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FINANCIAL TECHNOLOGY AND INTEGRATION FOR THE AMERICAS

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IDB
Inter-American Development Bank

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KEY STATISTICS

- **Latin America and the Caribbean (LAC) has the potential to further strengthen its financial integration.** In terms of capital market capitalization, the region accounts for less than 4 % of the global market.
- **Over the past 6 years, USD$50 billion dollars have been invested in approximately 2,500 FinTech ventures.**
- Pension Fund Management Companies (AFPs, by their abbreviation in Spanish) have been the most dynamic financial intermediaries in LAC for the past 25 years. **The size of these entities surpasses 17% of the region's GDP.**
- At the end of 2015, the capitalization value of the 7 most representative markets accounted for 32% of GDP. Current debt bond transactions reached 62% of regional GDP.

INTRODUCTION

Ever since the '90s, the financial integration of Latin America and the Caribbean (LAC) with the global financial markets has been an individual process whereby each individual country has been engaging with the big financial centers (New York, London or Luxemburg).

Rules adopted by each country in LAC in terms of taxes, financial and foreign exchange regulations have been independent. There has been no interest in developing a regional market. This is why domestic and international investors that participate in the purchase/sale of Latin American assets do so through the big international financial centers. This is a costly practice, both for issuers and investors, which impacts the external demand of local financial assets.

Thanks to the growth of financial markets in some countries in the region following the 2008 financial crisis, the issue of regional financial integration is more prevalent. For instance, the **Latin American Integrated Market**—MILA, by its abbreviation in Spanish—consists of integrating the stock exchange markets of the Pacific Alliance countries (Chile, Colombia, Mexico and Peru). To get to this point, although the countries are not part of a geographic bloc, at the end of the '90s and beginning of 2000 they had similar and convergent macroeconomic management in terms of financial regulations. In fact, these countries opted to establish market economies characterized by:

- Monetary policies based on inflation targets
- Liberation of foreign exchange markets
- Sustainable tax policy based on tax rules
- Development of internal debt domestic markets

DIAGNOSTIC AND TRENDS

Regional financial integration is a process whereby two or more countries are more connected with each other than with the main international financial centers. Some analysts sustain that this is a better strategy for growth and stability in the financial market.

Regional financial integration can offer many benefits such as:

- Market risk diversification
- Competition promotion
- Scale economy efficiency
- Lowering transaction costs
- Knowledge transfer and best practices
- Regulatory convergence towards higher standards

Undoubtedly, more integration can bring about risk. However, it is possible to minimize this risk through adequate supervision, strengthened regulatory frameworks and the adoption of best practices, in addition to better cooperation among supervisors.

In order for the financial integration initiative to be more competitive and increase foreign and local investor partic-ipation, **it must create comparative advantages in terms of price (transaction costs).** It must also offer efficient quality services to enable growth, depth, liquidity and variety of regional markets. **This is a long process that requires private investment, work and creativity.**

FINTECH

Over the past 6 years, USD$50 billion have been invested in 2,500 FinTech ventures, which have redesigned payment, savings, credit, insurance and investment plans.

In Mexico, for example, a law has just been approved to promote the FINTECH industry under policy guidelines dictated by the government. United States has recently adopted 10 principles that define how innovation can contribute to policy objectives for financial stability and inclusion. Additionally, The European Commission published a document "*Fintech: a more competitive and innovative European financial sector*", outlining the policy for innovating financial services.

According to a study conducted by the Inter-American Development Bank (IDB), the FinTech industry in LAC has grown. Over 700 companies offer financial solutions based on platforms. These companies include various business sectors:

- Alternative financing platforms (26%)
- Payments (25%)
- Financial management of companies and individuals (23%)
- Tech service delivery to financial institutions (8%)
- Trading and securities market (6%)

THE ROLE OF THE PRIVATE SECTOR

The growth of financial intermediation mainly depends on the investment decisions made by the private sector. The public sector is responsible for creating the right conditions for financial intermediation to grow in terms of security, liquidity and solvency.

In order to achieve regional financial integration, the countries involved must work together towards **regulatory convergence.** This way they will be able to reduce regulatory arbitrage and establish adequate conditions for managing risk in cross-border transactions. Additionally, mechanisms must be established in order for financial entity supervisors and regulators to be able to share information at the level of individual entities and financial conglomerates.

There is significant space in LAC to promote regional financial integration, both in commercial banking and with institutional investors. On the one hand, the banking sector has experienced firsthand the withdrawal and shrinking participation of global banking in the region. This has contributed to the consolidation of domestic banking. On the other hand, institutional investors, such as pension fund management companies and insurance companies have experienced rapid growth in the past years. Finally, the limited availability of negotiable instruments in each jurisdiction and investment restrictions has a negative impact on efficient allocation of transferable savings.

The following actions can help create the conditions for increasing and improving financial market integration in LAC:

- Adopt international financial regulatory standards and best practices. In particular, by implementing IFRS, applying Basel principles (II and III), and adopting IOSCO principles for financial market infrastructures.

- Explore opportunities for mutual recognition of duly supervised and authorized financial institutions
- Update regulations and financial institution mergers and acquisitions
- Adopt a regulatory framework enabling non-discriminatory access to financial entities in the region
- Facilitate access to credit bureaus for analyzing cross-border transactions
- Have clear and transparent tax rules
- Eliminate double taxation
- Enable and strengthen consolidated supervision of financial conglomerates, in particular with respect to cross-border activity
- Introduce and strengthen the limits to financial conglomerates with financial and non-financial related activities
- Work towards regulatory convergence in matters of: resolution and restructuring of banking and non-banking financial entities and insolvency regime legislation
- Increase the limits to investments abroad (in particular, in other countries of the region) imposed by pension funds and insurance companies. Always within clear risk management parameters
- Study the possibility of pension funds and insurance companies investing in regional infrastructure projects, avoiding market distortion and under clear risk management parameters
- Explore ways of developing derivative markets, in particular regional money futures
- Work towards full compliance with FATF recommendations to avoid money laundering and terrorism financing

Financial integration potentially has significant benefits for countries that will enable to:

- Address external shocks in the best way possible
- Improve investment financing by widening the supply of available financial instruments

- Diversify depositor risks and hence improve financial wealth management in the country

Significantly, t**he incentives for attracting foreign investors must translate into better market liquidity** and a greater amount of loanable funds for funding projects that favor economic growth, in particular infrastructure financing in the region.

Summing up, financial integration of banks, capital markets and FinTechs in LAC could offset the cyclical aspects of the global economy and the structural aspects of each country. This will help create a larger internal market, promote competition, and benefit from economies of scale.

Likewise, financial integration can reduce the *derisking* costs of global financial institutions and enable greater risk diversification. This helps the economies in the region become less vulnerable to global economic volatility. The integration of capital markets can also endow institutional investors (pension funds and insurance companies) with broader and better portfolio diversification and greater profitability for pension savers and policyholders.

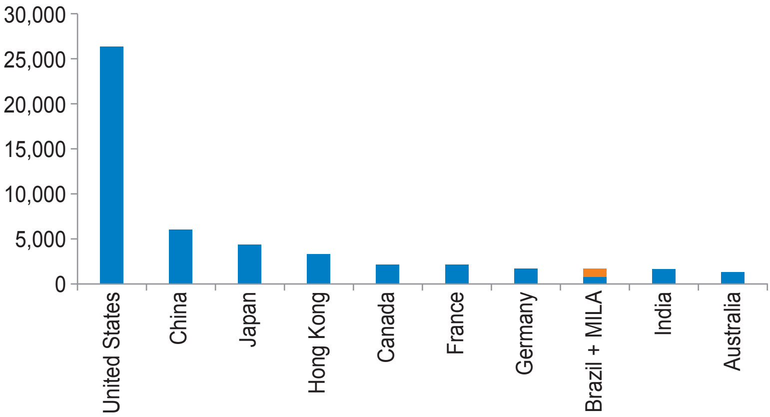
One of the main challenges of any financial integration process consists of implementing adequate regulatory convergence. Each country has its own institutional framework with respect to taxes, authorization to issue securities, exchange rate regimes, and cross-border transactions. These are the frameworks that must converge to attract additional funds to the economy, **which translates into securing addi-tional credit to finance productive processes**.

The MILA-Pacific Alliance experience shows that it is pos-sible to start integration processes without major changes in areas where each individual country has close ties with the global markets. However, it is practically impossible to make any progress in financial integration without introducing regulatory adjustments that seek convergence towards international standards and best practices.

Finally, we must underscore that financial integration is only one instrument among others to improve the delivery of financial services of each country. A**dditionally, financial integration can help create a regional policy agenda to achieve better outreach and interrelation among countries.**

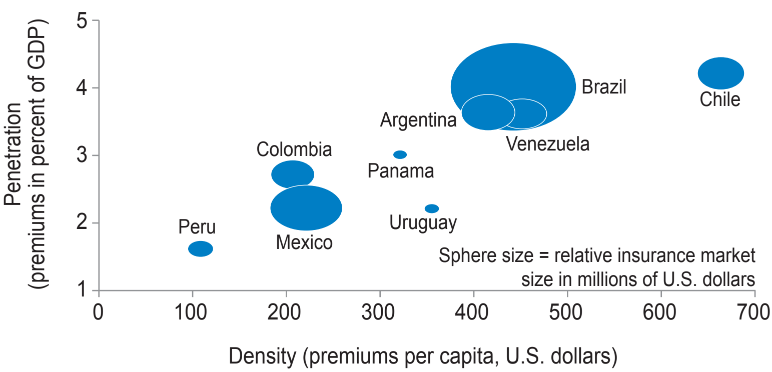
ATTACHMENTS

Financial Market Capitalization 2014 (USD$ Trillion)



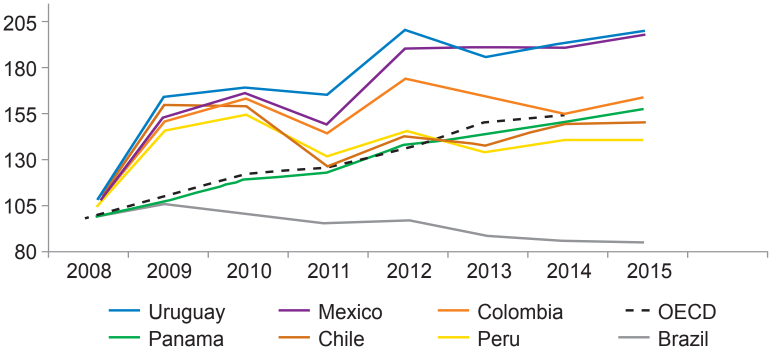
Source: World Bank, World Development Indicators.

Insurance Market: Size, Penetration And Density (Premiums In USD$ and Percentage of GDP, 2013)



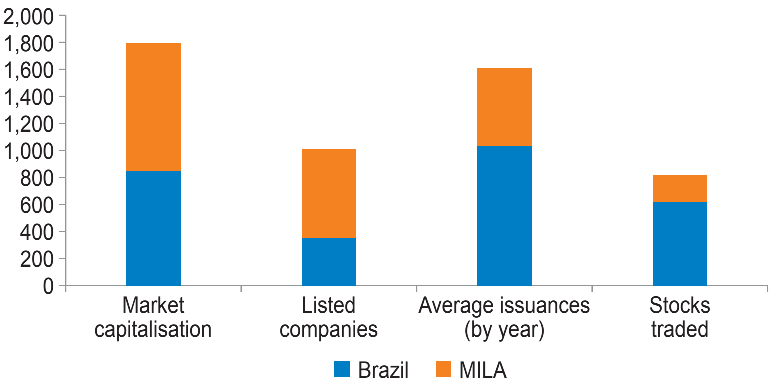
Source: SIGMA Swiss Re.

Pension Fund Management Assets
(% of GDP, Index Base 2008 = 100)



Source: Brazilian Association of Closed Pension Funds; Brazilian National Superintendent of Pension Funds; International Association of Bodies Supervision of Pension FUnds; Organisation for Economic Cooperation and Development; and IMF staff estimates ans calculations.
Note: Data for some countries may include partial estimates depending on availability. Data for Panama are from the Superintendency of Securities).
[a] *Estimates for Brazil reflect total assests of the Brazilian closed pension funds system.*

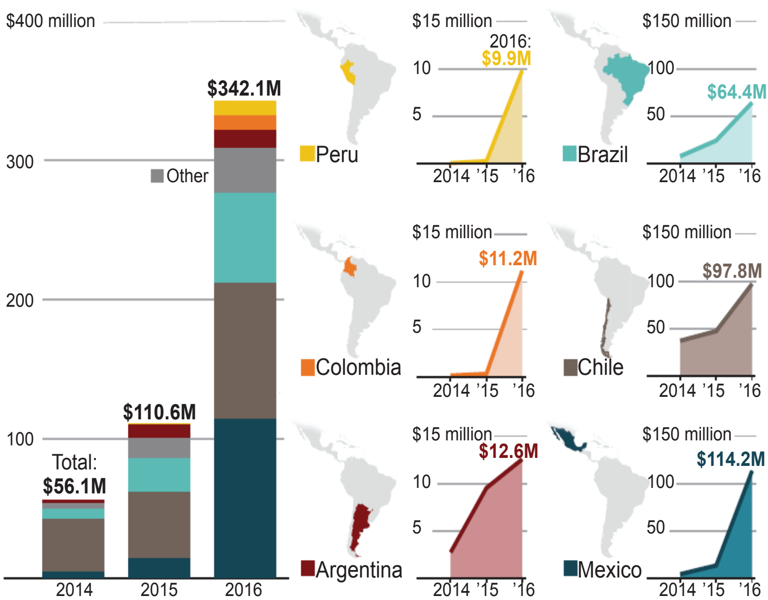
Latin America: Stock Market – 2014 Indicators



Source: World Bank and IMF. Market capitalisation in USD Trillion, listed companies in number. Average issuances by year in USD hundred million, and stocks traded in USD billion.

Crowdfunding in Latin America[1]

LAC Alternative Finance
Total Volume, 2014–2016 (USD)



[1] Source: The Cambridge Centre for Alternative Finance. Available at: http://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017–05-americas-alternative-finance-industry-report.pdf.