in New York. Liquidity concerns are also apparent in the low frequency of IPO issuance, muted volume of shares traded, and the large number of infrequently traded firms. In 2015, authorities introduced exemptions on capital gains and other reforms related to short selling, automated trading, and market makers to encourage higher trading volumes. Domestic bond markets are characterized not only by their small size and low trading volumes, but also by the limited number of long term bonds. While trading in the money market is quite active, especially for corporate issuers, only a small number of securitized instruments are listed on the BVL, and, derivative products are not traded domestically.

113. **There is scope for the Lima and Mexican exchanges to lead capital market integration within MILA and the region.** The 2013 agreement between the exchanges, which included the BMV attaining an 8 percent ownership stake and gaining a board seat on the BVL

<table>
<thead>
<tr>
<th>Table 15. Indicators of Equity Market Size and Liquidity on the Lima Exchange (BLV), 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Number of</td>
</tr>
<tr>
<td>firms</td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>Equities that trade more than 4 times a day, on average¹</td>
</tr>
<tr>
<td>Equities that trade 1 to 4 times a day, on average²</td>
</tr>
<tr>
<td>Equities that trade once a day or less, on average³</td>
</tr>
<tr>
<td>of which, those that traded 10 times or less in 2014</td>
</tr>
<tr>
<td>BVL total equity market</td>
</tr>
<tr>
<td><strong>Memorandum items</strong></td>
</tr>
<tr>
<td>domestic equities issued abroad</td>
</tr>
<tr>
<td>foreign equities listed on BVL by market makers</td>
</tr>
</tbody>
</table>

Sources: Bolsa de Valores de Lima and IMF staff calculations.

¹ Securities with more than 1000 executed trades in 2014 which had 252 trading days.
² Securities with between 250 and 1000 executed trades in 2014.
³ Securities with less than 250 executed trades in 2014.
also envisioned cooperation on technology and best practices: the BVL was to share its experiences, facilitating junior mining (pre-extraction) financing and alternative markets, while BMV was to help the BVL with establishing derivatives and commodities markets. At end 2014 a new cooperation was signed between the stock market regulators in the two countries.21 The level of cooperation by both exchanges and regulators could be a model for greater harmonization within the MILA countries, and beyond.

Table 16. Indicators of Debt Market Size and Liquidity on the Lima Exchange (BVL), 2014

<table>
<thead>
<tr>
<th></th>
<th>Debt securities outstanding</th>
<th>Number of Trades</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(Mil USD)</td>
<td>(pct of all BVL debt secur. outs.)</td>
</tr>
<tr>
<td>Total</td>
<td>$1,051.3</td>
<td>23.7</td>
</tr>
<tr>
<td>Corporate</td>
<td>$756.4</td>
<td>49.1</td>
</tr>
<tr>
<td>Public</td>
<td>$294.9</td>
<td>27.2</td>
</tr>
<tr>
<td>Continuous market</td>
<td>$343.6</td>
<td>28.9</td>
</tr>
<tr>
<td>Corporate</td>
<td>$122.2</td>
<td>26.9</td>
</tr>
<tr>
<td>Public</td>
<td>$221.4</td>
<td>21.0</td>
</tr>
<tr>
<td>Money market</td>
<td>$707.7</td>
<td>47.4</td>
</tr>
<tr>
<td>Corporate</td>
<td>$634.2</td>
<td>41.2</td>
</tr>
<tr>
<td>Public</td>
<td>$73.5</td>
<td>6.1</td>
</tr>
</tbody>
</table>

Sources: Bolsa de Valores de Lima and IMF staff calculations.

G. Uruguay

114. Uruguay’s financial system assets amount to about 92% of GDP, making it larger, in GDP-weighted terms, than the financial systems of Colombia and Peru, but smaller than Brazil, Chile and Panama. While the size of the system relative to the economy does not draw attention, there is much scope for financial deepening, as Uruguay’s private credit intermediation ratio is one of the lowest in the region. Banks dominate the financial landscape, but pension funds have grown in recent years and are the main institutional investors. The state plays a predominant role in Uruguay’s financial sector, with public institutions controlling 45 percent of banking system assets, 60 percent of pensions, and 80 percent of the insurance market.

115. Credit to the private sector in Uruguay, at just 25 percent of GDP, is among the lowest in the region. The high degree of financial dollarization in Uruguay (80 percent of deposits and 60 percent of loans are in U.S. dollars) is a key factor. Given the history of high inflation and currency devaluations, people have a preference for holding their savings in U.S. dollars, but the majority of lending to households is in pesos. Since the bulk of banks’ liabilities are in dollars, they limit their peso lending to avoid currency mismatches on their balance sheets. Dollar credit is stifled by high reserve requirements for foreign currency deposits on the supply side, and high transaction costs coupled with easy access to direct lending, bond markets and high levels of FDI on the demand side.

116. The crisis of 2002 left a legacy for Uruguay’s financial system. The role played by foreign banks, FX deposit withdrawals (especially by non-residents) and relatively lax regulations during the crisis have shaped the current policy mindset and supervisory framework. When the crisis erupted in 2002, key prudential regulations for FX-related risks (liquidity, reserves, capital requirements) were virtually nonexistent, even though almost 50 percent of total deposits were from nonresidents. By the end of that year, the banking system had lost 46 percent of total deposits, and the level of nonresident deposits had fallen by 65 percent; the bank run had led to the closing of one bank and the intervention/restructuring of three. The government provided US$2.4 billion in liquidity support. In December 2002, a new banking law was passed that strengthened regulations to limit liquidity and FX risks significantly. The system remains heavily regulated. At the same time, the 100 percent backing of US dollar demand and savings deposits—but not time deposits—in 2002 likely still impacts the choices of Uruguayans when putting their money in banks (90 percent of total deposits today are in short-term demand or savings deposits). The legacy of 2002 has led to a preference for caution and liquidity—which to a certain extent may have worked against deepening.
117. The banking system in Uruguay comprises two public banks, and nine private—all of which are foreign-owned. Commercial banks account for almost three-quarters of total financial system assets. The banking system is concentrated with the large public bank, Banco del Republica Oriental de Uruguay (BROU), holding 40 percent of total banking assets, and the top four banks holding three-quarters of assets. There is only one large regional bank: Banco Itau of Brazil. The sector is marked by a high degree of segmentation between the public and private banks. Until recently, BROU enjoyed a monopoly on public employee accounts by law, which has given the large public bank a majority share of the peso deposit market (largely at zero cost), and thereby facilitated its strong presence in the high spread peso retail lending market. The foreign banks, on the other hand, have highly dollarized deposit bases, and cater to commercial, higher income and some retail segments, in a highly competitive environment.

118. High operating costs and relatively low profitability have led to a process of consolidation in Uruguay’s banking sector. Banking fees and rates in Uruguay are high compared to the region because labor and operating costs are very high, while the high degree of competition among private banks operating in a dollarized environment has constrained their profitability. Consolidation of the sector, from 20 private banks in 2002, to just 9 private banks today has been driven at least in part by the search for efficiency gains through greater scale in this environment. Most of the consolidation has taken the form of mergers between foreign-owned banks' operations in Uruguay: in 2008, Santander and ABN Amro merged; in 2011, BBVA and Credit Agricole merged. Most recently, in December 2014, Scotiabank signed an agreement to buy Israel’s Discount Bank Latin America, Uruguay’s ninth largest bank, that will make Scotiabank the fourth largest bank by assets. Given the need for scale, it is likely that regional banks wanting to enter the Uruguayan market would have to do so through similar mergers rather than as greenfield entrants.

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22 The new financial inclusion law allows public employees to choose private banks for their payroll accounts.
119. The absence of private domestic banks in Uruguay, and the lack of focus of the BROU on regional opportunities, has dampened the extent of cross-border and regional activity by Uruguayan banks. When Scotiabank entered Uruguay in 2011, it did so by acquiring Banco Comercial, the last private domestic bank operating in Uruguay. Following this acquisition, Uruguay was left with only foreign private banks. This has had a material impact on cross-border regional banking activity. While Banco Comercial (and other private domestic banks) had historically maintained significant cross-border business ties with Brazil and Argentina, as well as non-negligible investments in regional banks, the entrance of Scotiabank severed these ties. The foreign private banks must abide by parent country regulations and compliance standards that are becoming ever more stringent. Many of these global banks have subsidiaries in various countries in the region, which operate as independent entities and are not allowed to pool their capital for projects. As a result, foreign assets of the banking system have reduced considerably in the past decade, as have non-resident deposits (which have shrunk to just 15 percent of total deposits, from 50 percent during the 2002 crisis).

120. Banks’ financial soundness indicators are adequate but there is heterogeneity, and overall banking profitability is low compared to the region. Uruguayan banks have adequate capital levels and ample liquidity. Resilience indicators are generally strong, with NPL ratios at less than 2 percent of total loans, loan-loss provisions on average three times larger than NPLs, and net foreign exchange positions below 1 percent of capital. Nevertheless, a few soundness indicators have weakened slightly in recent years—in particular, foreign currency lending to un-hedged borrowers has risen steadily, from 26 percent of total private sector loans in 2010 to 31 percent in 2014. Bank profitability on the whole remains subdued given the high levels of deposit dollarization and dollar liquidity, low interest rates on U.S. dollar assets, and high operating costs. That said, there is significant heterogeneity between BROU and the private banks, with the former enjoying higher profitability aided by its predominant position in the peso market.

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Figure 39. Uruguay: Return on Equity and Assets (Percent)

23 Staff Report for the 2014 Article IV Consultation, No. 15/81.
24 Ibid.
Figure 40. Uruguay: Selected Financial Soundness Indicators

Bank Regulatory Capital / RWAs (%)

Bank NPLs / Total Assets (%)

Bank ROA (%)

Bank ROE (%)

Capital Adequacy Ratio for Banks with Systemic Surcharge
(In percent; regulatory capital requirement from 2012 in parentheses)

Non-Performing Loans and Provisions in percent of Total Loans
(In percent)

Sources: Banco Central del Uruguay
121. **Pension funds are the main institutional investors in Uruguay.** There are four pension fund managers, with collective assets under management amounting to US$11 billion (20 percent of GDP). The defined-contribution pension system is characterized by two funds (an accumulation fund and a retirement fund). The largest of the fund managers is the publically-owned Republica AFAP, with almost two-thirds of pension assets (US$6.2 billion). The three private AFAPs are all regionally-owned: AFAP SURA from Colombia (US$1.99 billion); Union Capital, owned by Itau (US$1.82 billion); and AFAP Integracion, owned by the Venezuelan Banco Bandes (US$998 million). Given the small size of Uruguay’s private capital markets, nearly 80 percent of the pension system’s assets are invested in government bonds and held to maturity. The investment regulations governing the funds currently permit only 15 percent of assets under management to be invested abroad. Expanding this limit would not only diversify the investment portfolio of the pension funds from a risk management perspective, but also mitigate against the present crowding of out retail investors in the face of the limited investment opportunities in the domestic market. Enhancing regional integration and perhaps including a separate investment limit for regional investments could be a solution—particularly as the three private AFAPs are owned by regional pension fund managers and could capitalize on the expertise of each for regional investments.

122. **The insurance market in Uruguay is small and dominated by the large state-insurance company.** Total assets of insurance companies in Uruguay amounted to US$3.2 billion at end-December 2014 (6 percent of total financial system assets, or 5 percent of GDP). There are 15 insurance companies operating, but the sector is dominated by the state-owned Banco de Seguros del Estado (BSE), which controls 82 percent of the insurance market.

123. **The capital markets in Uruguay are small but there is purportedly a large informal market and much scope for deepening.** While total risk capital managed by brokers in Uruguay is projected at about US$5 billion (10 percent of GDP), only 5 percent of this goes through the formal Bolsa de Valores. There is a large informal market a significant volume of direct placements of securities between securities issuers and the pension funds. Given high brokerage fees, it is less costly for private companies to go directly to banks for private placements than to go through brokers. Formal capital market activity has also been dampened as the global banks have withdrawn their brokerage activities in Uruguay. Becoming an integrated member of a regional capital market initiative could be beneficial to Uruguay given the relatively small size of its market, need for scale, and room for deepening.
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Annex—Legal Frameworks

This annex serves as background to the Section on “Legal Barriers to Regional Integration” in the main paper. It summarizes staff’s legal analysis of the relevant legal provisions in legislation and secondary regulation. It is based on “desk reviews” performed at IMF headquarters and on discussions held with authorities and the private sector.

BRAZIL

A. Prudential Rules on Establishments

Inward

This section will describe the legal framework governing the opening by foreign financial institutions of subsidiaries, branches and representative offices in Brazil, as well as the acquisition of equity stakes by foreign financial institutions in Brazilian financial firms. The specificity of the Brazilian framework pertaining to such access of non-residents to the Brazilian financial market is that the key provisions are included in the Constitution.

Banks - Subsidiaries and Equity Stakes

The Brazilian Constitution requires Congress to enact legislation on the participation of foreign capital in the financial sector (Art. 192 of the Constitution). Until such legislation is enacted—and no such legislation has been enacted to date—nonresidents are not allowed to hold shares in domestic financial institutions (which mainly entails banks, but not insurance firms), or increase their equity stakes in any domestic bank (Constitution, Transitional Provisions, Art. 52). Shareholdings existing when the Constitution entered into force on October 5, 1988 are, nonetheless, grandfathered.

A waiver for this constitutional prohibition may be granted by the President of the Republic. Such waiver may be justified on the basis of (i) international agreements, (ii) reciprocity, or (iii) the interest of the government. In this regard, the acquisition of non-voting shares in a publicly traded financial institution is presumed to be in the government’s interest, and the waiver is automatically granted (Presidential Decree of December 9, 1996).

In respect of the procedure for obtaining the Presidential waiver, the central bank reviews, and submits for the President’s decision, the applications for licensing of a bank in which a nonresident intends to hold a direct or indirect participation, or for acquisition of, or increase in, a direct or indirect participation in an existing bank by a nonresident (BCB Circular 3317/2006, article 1).

Foreign banks intending to acquire an equity stake in a domestic bank must register their investment with the central bank (Resolution 3844/2010, Annex I, article 5).
Members of the senior executive management of a bank must reside in Brazil (Resolution 4122/2012, Annex II, article 2). In addition, nonresident supervisory board members must authorize a resident representative to receive judicial summons on their behalf and register as a taxpayer in Brazil (Law on Corporations, article 146; Decree 3000/1999). Non-Brazilian nationals must secure a work permit, except in the case of citizens of a State that has signed the Agreement on Residence for Nationals of State Parties to the Southern Common Market (Mercosur and Associates) and who hold a two-year temporary residency authorization. (Normative Resolution 104/2013, of the National Immigration Council; Normative Instruction 111/2010, of the Department of Business Registration and -Integration).

Both the establishment of a local subsidiary and the acquisition of a controlling interest in a domestic bank are conditioned on non-objection by the home country supervisor (Resolution 4122/2012, Annex I, article 18).

**Banks - Branches**

Just as in the case of nonresident ownership of local banks (paragraphs 2–4), and until legislation on the participation of foreign capital in the financial sector is enacted, foreign banks are not allowed to open new branches in Brazil as from the entry into force of the Constitution (Transitional Provisions, Art. 52). Other provisions that apply to branching as well as to nonresident ownership are those (i) waiving the aforementioned prohibition on the basis of international agreements, reciprocity or governmental interest (para. 3); grandfathering existing participations or branches (para. 2, in fine); granting decision-making authority to the President (para. 3); and mandating registration of the investment with the central bank (para. 7).

Although the law sets out that foreign banks are subject to the same statutory provisions as those applicable to domestic banks (Law 4595/1964, article 39), the legal framework does not explicitly extend to branches of foreign banks the capital and governance requirements applicable to domestic banks.\(^1\) With regard to capital standards in particular, foreign banks are not expressly required to set aside capital for their operations in Brazil. Nonetheless, the central bank’s *Financial System Organization Manual*, which is not legally binding per se, contains language on the augmentation of branch capital (items 4-21-20 and 4-22-50-18), mandating, for example, that paid-in capital be converted into local currency and deposited with the central bank, as occurs with national financial institutions.

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\(^1\) Thus, opening a branch by a foreigner will require the compliance with the capital requirements and operational limits established in the regulations for a national institution (Resolution 4.072/2012, article 2). For example, the regulation of the minimum capital requirements for each type of financial institution that is established in the article 1 of the Annex II of the Resolution 2.099/1994.
Banks - Representative Offices

According to Resolution 2592/1999, representation offices may be opened but they must only operate as a commercial or information contact for the main office or branches located abroad.

Insurance Firms - Subsidiaries and Equity Stakes

The legal framework provides for the constitution of insurance firms only as corporations “sociedades anônimas”, under national law. Brazilian law does not prohibit foreign nationals to acquire shares in insurance firms.

Pension Funds

Supplementary pension funds are classified as “closed entities” or “open entities” and their organization varies accordingly. Closed entities are organized as foundations or civil societies, are not for profit and only accessible to employees of a certain company/group of companies, unions, provinces or municipalities. “Open entities” are organized as corporations, under national law, and are accessible to anyone who wants to invest with them.

Outward

Banks

Domestic banks may open branches abroad or acquire direct or indirect ownership interests in banks or similar entities established in other jurisdictions provided the acquirer: a) has been in business for at least six years; b) complies with the applicable prudential requirements; c) holds a capital surcharge of 300%; and d) demonstrates the viability of the intended business (Resolution 2723/2000, article 2). The central bank must be satisfied it can obtain access to information, data and documents necessary to ensure the effective exercise of supervision on a consolidated basis (id.). Cross-ownership, whether direct or indirect, among domestic banks and their foreign affiliates is disallowed (id., article 7).

Insurance Firms and Pension Funds

Insurance firms/open entities may open branches or subsidiaries abroad, subject to prior authorization from the Ministry of the Industry and Commerce through an application before the Superintendency of Private Insurance (SUSEP). The application process is exactly the same as that one required for licensing domestic insurance firms/pension funds operating in Brazil.

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2 Decreto-Lei N°73, de 21 de Novembro de 1966, Art. 72; and Lei No 4.595, de 31 de dezembro de 1964, Art. 25.
3 Lei Complementar N° 109, de 29 de Maio de 2001
4 Decreto N° 60.459 regulating Decreto-Lei N° 73; Decreto N°. 81.402
B. Rules on Cross-Border Investment/Lending/Borrowing

Banks - Local asset maintenance requirements

See para. 9.

Local financial firms’ investments in financial assets abroad

Domestic banks are subject to counterparty exposure limits that do not discriminate against nonresidents. In general, a bank’s exposure to a single client or group of clients must not exceed 25% of capital (Resolution 2844/2011, articles 1 and 4). The total combined large exposure must be less than 600% of capital. Banks must also observe exposure limits on exchange rate fluctuations of 30% of capital on a consolidated basis. The central bank is authorized to amend this limit.

Domestic banks are allowed to borrow overseas and to use freely the proceeds in their domestic operations (Resolution 3844/2010, Annex I, article 10).

Domestic banks may also take deposits from nonresidents in local or foreign currency. Local currency deposits owned by nonresidents must be registered with the central bank and are subject to the rules on foreign exchange transactions (Resolution 3568/2008, articles 24 and 25). Only foreigners in transit in Brazil and Brazilians residing overseas are allowed to hold foreign currency deposits (id., article 34).

Insurance Firms and Pension Funds

In principle, insurance firms and open entities are not allowed to invest their resources in assets abroad with the legal framework. Among the exceptions are investments by branches or subsidiaries established abroad; equity stakes in insurance companies, reinsurers, or pension funds previously authorized by SUSEP, and investments expressly provided for by CMN (National Monetary Council) or CVM (Securities Commission) regulation. In connection to the last exception, the CVM enacted two new regulations – Instrução 554 and 555 that broaden the scope and limits for foreign investments. According to these regulations, insurance firms and open entities are considered 'professional investors' and have the following foreign investment limits:

- **unlimited**: for funds intended exclusively for professional investors that include the suffix 'investment abroad'; and for funds intended exclusively for professional investors that establish in their bylaws that a minimum 67% of the liquid capital is to be invested in financial assets abroad.

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5 Resolução CNSP N° 321, de 2015 Art 91 VI
6 Both regulations date from mid and end 2014, but are in place since mid-2015.
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- **40% of liquid assets**: for funds intended exclusively for professional investors to which the unlimited exception above does not apply.

In addition to these limits, the CVM regulations include limits per issuer and per issuance.

**Rules governing/authorizing the cross border provision of banking and financial services**

Foreign banks may lend to resident persons or companies, subject to registration of the transaction with the central bank (Resolution 3844/2010, Annex II, article 1). The costs and terms and conditions of such transactions must follow those usually observed in international markets (*id.*, article 3).

Foreign banks are allowed to invest in instruments and securities negotiated in the domestic financial and capital markets. The investors and their investments must be registered with the securities commission and the central bank, respectively (Resolution 4373/2014, articles 3 and 4).

Foreign banks may take deposits from resident persons or companies provided the rules on international money transfers are observed (Resolution 3.568/2008, article 8(1)).

**Insurance Firms**

The law only permits purchasing insurance policies offered by Brazilian companies. The law allows Brazilian residents only under exceptional circumstances to buy an insurance policy offered by a foreign firm (i.e. when the policy covers of risks not offered within the country; the case of insurance policies subject to international agreements ratified by Congress). However, Brazilian residents can acquire foreign insurance to cover for risks taking place outside of Brazil.

**C. Trade Liberalization and Bilateral Investment Treaties**

**Multilateral**

Brazil is a member of the Southern Common Market (Mercosul or Mercosur, in the Portuguese or Spanish acronyms) and a party to the financial services annex to the Montevideo Protocol on Trade in Services. This annex provides for the mutual recognition of prudential measures taken by member states to protect investors, depositors or policyholders, or to ensure the solvency and liquidity of the financial sector. Such recognition may be granted unilaterally, through harmonization, or pursuant to memoranda of understanding. The annex also sets out that member states undertake to pursue harmonization in prudential regulation, consolidated supervision, and information exchange on financial sector matters. Brazil’s schedule of

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7 Lei Complementar N° 126, de 15 de Janeiro de 2007 Art. 19
8 *Id.* Art. 20
9 Mercosur member countries are Argentina, Bolivia, Brazil, Paraguay, Uruguay and Venezuela,
10 Approved by Legislative Decree 926/2005 and enacted by the Presidential Decree 6.480/2008
commitments to financial sector liberalization includes reservations on market access and national treatment for new branches and subsidiaries of foreign banks, in line with the constitutional prohibition discussed above.

**Bilateral**

Brazil, as part of Mercosul/Mercosur, has bilateral free trade agreements in force with Chile, Bolivia, Peru and Israel, and preferential trade agreements with Uruguay, Argentina, Guyana, Mexico, India, Colombia, Ecuador, Venezuela and Suriname. None of these, however, makes provision for trade in financial services.

**CHILE**

**A. Prudential Rules on Establishments**

**Inward**

*Banks- Branches, Subsidiaries, Representative Offices and Equity Stakes*

Foreign banks may establish branches, subsidiaries, and representative offices in Chile upon authorization of the Superintendencia de Bancos e Instituciones Financieras (SBIF), the supervisor (General Banking Law – GBL, articles 27-33). The Chilean operations of foreign banks enjoy the same rights as those of domestic banks (article 34).

(a) *Branches*— Local branches must be assigned capital and reserves by their home bank. Such dotation capital and reserves must be paid up in local currency and held in the country (id.). The resident creditors of the bank have a priority claim on the bank’s assets located in the country, irrespective of whether they have Chilean nationality (id.). Further, the transfer of liquidity abroad requires authorization from SBIF (id.). These provisions on dotation capital, local creditor priority, and liquidity transfer allow the Chilean authorities to ring-fence the assets of a foreign bank held in Chile to protect the interests of resident creditors.

(b) *Subsidiaries*—Foreign banks are allowed to incorporate subsidiaries which will be subject to the same general regime for the licensing of new banks (articles 27-31).
(c) **Representative Offices**—A representative office may not engage in the business of banking (article 33). Its only permissible activity is to advertise the products and services of the foreign bank they represent (*id.*).

(d) **Equity Stakes**—A foreign bank wishing to hold more than 10% of the capital in a new or existing bank in Chile must have prior authorization granted by the supervising entity in the country where its main office is located and also must come from a country which permits the Chilean supervisor to adequately monitor the risk of its operations. In addition, an agreement for the exchange of information must be in place between the home and the host supervisors (*GBL* article 29).

**Insurance Firms - Subsidiaries**

The legal framework provides for the organization of insurance firms as corporations “sociedades anónimas” under national law.¹¹ Nothing in the law prevents foreign nationals to hold equity stakes in domestic insurance companies.

**Pension Funds- Subsidiaries and Equity Stakes**

The legal framework for pension funds requires pension fund managers (administradoras de fondos de pensiones) to be incorporated as corporations under national law.¹² Nothing in the legal framework prevents nonresidents to hold shares in Chilean pension fund managers.

**Outward**

**Banks**

Chilean banks may open branches and representative offices abroad upon authorization of SBIF. They are also allowed to hold participations in foreign banks or corporations that conduct the same business purpose authorized for local subsidiaries upon joint authorization of SBIF and the Central Bank (article 76).

To open a branch, a subsidiary, a representative office or to invest abroad, a bank must comply with minimum capital requirements, have a high supervisory rating, and demonstrate the financial and economic viability of the investment. In addition, the target country must conduct satisfactory supervision and the shareholders owning 10% or more shares in the existing company must comply with the solvency and integrity requirement set up in article 28 of the GBL (GBL, article 77). The capital of a branch established abroad must be no less than 3% of the bank’s total assets (article 81 No2, Chapter 11-7, III, 3,a) of the Instructions of SBIF “Recopilación Actualizada de Normas” RAN).

¹¹ Decreto con fuerza de ley 251 “Compañías de Seguros, Sociedades Anónimas y Bolsas de Comercio”, Art. 4
¹² Decreto Ley Nº 3500 de 1980, Art. 23
A bank may invest up to 40% of its capital in the authorized companies established in any one country (article 80). The capital assigned to a branch established abroad counts toward the single country exposure limit (id.). The total amount of a bank’s investments in foreign companies added to other investments authorized by law may not exceed its paid-up capital plus reserves (article 69).

A domestic bank is required to ensure its subsidiaries and branches abroad as well as the companies in which it invests observe the related party exposure limits and the limits on loans to residents of Chile set out by Chilean law (article 80).

**Pension Funds**

The legal framework for pension funds allows Chilean pension fund managers to constitute subsidiaries in Chile in order to provide services to persons or companies operating abroad, or that invest in foreign pension fund managers or companies with pension fund-related activities abroad. Just as Chilean pension fund managers, their subsidiaries are supervised by the Superintendence of Pensions.

**B. Rules on Cross-Border Investment/Lending/Borrowing**

**Banks**

Domestic banks are subject to numerous limitations on transactions with foreign banking and non-banking counterparts. Below are the most relevant ones.

- **Related-party exposure.** The total amount of claims, including deposits and loans, against a related foreign bank and its subsidiaries may not exceed 25% of the foreign banks’ capital (GBL, article 80).

- **Permissible investments.** A bank may only invest in the following types of foreign assets classified by the Central Bank of Chile as a financial instrument among others: bonds and other debt securities issued or guaranteed by foreign governments or central banks or by foreign or international banking or financial entities; bonds issued by foreign companies; and structured notes issued by investment banks (art. 83, Chapter 12-15 RAN, Chapter III.B.5 Central Bank’s Rules “Compendio de Normas Financieras”).

- **Sovereign and third-party exposure.** A bank may only hold up to 30% or 50% of its capital, respectively, in foreign bank deposits or in government bonds (id.).

- **Permissible lending operations.** A bank may only enter into credit operations for trade purposes with foreign subsidiaries or branches of domestic companies, or individuals or companies domiciled abroad (art. 83, Chapter 12-15 RAN, Chapter III.B.5 Central Bank’s Rules “Compendio de Normas Financieras”).
Insurances Firms

Cross-border provision of services. Chilean insurance law restricts the types of insurance policies that foreign insurers can offer in Chile to those related to trade and satellites. However, Chilean residents are allowed to acquire any kind of insurance policy abroad.13

Investments in financial assets abroad. The legal framework specifies the types of financial investments that insurance firms are allowed to make with their assets and reserves, including foreign assets. Among these, the law allows the following: debt securities; deposits, bonds, promissory notes and other debt securities issued by foreign financial institutions, companies or corporations; shares of foreign companies or corporations; shares in foreign mutual or investment funds; shares in Chilean mutual or investment funds with investments abroad; and real estate located abroad.14 The legal framework also includes a global limit of 20% for foreign investments. However, there is a 5% limit for debt securities, deposits, bonds, promissory notes and other debt securities issued by foreign financial institutions with a rating under BBB or N-3; a 10% limit for shares of foreign companies or corporations, shares in foreign mutual or investment funds and shares in Chilean mutual or investment funds with investments abroad; and 3% for real estate located abroad. In addition to these limits, the Superintendency of Securities and Insurance has powers to establish limits per issuance following the guidelines established by the law.15

Pension Funds

The Chilean legal framework is the only one analyzed that explicitly allows pension fund managers to delegate their asset management function. The law permits such delegation to operate in favor of corporations, organized under Chilean law, whose purpose is exclusively the management of pension resources.16 It is worth noting that there is no limitation for nonresidents to establish or participate as shareholders in such a corporation.

The legal framework includes other safeguards to this delegation of functions such as the supervision of the asset manager by the Superintendency of Pensions -in addition to the supervision of other regulators if applicable.

Investments in financial assets abroad. Each pension fund manager is authorized to manage up to five funds ("A", "B", "C", "D" and "E") which differ based on their risk exposure. The legal frameworks allows these funds to invest in the following foreign instruments: debt securities issued or guaranteed by foreign states, banks, foreign central or international banks; debt securities issued by municipalities, regional or local governments; negotiable securities issued by municipali-
foreign banks; debt securities issued by third parties and secured by foreign banks; bonds and commercial paper issued by foreign companies; short-term deposits issued by foreign banks; shares of companies and foreign banks; shares of foreign mutual funds and investment funds.\textsuperscript{17}

While the law sets out guidelines for the types of investments that may be made by pension funds, the Central Bank has the powers to set the maximum limits for the investments of each type of fund. Thus, the Central Bank has set an 80% global limit for investments in foreign assets and has also set limits for each type of fund –ranging from 90% for the riskier fund, to 35% to the most conservative fund.\textsuperscript{18}

C. Trade Liberalization and Bilateral Investment Treaties

Multilateral

Chile has subscribed multilateral FTAs such as the Pacific Alliance; MERCOSUR; with Central America; EFTA; EU; and the Trans-Pacific Economic Partnership Agreement with Brunei Darussalam\textsuperscript{19}, New Zealand, and Singapore. Only the Pacific Alliance and the EU trade agreement include chapters on financial services (with prudential recognition and carve-out provisions) in addition to the standard provisions such most favored nation, and national treatment.

The Pacific Alliance agreement contains some reservations made by Chile in connection with financial services. The most salient one is the reservation made on the establishment of financial institutions as branches: only foreign banks are allowed to establish branches, while other foreign financial institutions can only be established as a subsidiary or through the acquisition of equity stakes.

Bilateral

Chile has also signed bilateral FTAs with many countries, including Thailand, Hong Kong, Vietnam, Malaysia, Turkey, Australia, Japan, Colombia, Peru, Panama, China, United States, Korea, Mexico and Canada. From these agreements, only those with Hong Kong, Australia, Japan and the United States include chapters on financial services. While all these agreements include standard provisions, it is worth mentioning that the FTA with the United States includes a provision on cross-border trade that permits persons located in one of the signatory countries,

\textsuperscript{17} Id. Art 45 j)

\textsuperscript{18} Acuerdo N° 1680-03-120517 - Circular N° 3013-699 B.2.

\textsuperscript{19} In October 2015 the TPP negotiations were concluded among Australia, Canada, Japan, Malaysia, Mexico, Peru, United States, Vietnam, Chile, Brunei Darussalam, Singapore, and New Zealand. This agreement does include a financial services chapter. Interesting features of this agreement are provisions related to cross-border trade of financial services under which each party to the TPP permits its residents to purchase financial services from cross-border financial service suppliers of another party located in the territory of a party other than the permitting party.
and its nationals wherever located, to purchase financial services from cross-border financial
service suppliers of the other Party located in the territory of the other Party. This provision has
been inserted in the TPP agreement concluded in October 2015.

**COLOMBIA**

**A. Prudential Rules on Establishments**

**Inward**

**Banks and Insurance Firms- Subsidiaries, Branches and Equity Stakes**

Colombian law explicitly authorizes the establishment of subsidiaries and branches in Colombia
of foreign banks and insurance firms. Banks and reinsurance firms are permitted to establish a
representative office in Colombia.

(a) **Subsidiaries**—Foreign financial firms can establish subsidiaries in Colombia; the Supervisor\(^{20}\)
may condition such establishment on the existence of consolidated supervision on the foreign
parent (Art. 53.3.f. of Organic Statute of the Financial System “EOSF”) and the consent of the
home supervisor (ibid.).

(b) **Branches**—The legal framework for branches is explicit. The licensing requirements and
procedure focus on the specific circumstances of branches (e.g., no specific Colombia-style legal
form is imposed: Art. 53.1 \textit{in fine} EOSF). Colombian law requires full (i.e. same amount of
minimum capital of Colombian banks) payment of \textit{dotation capital}, which must be converted into
pesos and held in Colombia (Art. 45A, third para. of EOSF). Dotation capital guarantees creditors
of the branch in case of insolvency, in which case creditors \textit{residing} in Colombia are preferred
over other creditors. (Art. 45B.2 of EOSF). The \textit{governance arrangements} for branches include fit
and proper requirements (Art. 45B.3 of EOSF), but no nationality requirement. The opening of
branches is governed by detailed rules in the \textit{Commercial Code} (Art. 469 et seq.). The Commercial
Code imposes a nationality requirement on branches of firms operating a public service or in
sphere of public interest for national security (Art. 473). The financial sector is not covered by
these provisions.\(^{21}\)

The Exchange Control Framework (ECF) explicitly authorizes the initial pay-in and subsequent
augmentation of dotation capital (Decree Nr. 1068 Art. 2.17.2.3.1.1., 2nd para.). The ECF includes
however detailed rules on the dotation capital (Art. 2.17.2.3.2).

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\(^{20}\) The Supervisor is the Financial Superintendency of Colombia.

\(^{21}\) The Constitutional Court in Colombia in decision C-378/10 adopt the definition of public service formulated by
the Labor Code. This definition includes activities carried out in any branch of the public power, those carried out
by air, water and ground transportation companies; aqueducts, energy and telecommunications; hospitals; social
care facilities; dairy plants, slaughterhouses and distribution facilities.
(c) Representative Offices—With the approval of the Supervisor, representative offices can be opened in Colombia; their activities are however limited to serving as a liaison between the financial entity abroad and its customers in Colombia, carrying administrative tasks related to the promotion of the services provided by financial institution located abroad; promoting the activities of the parent institution in Colombia; and serving as a collection agency for the parent institution. (Art. 94 of EOSF).

Colombian law authorizes and regulates the acquisition by foreign banks and insurers of equity stakes in Colombian banks and insurers. Such acquisitions are explicitly authorized (Art. 91 of EOSF). The law states that the acquisition of shares by a foreign entity may be subjected to consolidated supervision and a formal approval of the home authority (Art. 53.3 f) EOSF). In any event, the acquisition of more than 10% in a supervised entity requires approval by the Supervisor who will assess the suitability of the investor (Art. 88 EOSF. This being said, the Supervisor in approving such transactions has to verify conformity with the “public interest”.

In addition to the 10% approval requirement for all investors, the Banking law prescribes that the Supervisor “verifies the solvency, fitness and properness of foreign investors” (Art. 91.1, 2nd para.) irrespective of their investments. Such investments are subject to the ECF and need to be registered with the Central Bank (Decree Nr. 1068 Art. 2.17.2.3.1.1., 1st para.).

Pension Funds

The EOSF provides for management of retirement and disability pension funds only by trusts (sociedades fiduciarias) and insurance companies (Art. 168) while pensions and severance funds are managed by financial services institutions incorporated with the exclusive corporate purpose of managing and administering mandatory pension funds, severance pay funds and voluntary pension funds (art 30). Decree 656/94 requires pension fund management companies to be incorporated either as corporations ‘sociedades anónimas’ or as cooperatives (Art. 1). Credit institutions and insurance companies can participate in any proportion in the capital of the pension fund management companies (Art.3 of the Decree). The law does not distinguish between domestic and foreign financial institutions.

Outward

Colombian banks and insurers may invest in branches and agencies abroad (Art. 92, 3rd para. EOSF). Additionally, they may open branches and subsidiaries abroad in accordance with the legal framework of the host country, but subject to formal approval by the Supervisor, and to its regulation in this regard (Art. 2.17.2.4.4.1 of Decree 1068 of 2015). Both domestic banks and insurance companies can invest in foreign branches, with the Supervisor’s prior authorization and

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22 Permitted activities are set forth in Decree 2555 of 2010 Art. 4.1.1.6 et seq
in compliance with the exchange regulations to capital investment abroad. (Instrucciones Aplicables a las Entidades Vigiladas Chapter V and Title II Part I).

B. Rules on Cross-Border Investment/Lending/Borrowing

Local financial firms investment in financial assets abroad

Colombian laws and regulations impose certain restrictions to investments of local financial firms in financial assets abroad.

(a) Banks—Banks can buy, own or sell bonds or other interest-bearing liabilities issued by the national government, foreign governments or railway and industrial companies. However, if the investment consists of foreign or company-issued instruments, the law sets a global large exposure limit of 10% of the commercial banks’ paid up capital and reserves (Art. 9 b EOSF).

In connection with Colombian capital investments in foreign financial, securities and insurance sectors\(^23\), Art. 2.17.2.4.4.1 of Decree 1068/2015 allows entities supervised by the Superintendence to invest capital in accordance with the provisions of the EOSF.

(b) Insurance companies—The legal framework provides for a minimum of technical reserves - 40% - that it requires to be backed by investment on securities issued or guaranteed by the Colombian Government or the Central Bank; or other securities of fixed or variable income and high liquidity, security and profitability. The law also specifies the types of investments – also highly liquid, secure and profitable- that are admissible for the remaining 60% of the technical reserves. While these admissible investments include mainly national assets\(^24\), the law leaves room for investments in foreign assets by delegating to the government the power to authorize other types of investments (art. 187 EOSF). Decree 2555/2010 provides investment criteria and investment limits for the insurance companies’ technical provisions. The investment regime for technical reserves is different for life-insurers and non-life insurers. The investment criteria for life insurance mirrors the requirements applied to pension funds due to their long term nature. Article 2.31.3.1.2 establishes the admissible investments, the foreign financial assets and demand deposits in foreign banks included. The aforementioned decree establishes a 40% global investment limit to the value of the portfolio backing the technical provisions – both life and non-life insurers- on foreign financial assets and demand deposits in foreign banks

\(^{23}\) Art. 326 2) of the EOSF provides that the Superintendence is in charge of approving capital investments in foreign financial, securities and insurance sectors.

\(^{24}\) inter alia, securities issued and guaranteed by the national government or the Central Bank, securities issued by entities supervised by FSC, real property located in Colombia, bonds and shares issued by national corporations.
(c) Pension Funds — Decree 2555/2010 establishes, as mandated by the EOSF\textsuperscript{25}, the investment regimes for pension funds. For these purposes, three different types of funds are defined based on their risk exposure (Article 2.6.12.1.1): Conservative Fund; Moderate Fund; and High Yield Fund.

The decree includes foreign financial assets and demand deposits in foreign banks in the list of admissible investments for pension funds (Article 2.6.12.1.2 Decree 2555/2010). However, it sets different global investment limits on foreign financial assets for each class of fund: 40% for the Conservative fund and the Special Scheduled Retirement Fund\textsuperscript{26}; 60% for the Moderate fund; 70% for the high yield fund.

Additionally, the decree sets concentration limits on the investments of each of the funds based on the issuer and on the issuance. In relation to the limits based on the issuer, exposure to the same entity or issuer cannot exceed 10% of the value of each type of mandatory pension funds (Article 2.6.12.1.12). Similarly, the framework does not allow the acquisition of more than 30% of the total value of all types of mandatory pension funds in a given issuance, with an exception made for investments in debt securities issued or guaranteed by the Colombian government or by the Colombian Central Bank.

Local asset maintenance requirements of foreign firms

Article 2.36.12.2.2 of Decree 2555/2010 requires foreign banks and insurance companies established in Colombia to have their allocated capital permanently backed by assets located in Colombia.

Rules governing/authorizing the cross border provision of banking and financial services.

Rules governing the cross-border provision of Colombian banking and financial services allow domestic institutions to establish branches abroad and to borrow from and lend money to foreign residents.

- The EOSF allows domestic banks to borrow within the country and abroad. (EOSF Art. 7.1.i). Colombian residents more generally can borrow from and lend in foreign currency to non-residents. In the case of loans from non-residents they cannot be granted by individuals (R.E. 8/2000 Article 24). As a condition for disbursement of loans in foreign currency obtained by residents, the regulation requires a deposit with the Central Bank as

\textsuperscript{25} Article 48 EOSF.

\textsuperscript{26} The rules for the Conservative Fund will apply to the Special Scheduled Retirement Fund until a regime is in place for the latter. (Article 2.6.12.1.24 Decree 2555/2010).
determined by the Board of Directors\textsuperscript{27}. However, the regulation expressly exempts from the deposit requirement loans obtained to finance Colombian investments abroad, loans for personal expenses obtained through international credit cards, concessional loans with an aid component obtained from foreign governments, etc. The deposit with the Central Bank is not required when Colombian residents are the lenders of foreign currency to non-residents. However, they have an obligation to inform the Central Bank of such loans (R.E. 8/2000 Article 26).

- In relation to insurance companies, the EOSF authorizes any natural or legal person residing in Colombia to acquire abroad any type of insurance. However, insurance related to social security, mandatory insurance, insurance requiring the prior acquisition of mandatory insurance, and insurance in which the policyholder, insured or beneficiary is a State entity, cannot be acquired abroad. In the latter case, the Government may establish events and conditions in which these public entities can acquire insurance abroad (EOSF Art. 39 Par. 2).

C. Trade Liberalization and Bilateral Investment Treaties

Multilateral

Colombia has signed multilateral FTAs such as Northern Triangle (El Salvador, Guatemala and Honduras), European Free Trade Association (EFTA), European Union (EU), the Pacific Alliance (Chile, Perú and México). All of those but the Northern Triangle include a section or a chapter on financial services, as follows: EFTA (Annex XVI: Financial Services), EU\textsuperscript{28} (chapter 5, section 5) and PA (Chapter 11). The chapters or sections of financial services in the FTAs contain standard provisions such as prudential recognition, carve-out provisions allowing a party to adopt or maintain for prudential reasons measures to protect investors, depositors, policy-holders; or to ensure the integrity and stability of the financial system. Additionally, they primarily: i) provide national treatment to foreign investors in financial services and to cross-border financial service suppliers; ii) grant the right for establishment, iii) set the rules for cross border trade in financial services, among other provisions. Finally, and as an exception to the general rule in place until 2009 forbidding branching in Colombia\textsuperscript{29}, financial chapters and sections also provided for the opening of branches of foreign banks and insurance companies in Colombia.

All FTAs contain reservations made by the parties in connection with the disciplines of the agreement. In the case of Colombia, these reservations cover various issues such as the dotation capital for banking and insurance branches.

\textsuperscript{27} At the moment it is 0% - R.E. 8/2000 Article 83.
\textsuperscript{28} Also entered into by Peru.
\textsuperscript{29} Until 2009 the Colombian legal framework did not allow the establishment of branches in the country. In 2009, the provisions on foreign banking and insurance companies were included in the EOSF and became effective in 2013.
Bilateral

Bilateral FTAs have been signed with Mexico, Chile, Canada, U.S, Panamá (signed but not in force) Israel (signed but not in force), Costa Rica (signed but not in force) and Korea (signed but not in force). All of those, but the one with Korea, include chapters on financial services. The financial services chapter with Chile is currently under negotiation. In addition to the standard provisions, these agreements also provided for the opening of branches of foreign banks in Colombia as an exception to the general rule forbidding branching that was in place until 2009 (see above). Colombia has only one BIT in force with a Latin American country. This BIT was signed with Peru and entered into force in 2010. The BIT includes provisions related to financial services and contains standard provisions such as national treatment and most favored nation. From a financial integration perspective, the following two elements are salient:30

- Prudential carve-out provision, which allows the parties to take reasonable measures for prudential purposes to protect depositors, investors, participants in the financial markets, and policy holders; to maintain the solvency, financial integrity and responsibility of financial institutions; and to guarantee the financial integrity and stability.

- A provision removing any barrier that could exist in connection to nationality or residency requirements for management positions.

MEXICO

A. Prudential Rules on Establishments

Inward

Banks and Insurance Firms

Mexican law explicitly authorizes the establishment of subsidiaries and representative offices in Mexico of foreign financial institutions. The Mexican legal framework does not, however, allow for the establishment of branches of foreign banks.

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30 The BIT also incorporates an article called “non-conforming measures” (Article 7) in which it exempts some measures from the fair and equitable and most favored nation principles and requirements for Executives. Annex 1 establishes that national treatment will not apply and Colombia can grant exclusive rights or preferential treatment to public entities including the National Guarantee Fund, the Fund for Financing the Agricultural Sector (Finagro); Trade Bank (BANCOLDEX). Such advantages/preferential treatment will include tax exemption, purchase of securities issued by the Colombian Government, and exemptions to registry and periodic reporting requirements related to issuance of securities.
(a) **Subsidiaries**—foreign financial institutions can establish banks and insurance firms as subsidiaries in Mexico, among other financial institutions, but subject to specified conditions, in accordance to the Law of Credit Institutions (LCI) and the Law of Insurance Institutions (LII).

**Banks**- In line with the LCI, foreign banks can enter Mexico by either establishing a subsidiary in the country or through the ownership of equity stakes in Mexican banks which could be incorporated by foreign banks for that purpose. In the first case, 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 one in Mexican territory (Article 45-A of the LCI). Thus, subsidiaries of foreign financial institutions are subject to the treaties or agreements allowing for their establishment, to the LCI and the rules for their establishment set by the Ministry of Finance (Secretaría de Hacienda y Crédito Público) in consultation with the Central Bank and the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores), the supervisor. (Article 45-B and 45-N). In any other case, any foreign financial institution or group of investors are allowed to own capital stock of Mexican banks. According to the Mexican legal framework, in order to establish a subsidiary, such subsidiary needs to obtain authorization from the Mexican supervisor, after obtaining an opinion from the Central Bank (Article 45-C). The law requires that the foreign financial institution must at least own 51% of the capital stock of the subsidiary (Article 45-G). Additionally, in order to own shares in a subsidiary; the foreign financial institution must conduct the same type of operations in the home country as those the subsidiary is authorized to perform in Mexico. The law excludes from this prescription subsidiaries integrated in a financial conglomerate that is controlled by a foreign financial institution through a holding company authorized in Mexico (Article 45-E). Subsidiaries are allowed to conduct the same operations as domestic banking institutions, unless the applicable agreement or treaty establishes otherwise (Article 45-D).

The Rules for the Establishment of Subsidiaries of Foreign Financial Institutions (DOF 31/12/2014) set the requisites for license applications. Pursuant to Rule Fourth II license applications must describe the type of financial services that the foreign financial institution carries out in the home country and include a general description of the way in which such activities have contributed to the economic development of those countries in which the institution is established. Additionally, the foreign financial institution must describe the benefits it will bring to the Mexican economy by establishing a subsidiary.

There are no nationality requirements for members of the executive board and directors of the subsidiary, but the law requires that the majority of the members of the executive board and all the general directors of a subsidiary reside in Mexico. (Articles 45-K and L).

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31 Capital of subsidiaries is integrated by shares of series “F”. Series “F” shares can only be acquired directly or indirectly by a foreign financial institution and will represent no less than 51% of the capital. The remaining 49% can be acquired by either or both series “F” and “B”. “B” Series are treated like ordinary shares and can be freely subscribed.
Insurance Companies Same rules apply. (See LII Articles 74-85).

Pension Funds—The legal framework for pension funds requires pension fund management companies to be incorporated as ‘corporations’, under national law (Law on Retirement Savings Systems, Article 20). In connection with the establishment of subsidiaries by foreign financial institutions, the Law refers to applicable international agreements (Article 21). In a similar solution to that one applied to banks, foreign financial firms must at least own 51% of the capital of the subsidiary.

(b) Representative Offices—With the approval of the Supervisor, representative offices can be opened in Mexico; their activities are limited to provide to clients—only upon their request—information regarding their operations in the home country (Article 7).

(c) Equity Stakes—Mexican law authorizes and regulates the acquisition by foreign banks of equity stakes in Mexican banks, and also the establishment of a de novo bank with the entirety of its equity stakes acquired by foreign investors (Article 8 of the LCI, in relation with article 17). Pursuant to the LCI, capital of domestic banks is represented by two different classes of shares which can be freely subscribed. When the acquisition or transfer of ordinary shares exceeds 2% of the institution’s paid capital, notice must be given to the National Banking and Securities Commission (Article 14 of the LCI). If the acquisition of the paid capital is above 5%, authorization from said Commission is required, prior to hearing the Central Bank’s favorable opinion. The same applies in the case of acquisition or transfer of 20% of the ordinary shares or to obtain control of the institution. (article 17 of the LCI).

Outward

Mexican banks can open branches and subsidiaries abroad with the authorization of their supervisor. The law prescribes that foreign branches can, with the authorization of the Ministry of Finance, carry out operations not provided for in Mexican legislation in order to adapt to the market conditions of the host country (Article 87 of the LCI). Additionally, credit institutions can invest directly or indirectly in foreign financial entities, with the prior authorization of the supervisor. The LCI provides that when a Mexican credit institution owns more than 51% of the paid capital or has control over a foreign credit institution, the Mexican institution will have to make sure the latter complies with applicable foreign law and those regulations determined by the Mexican financial authorities (Article 89).

The legal framework also allows Mexican insurance companies to open branches or offices abroad with the authorization of the supervisor, the National Insurance and Bonding Commission (Comisión Nacional de Seguros y Fianzas) (Article 194 of the LII). However, there is no specific provision on the establishment of subsidiaries abroad.

32 Ley de los Sistemas de Ahorro para el Retiro of 1996.
B. Rules on Cross-Border Investment/Lending/Borrowing

Local financial firms investment in financial assets abroad

(a) Banks—For purposes of calculating the Liquidity Coverage Ratio, Mexican regulations\(^{33}\) address the banks’ eligible assets and include among them bonds issued by foreign governments and foreign non-financial firms subject to credit rating requirements.

(b) Insurance companies—Pursuant to the LII, insurance companies can invest in financial assets abroad subject to the guidelines set by the legal framework and by the companies’ investment commissions (Article 247).

(c) Pension Funds—A recent regulation\(^{34}\) identifies the different types of funds based on the workers’ age and sets the global limits for investment of their assets. According to this regulation, pension funds can invest up to 20% of their assets in foreign securities. The annexes to the regulation establish the credit rating requirements for these instruments. Additionally, there are certain limits per issuer and per issuance for the purposes of risk diversification.

Rules governing/authorizing the cross border provision of banking and financial services

Rules governing the cross-border provision of Mexican banking and financial services allow domestic institutions to borrow from and lend money to foreign residents.

In relation to insurance companies, the Mexican law prohibits any natural or legal person residing in Mexico to acquire abroad certain types of insurance (Article 21 LII). However, the law provides some exceptions under which the National Insurance Commission might authorize contracts with foreign insurers. These exceptions cover the cases in which a foreign insurance company issues a policy on Mexican territory for risks that can only occur abroad; or when a person can prove that local insurance companies cannot or are not willing to provide coverage to such person.

C. Trade Liberalization and Bilateral Investment Treaties

Mexico has entered into many multilateral and bilateral FTAs (Bolivia, Central America, Chile, Colombia, EFTA, EU, Japan, NAFTA, Pacific Alliance, Panama, Peru and Uruguay). Many of these agreements (EU, NAFTA, Pacific Alliance, Colombia, Guatemala, Honduras, El Salvador, Nicaragua, Peru and Panama) include a financial services chapter with a “right of establishment” clause.

\(^{33}\) Disposiciones de Carácter General sobre los requerimientos de Liquidez para las Instituciones de Banca Múltiple (DOF 31/12/2014).

\(^{34}\) Disposiciones de carácter general que establecen el régimen de inversión al que deberán sujetarse las sociedades de inversión especializadas en fondos para el retiro (DOF 29/05/2014).
Mexico has signed a large number of Bilateral Investment Treaties (BITs) with different countries. These instruments cover all type of investments, however, they do not include explicit provisions related to financial services. Nevertheless, it has been interpreted that financial services sector is covered by said agreements.

**PANAMA**

**A. Prudential Rules on Establishments**

**Inward**

Panama law explicitly authorizes the establishment of subsidiaries, branches and representative offices in Panama of foreign banks. There is a specific licensing procedure for subsidiaries and branches (Art. 10 and 12 Regulation No. 3-2001). The consent (or no objection) of the home supervisor is required for all three types of activities (Art. 43 Banking Law or BL). Both subsidiaries and branches are subject to local asset maintenance requirements (Art. 78 BL). Licenses for subsidiaries and branches of foreign banks whose capital is represented by bearer shares are prohibited (Art. 6 Regulation No. 3-2001).

(a) **Subsidiaries**—Foreign banks can establish subsidiaries in Panama. Such establishment is conditional on the existence of consolidated supervision on the foreign parent (Art. 62 BL). The capital of the subsidiary must be additional to the capital of the foreign parent; it may not be part of it (Art. 10.1 in fine Regulation No. 3-2001).

There is an explicit “general interest” test for granting the license, which can be refused if “the bank does not contribute to Panama’s economy” (Art. 48.3 BL). In addition, the Banking Law authorizes the Supervisor to make the licensing subject to “any criterion it deems pertinent” (Art. 48.5 BL). Third parties can object to granting the license on account of “circumstances that make it inconvenient to establish a new bank in Panama” (Art. 51, 2nd BL).

(b) **Branches**—Panama law requires the same amount of *dotation capital* (Art. 10.i Regulation No. 3-2001) as the minimum capital for local banks. Dotation capital guarantees local creditors in case of insolvency, in which case creditors of the Panama branch (whatever their nationality) are preferred over creditors of the foreign parent (Art. 221 BL).

The CAR is not applied separately on the branch, but the parent must certify yearly the compliance of the parents consolidated CAR with the home country’s requirements (Art. 18 Regulation no. 001-2015).

In terms of *governance arrangements* for branches, the Supervisor can rely on the parent complying with sound corporate governance principles (Art. 1, 3rd of regulation No. 005-2011), in the absence of which the Supervisor can apply Panama’s framework (Regulation No. 005-2011).
(c) **Representative Offices**—With the approval of the Supervisor, representative offices can be opened in Panama, but they cannot exercise the banking business in Panama or from Panama (Art. 13 Regulation No. 3-2001).

Panamanian law authorizes and regulates the acquisition by foreign banks of equity stakes in Panamanian banks as part of the general framework for the acquisition of significant stakes in such banks (Art. 16.1.7 BL and Regulation No. 1-2004). The acquisition of more than 25% in a Bank requires approval by the Supervisor who will assess the suitability of the investor. The regulation contemplates foreign acquirers and sets out some specific requirements to deal with such acquisition (e.g., approval of home supervisor: see Art. 7.22 of the regulation). The regulation prescribes that the supervisory approval can be withheld when the “Supervisor determines this is not useful for the banking center” (Art. 14.10 of the regulation).

**Outward**

Panama’s banking regulation includes an explicit framework for the acquisition or opening by Panamanian banks of foreign subsidiaries and branches. The Supervisor has issued a specific regulation in this respect: No. 4-2002. The regulation requires subsidiaries of Panamanian banks to comply with Panamanian capital adequacy rules (Art. 2). Also, Panamanian banks require the authorization of the Supervisor before acquiring any amount of shares in any type of foreign financial institution.

**B. Rules on Cross-Border Investment/Lending/Borrowing**

**Local asset maintenance requirements**

**Banks**—The banking law (Art. 78) requires all banks to maintain assets in the country for an amount equivalent to a percentage of their local deposits determined by the supervisors. Such percentage cannot exceed 100% of local deposits.

**Local financial firms’ investments in financial assets abroad**

**(a) Banks**—While there is no general rule for admissible investments, the Banking Law covers the types of investments domestic banks can make for purposes of complying with liquidity ratio requirements. In this sense, the Banking Law requires domestic banks, subsidiaries, and domestic branches of foreign banks to maintain at all times a minimum net balance of liquid assets equivalent to the percentage of the gross total of their deposits established by the supervisor. Such percentage cannot exceed 35%. (Article 73). Supervisor’s Regulation 004-2008 (“Acuerdo”) established such percentage at 30%. The Banking Law explicitly excludes from the calculation of such percentage deposits of a foreign parent bank, foreign subsidiary, foreign branch, and foreign affiliate.

The BL lists the assets considered to be liquid and includes among them securities issued by foreign countries authorized by the supervisor; securities of foreign private companies
authorized by the supervisor; net balances in banks located abroad, payable on demand or term with a maturity not exceeding 186 days, and authorized by the supervisor. Supervisor’s Regulation 004-2008 (“Acuerdo”) establishes the rating requirements for these instruments. Additionally, the Banking Law leaves the door open for the supervisor to authorize other assets (Article 75 BL). Supervisor’s Regulation (“Acuerdo”) 002-2011 defines the other assets authorized pursuant to Article 75 of the Banking Law and sets the requirements that these must comply with. The regulation includes securities from foreign private companies provided that they comply with the international rating requirements, they are payable in US dollars or a freely convertible and transferable currency, and are subject to periodic quotes in an organized securities market. Up to 50% of the minimum liquidity index can consist of these securities. The Banking Law gives room for the banks’ discretion in the cases of assets which do not have a percentage set by the supervisor.

(b) Insurance companies—The insurance law36 (IL) requires insurance companies to build and maintain in Panama a reserve fund of 20% of the company’s net profits to establish a fund of two million balboas, and thereafter of 10% to reach 50% of the paid capital (Article 213 IL).

In connection with the assets insurance companies are allowed to invest in, the IL establishes the general principle that admitted assets must be composed of easily realizable investments (Article 214 IL). The law goes further to list the admitted assets and set the rules for the investments of insurance companies. While the law requires that a minimum of 50% be invested in local assets (such as credit instruments guaranteed by the national government; or credit instruments issued by banks having a general license or by legal entities registered by the securities market supervisor), it leaves the door open for the supervisor’s discretion to approve any other investment on the basis of a technical study that shows it to be financially healthy and that it observes the universal principles of diversification and risk management.

(c) Pension Funds—The legal framework37 requires pension fund managers to have at least a basic fund in compliance with the rules set forth in the law. The law sets a maximum of 15% of the value of the fund’s resources for investments consisting of credit instruments issued or guaranteed by foreign states as long as they have a credit rating similar or higher than that of Panama. Similarly, the law allows pension fund managers to invest up to a maximum of 15% in credit or capital instruments issued by foreign legal entities authorized for public offering by

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35 Foreign banks will be considered acceptable if they have a long-term international rating of not less than BBB-/Baa3; or a short-term international rating of not less than A-3/P-3. Additionally, the supervisor establishes the maximum acceptable percentages of securities issued by a foreign government according to the risk associated with them (AAA+- BBB-, 100%; BB+, 50%; BB, 40%; BB-, 20%; B+ 10%; and B 5%). The regulation also includes minimum rating requirements for securities issued by foreign private and governmental agencies.

36 Ley 12 de 3 de abril de 2012.

37 Ley 10 de 1993 “por la cual se establecen incentivos para la información de fondos para jubilados, pensionados y otros beneficios”
foreign supervisors recognized by the securities market superintendence; or bank deposits in banks from jurisdictions recognized by the securities market superintendence (Article 8). Pension fund managers are authorized to create funds different from the basic fund, with different risk profiles and profitability. In these cases, even though they must invest in the assets mandated by law, they will not be subject to the limits established for investments of the basic fund. (Article 8-A)

**Rules governing/authorizing the cross border provision of banking and financial services**

(a) **Banks**—The regime does not make a difference between foreign residents and citizens for purposes of borrowing/lending.

(b) **Insurance companies**—The IL does cover the possibility of local residents acquiring insurance policies from companies established abroad. The law provides generally that residents must purchase insurance policies—those over assets and persons located in Panama—only from companies authorized to operate in Panama. However, the superintendency can authorize contracts with foreign companies when authorized by international treaty; when policies offered do not exist in Panama; and in those cases when it is impossible to obtain coverage in Panama. Residents obtaining such authorizations are required to register them with the Superintendence. (Article 153 IL)

(c) **Pension Funds**—The law does not contain provisions related to the cross-border activities of pension funds.

**C. Trade Liberalization and Bilateral Investment Treaties**

**Multilateral**

Panama has subscribed multilateral FTAs with EFTA and the EU. The EFTA agreement has an annex on financial services containing all the standard provisions such as national treatment, most favored nation, prudential carve-out and prudential recognition, and providing for the expeditious treatment of license application procedures. The EU FTA also contains a section on financial services with similar characteristics.

**Bilateral**

Bilateral trade treaties have been signed with Mexico, Costa Rica, China (Taiwan), Guatemala, Nicaragua, Singapore, U.S. (TPA); Colombia; Canada; Chile; El Salvador; Honduras; Perú; and the Dominican Republic. All these FTAs (with the exception of Chile and the Dominican Republic) include a chapter on financial services covering standards such as national treatment, most favored nation, prudential carve-out and recognition of prudential measures. Finally, most of

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38 FTA between EFTA and Central America (Costa Rica and Panama).
39 Annex XVII “Financial Services”.
these agreements create a Financial Services Committee in charge of the application of the agreement.

Panama has Bilateral Investment Treaties with the following countries: Argentina, Canada, Chile, Czech Republic, Dominican Republic, Germany, France, Korea, Mexico, Netherlands, Spain, Switzerland, Ukraine, U.K., U.S. and Uruguay. Only the BIT with Canada has a section covering investments in financial services where it includes a prudential carve-out provision.

PERU

A. Prudential Rules on Establishments

Inward

Banks and Insurance Firms

Peruvian law explicitly authorizes the establishment of subsidiaries, branches and representative offices in Peru of foreign banks and insurance firms. The legal framework establishes that foreign investment in financial firms will have the same treatment as domestic investment (Article 5 Banking and Insurance Law).

(a) Subsidiaries—Foreign financial firms can establish subsidiaries in Peru (Article 34-37).

(b) Branches—The legal framework for branches set out primarily in the BIL, requires the prior authorization of the Superintendency of Banks, Insurance and Pension Funds—the supervisory authority—for the establishment of branches of banks and insurance companies. In the case of financial companies, the supervisor is required to request the opinion of the Central Bank (Article 39 BIL). Peruvian law requires full (i.e., same amount of minimum capital of Peruvian banks) payment of dotation capital, which must be held in Peru (Article 42 BIL). Dotation capital guarantees creditors in case of insolvency, in which case creditors of the branch residing in Peru are preferred over other creditors (Article 39 in fine of BIL).

The governance arrangements for branches include no nationality requirement for their representatives in Peru (article 39a of BIL).

(c) Representative Offices—With the approval of the Supervisor, representative offices can be opened in Peru; their activities are however limited to promote services to similar companies in Peru with the purpose mainly to facilitate trade and provide external financing (article 45-46 of BIL).

(d) Equity Stakes—The law authorizes the acquisition by foreign banks and insurers of equity stakes in Peruvian banks and insurers and subjects them to the same limitations imposed to the acquisition of equity stakes by Peruvian banks and insurers. The acquisition of more than 10% in a supervised entity requires approval by the Supervisor (article 57 BIL).
**Pension Funds**

The legal framework authorizes the establishment of pension funds management companies under national law, as corporations –sociedades anónimas. It also authorizes the acquisition by foreign legal persons of equity stakes in Peruvian pension funds by requiring the pension fund management company to notify the Superintendency of Banks, Insurance and Pension Funds – the supervisory authority—whenever there is change in ownership involving a foreign legal person. Such notification must include the names of the individual shareholders of the foreign legal person.

**Outward**

**Banks and Insurance Firms**

Peruvian banks and insurers can open branches and subsidiaries abroad subject to formal and prior approval by the Supervisor (article 30 BIL). They can also acquire equity stakes in foreign banks and other foreign institutions. If such acquisition is of more than 3% of the assets of the acquired entity, the supervisor’s approval is required (article 221.13 BIL).

**Pension Funds**

There is no provision in the legal framework in connection to the establishment of subsidiaries of Peruvian pension fund management companies abroad.

**B. Rules on Cross-Border Investment/Lending/Borrowing**

**Local asset maintenance requirements of foreign firms**

Branches of banks and insurance companies are subject to asset maintenance requirements in Peru: the amount of assets to be held is the same as the minimum capital required for domestic banks (article 42 BIL).

**Local financial firms investment in financial assets abroad**

The framework permits local financial firms to invest in assets abroad. Peruvian law permits a financial entity to engage in operations with derivatives; purchasing, selling and maintaining foreign debt securities; and purchasing, selling and maintaining bonds issued by multilateral credit institutions. (article 221 BIL). The law provides for global investment limits and allows the Superintendency to set additional global limits for prudential reasons (article 200 BIL). Additionally, the law establishes some guidelines to determine individual limits, mostly based on risk diversification (article 203 BIL).

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40 Texto Único Ordenado de la Ley del SPP, Art. 13.

41 Texto Único Ordenado de la Ley del SPP, Art.13 A
The law addresses the investments of a financial entity in legal persons abroad—excluding other financial entities. Investments in these legal persons are limited to up to 5% of the Peruvian financial entity’s assets (Article 211BIL). The law allows such limit to be increased to up to 30%, but only under certain conditions, such as the granting of guarantees.

**Pension Funds**

The law on pension funds establishes the instruments a pension fund management company can invest in and also sets the limits for those investments. Among the foreign instruments that a Peruvian pension fund management company can invest in are financial instruments issued or guaranteed by foreign governments and central banks as well as shares and securities representing rights to shares; debt instruments; participation shares in mutual funds and hedge operations issued by foreign institutions.\(^{42}\) The law sets a global investment limit of 50% of the value of the pension fund for these instruments, but the Central Bank of Peru can set a different operational limit.\(^{43}\)

**Rules governing/authorizing the cross border provision of banking and financial services.**

Rules governing the cross-border provision of Peruvian banking and financial services allow domestic institutions to establish branches abroad and to borrow/lend money to foreign residents.

- The legal framework allows domestic *banks* to lend and borrow within the country and abroad (BIL article 221). Additionally, the BIL authorizes domestic financial institutions to provide credit to financial institutions abroad but subject to certain limits related to the similarity of their supervisory regimes with that of the Peruvian financial entities (BIL article 205).

- In relation to *insurance companies*, the BIL explicitly authorizes any person residing in Peru to acquire abroad any type of insurance/reinsurance (BIL article 10).

- Insurance companies or insurance services suppliers domiciled in a territory of a Party that has an international agreement signed with Peru which allows the cross-border

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\(^{42}\) *Id.* Art 25

\(^{43}\) *Id.* Art 25 D
supply of, or trade in, financial services (30th Final and Complementary Disposition BIL) may supply in Peru certain services as provided for in the BIL. 44

C. Trade Liberalization and Bilateral Investment Treaties

Peru has signed FTAs such as Pacific Alliance,45 the EU, Japan, EFTA, Costa Rica, Mexico, Panama, Canada, Chile, the U.S., MERCOSUR, Thailand, South Korea, China, and Singapore. All of these agreements—with the exception of the ones with EFTA, MERCOSUR, Chile, Thailand, China and Singapore—include a chapter on financial services. These agreements contain standard provisions such as prudential recognition and carve-out provisions—allowing a party to adopt or maintain for prudential reasons measures to protect investors, depositors, policy-holders; or to ensure the integrity and stability of the financial system. They also provide for the adoption of effective and transparent regulation. Many of the FTAs signed by Peru contain reservations in connection to market access and national treatment. The non-conforming measures about preferential treatment of Peruvian residents with regard to the assets located in Peru of a branch of a foreign financial services supplier in case of liquidation is always a limitation of the cross border trade/national treatment provisions in FTAs signed by Peru, as well as, for example, the assignation of capital located in Peru.

Bilateral Investment Treaties (BITs) have been signed with a large number of countries. In addition to standard provisions such as national treatment and most favored nation, only two BITs include provisions related to the financial sector. The BIT concluded with Canada contains some provisions related to prudential measures by financial authorities. The BIT with Colombia includes provisions related to financial services. From a financial integration perspective, the following two elements are salient:

- Prudential carve-out provision, which allows the parties to take reasonable measures for prudential purposes to protect depositors, investors, participants in the financial markets, and policy holders; to maintain the solvency, financial integrity and responsibility of financial institutions; and to guarantee the financial integrity and stability.

44 These services are: (a) insurance of risks related to:

(i) maritime shipping and commercial aviation and space launching and freight (including satellites), with such insurance to cover any or all of the following: the goods being transported, the vehicle transporting the goods, and any liability arising there from, and

(ii) goods in international transit;

(b) reinsurance and retrocession;

(c) consultancy, actuarial, risk assessment, and claim settlement services; and

(d) insurance intermediation, such as agency and brokerage, as referred in (i) and (ii).

45 Pacific Alliance members are Chile, Colombia, Mexico and Peru.
A provision removing any barrier that could exist in connection to nationality or residency requirements for management positions.

URUGUAY

A. Prudential Rules on Establishments

Inward

Banks

Foreign banks are allowed to set up subsidiaries and branches in Uruguay, provided their by-laws or policies do not bar Uruguayan citizens from serving as directors, managers or employees in their operations in Uruguay (Decree-Law 15322/1982, article 8). Banks must be established as corporations; branches of foreign banks are exempt from such requirement, however (id., article 17). The law requires dotation capital for branches, and the amount of capital that will be assigned to branches to be indicated in the application for a license (Recopilación de Normas de Regulación y Control del Sistema Financiero – RNRCSF, article 18). The amount of dotation capital is identical to the minimum capital requirement for local banks (articles 21 and 159 RNRCSF). In case of insolvency or liquidation of a branch, the Uruguayan banking does not impose “ring-fencing” of local assets to satisfy local liabilities.

Foreign banks may also open representative offices to promote their businesses (id., article 113). Representative offices are not allowed to carry out any type of financial activities (id.). Foreign banks in general must comply with minimum risk rating requirements to open a representative office. These requirements do not apply to Mercosur countries (id., article 115).

Insurance Companies

Foreign insurance companies wishing to underwrite risks arising in Uruguay must establish themselves locally as corporations and secure authorization from the government (Law 16426/1993, article 2). This requirement does not apply to the issuance of policies against risks arising from international transportation and trade (id.).

Foreign residents, including financial institutions, are allowed to hold equity stakes in or to control insurance companies in Uruguay (Recopilación de Normas de Seguros y Reaseguros – RNSR, articles 4 and 6). Foreign nationals and residents are also authorized to serve as directors or managers of insurance companies (id, article 4).

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46 Recompilation of Rules for Financial Sector Regulation and Control.
47 The general insolvency law is not applicable to banks: see Art. 2, 3rd of Law 18.387.
48 Recompilation of Rules on Insurance and Reinsurance.
**Pension Funds**

Foreign residents, including financial institutions, are effectively permitted to hold equity stakes in or to control pension fund managers in Uruguay. This permission is found in legal provisions mandating that the home country of foreign controlling financial institutions should be a member of the FATF and that home country supervisors should exercise supervision on a consolidated basis (*Recopilación de Normas de Control de Fondos Previsionales*⁴⁹ – RNCFP, article 1). Such permission can also be inferred from a requirement that license applicants must provide information on their foreign shareholders (*id.*, article 3).

Foreign nationals and residents are also allowed to serve as directors or managers of pension fund managers. This permission flows from the existence of legal provisions that require the submission of certain information on candidates who are nationals or residents of third countries (*id.*, article 4).

**Outward**

**Banks**

Domestic banks must request authorization from the supervisor to open branches abroad (RNRCSF, article 29). The applicant must demonstrate the branch’s viability (*id.*). The legal framework does not provide an explicit regime for local banks to set up subsidiaries or representative offices abroad.

**Pension Fund Managers, Insurance Companies and Securities Firms**

The legal framework does not provide an explicit regime for local pension fund managers, insurance companies and securities firms to set up subsidiaries, branches or representative offices abroad.

**B. Rules on Cross-Border Investment/Lending/Borrowing**

**Inward**

The legal framework does not provide an explicit regime governing the local operations (investments and provision of services) of foreign banks, pension fund managers, insurance companies, and securities firms. The only exception is the provision, mentioned above, requiring foreign insurance companies to establish themselves locally so they can underwrite policies for risks arising in Uruguay other than risks in connection with international transportation and trade (Law 16426/1993, article 2).

**Outward**

⁴⁹*Recompilation of Rules for Pension Fund Control.*
Banks

Deposits. Local banks may open savings accounts for nonresidents (RNRC5, article 311.1). A particular type of deposit-taking institution, named an external financial institution (EFI), is allowed to transact exclusively with nonresidents and to carry out operations involving securities and money located abroad (id., article 12).

Other liabilities. Banks may issue certificates of deposit, negotiable instruments and mortgage-backed securities to nonresidents (id., articles 289.1 to 298.20).

Assets. Banks may not invest in shares, bonds and other financial instruments issued by private companies (Decree-Law 15322/1982, article 18). This prohibition does not discriminate between local and foreign issuers. Banks may nonetheless invest in shares of foreign financial institutions upon authorization (id.). They may also hold shares in pension and mutual funds and acquire publicly offered securities (Law 16713/1995, article 92; Law 16774/1996, article 5; and Law 18627/2009, article 47).

Despite the statutory prohibition on investments in shares and bonds issued by private companies, regulation allows banks to invest in negotiable instruments and mortgage-backed securities issued by nonresidents (RNRC5, article 286), as well as in shares of banks established abroad and EFIs, among other exceptions (id., article 252).

Local asset maintenance requirement. Banks must hold assets located in Uruguay or claims against residents in an amount at least equal to their minimum capital requirements (id., article 199). EFIs must hold at least US$ 500,000 in local assets, which must be deposited at the Central Bank (id., article 221).

Exposure limits. A bank may hold investments in foreign countries in amounts varying from one time to 10 times its capital (id., article 214). In general, it may not hold or issue foreign-exchange denominated assets or liabilities worth more than twice the amount of its minimum capital requirement (id., article 200). The maximum credit exposure to a foreign sovereign may be as low as 15% of a bank's capital to 5 times as much, depending on the sovereign's credit rating (id., article 209). The credit exposure to foreign banks may range from 70% to 150% of a bank's capital depending on the credit rating of the foreign bank (id., article 211).

Pension Funds

Pension funds may invest up to 15% of their assets in fixed income instruments issued by international financial institutions or highly rated foreign governments (Law 16713/1995, article 123). Such instruments must be traded on securities exchanges under supervision by Banco Central del Uruguay (Decree 399/1995, article 69). Investment in securities issued by foreign companies is not allowed, except if the foreign company is a bank operating in Uruguay (Law 16713/1995, article 124). Likewise, deposits may be held at banks established in Uruguay only (RNCFP, article 62).
Insurance Companies

Insurance companies established in Uruguay are effectively permitted to underwrite insurance with respect to risks and persons abroad (Decree 354/1994, article 24). They may also seek reinsurance from companies established abroad (id., article 22).

Up to 30% of an insurance company’s capital and non-provisional obligations may be covered by investments in: a) securities issued or guaranteed by foreign governments; b) securities issued by international financial organizations; c) foreign bank deposits; d) bonds and shares issued by foreign companies, including financial institutions; and e) other authorized instruments (RNSR, articles 49 and 51). Up to 15% of the provisional obligations may be covered by investment in high quality fixed-income instruments issued by international financial institutions or foreign governments (id., articles 53 and 55).

C. Trade Liberalization and Bilateral Investment Treaties

The country is a member of the Southern Common Market (Mercosur) and a party to the financial services annex to the Montevideo Protocol on Trade in Services. This annex provides for the mutual recognition of prudential measures taken by member states to protect investors, depositors or policyholders, or to ensure the solvency and liquidity of the financial sector. Such recognition may be granted unilaterally, through harmonization, or pursuant to memoranda of understanding. The annex also sets out that member states undertake to pursue harmonization in prudential regulation, consolidated supervision, and information exchange on financial sector matters.

Uruguay, or as part of Mercosur, has bilateral free trade agreements in force with Bolivia, Chile, Peru and Israel, framework agreements with Mexico and Morocco, and preferential trade agreements with Colombia, Ecuador, India and Mexico. None of these, however, makes provision for trade in financial services.

Uruguay has also bilateral investment treaties in force with several countries. These treaties in general allow foreign investors to make investments and carry out business under conditions no less favorable than those applicable to domestic investors or other foreign investors. A recurring provision, however, allow the parties to restrict certain investments in accordance with their domestic law. An exception is the treaty with the United States, which allows for the imposition of restrictions only in pursuit of financial stability or as warranted by monetary policy.