Capital Markets Integration in Latin America: Where the future is?

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Abstract
This paper analyses the recent development of financial integration in Latin America from a Brazilian point of view. It presents an analytical framework to discuss financial integration and provides a short historical overview of this process in Latin America, comparing capital markets from Brazil, Mexico, Chile, Colombia and Peru. We give particular attention to the formation of the Latin America Integrated Market (MILA), which comprises the stock markets of the late four countries. The paper also scrutinises the regulatory environment in those countries, showing the lack of regulatory harmonization among Brazil and its pairs. We conclude that financial integration should be an initiative that envisages competing directly with international financial hubs for financial assets and investors of Latin America, though is not a panacea that can solve its structural problems. To move ahead with integration, authorities should not adopt the European trajectory towards unification: they should prefer a bilateral approach among Brazil and MILA countries, promoting regulatory harmonization.

Keywords: Financial Integration; Capital Markets; MILA; Financial Regulation; Latin America; Brazil.

JEL Classification: G10; G15; G18; N26.
1 Introduction

The integration of the Latin American countries to the global financial system followed a center-periphery rational in the 1990s. Each country connected its financial market directly to the global centers, particularly New York. The rules adopted by each government in terms of taxation, financial regulation and foreign exchange were very different from each other. There was no purpose at that time on developing a regionally integrated financial market.

As a consequence, large international and Latin American investors already buy regional assets regularly - mostly equity and public bonds - through the global financial centers. The "inefficiencies" of the different local tax, regulatory and foreign exchange regimes are overcome by the banks which operate in the region. This however is costly for issuers and investors and depresses the foreign demand for local assets.

In the second half of 2000s, private investors from the region started two independent initiatives envisaging regional integration of local capital markets: Brazil Investments & Business (BRAiN) in Brazil and Mercado Integrado Latinoamericano (MILA) or Latin American Integrated Market, which includes Chile, Peru, Colombia and Mexico, – which recently created a trade bloc, the Pacific Alliance (PA).

Both aimed at promoting the harmonization of the domestic regulatory, tax and foreign exchange in order to create the ground for private actors to build a low cost and reliable electronic platform to attract trade which nowadays is set overseas. There are high value added services connected to it and a successful regional financial integration strategy would bring part of the intermediation services and fees to financial institutions in the region. This trajectory, however, would require a lot of money, time, work and political will to be achieved, as the European experience illustrates.

This paper analyzes the recent development of the financial integration process in Latin America, from a Brazilian point of view. Therefore, it has two main focuses. The first is geography. Pragmatically, a process of regional financial integration between Brazil and other Latin American countries requires some preconditions in terms of macroeconomic policies, liberalization of capital accounts and regulatory architecture of capital markets. These characteristics are more prone to be found in countries that, as Brazil, have successfully linked their economies to the global financial markets, such as the PA
countries. As a consequence, the capital markets of these five countries have grown fast in the 2000s and they were responsible for 95% of the stock market capitalization of the region in 2013. Therefore, have the greatest potential for a successful financial integration process involving Brazil.

The second focus is the prioritization of equity over debt markets. Many local equity markets are already well developed, homogeneous and internationalized while corporate debt markets remain relatively small, shallow and short-term oriented. Corporations in the region usually finance themselves through bank loans. Moreover, foreigners do not use local currencies for funding their international operations. In this context, it would be very difficult to move forward with the integration of debt markets.

The main conclusion of this paper is that integration of the equity markets of Brazil and the Pacific Alliance countries is a goal that should be pursued by the Brazilian authorities. This is a long term initiative that should follow an incremental path. In the short period, there are "quick wins" that could be achieved bilaterally, particularly with Chile. Mexico is also a partner to start a dialogue with.

From the political perspective, as the MILA and the European experiences show, financial integration can provide immediate political gains for the countries involved. The new geopolitical reality of the Pacific Alliance should also be taken into account when analyzing the path for regional financial integration. In this sense, the integration of capital markets could be an important item in the Brazilian agenda of a broader economic integration in the region. Brazilian equity market is too large and liquid to be ignored. At the same time, the PA countries are among the most important economies of the continent. In this sense, mutual recognition among the Brazilian Securities Commission (CVM) and other PA regulators seems to be the best way to start an approximation.

This paper is divided in three additional sections. The first section presents a analytical framework to analyse the financial integration among Latin American countries and a short historical overview. The second section provides a picture, on a comparative basis, of the capital markets of Brazil, Mexico, Chile, Colombia and Peru. The last section analyses the differences of the regulatory environment of the Brazil and the PA countries and suggest four different initiatives.
2 Capital Markets Integration in Latin America

2.1 Regional Financial Integration and Latin America

Regional financial integration is the process through which the financial markets of two or more countries become more connected to each other than to the main international financial centres. There is some economic literature that argues that regional financial integration would be the best strategy to preserve the benefits promoted by financial globalization in terms of growth and stability. It would also help fostering the micro benefits of economies of scale, competition and cost in the local financial markets. As stated by Kose et al. (2003):

"the evidence on the long-term benefits of financial globalization suggests that, notwithstanding the crises that have wracked some of them, more financially integrated economies have done better, on average, than less-integrated economies in terms of improvements in per capita income and standards of living." (Kose et al., 2003: 02).

On a similar vein, Ríos (2015) highlights three main benefits of this kind of integration:

"La integración financiera tiene beneficios potenciales importantes para los países entre los cuales se pueden destacar tres: i) permite enfrentar de mejor manera los shocks externos, al facilitar la suavización del consumo interno, ii) permite financiar mejor la inversión al enriquecer la oferta de instrumentos financieros y, por esa vía, mejorar la productividad de las empresas y iii) diversificar los riesgos de los ahorrantes, mejorando de esta manera, el manejo de la riqueza financiera del país". (Ríos, 2015: 01)

Those three potential benefits might not be evenly distributed among the countries involved in the integration process. The gains will depend on the size and on the level of financial development of each country compared to the future regional market. The

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1 In free translation:"Financial integration has important potential benefits for the countries, among them the three more important are: i) to allow better management of external shocks, by taming the volatility of domestic consumption, ii) to increase the range of financial instruments that firms could use to finance their investments and, by this way, improve their productivity; iii) to diversify the risks of the investors, thus improving the management of the financial wealth of the country".
smaller and less developed a nation is, the most promising the integration might look. Local private sectors and governments might perceive differently the benefits involved in integration. Also very important, is what the benefits for the foreign investors will be and if the new regional market would attract more international liquidity and investors than they, if added individually, would do in the absence of integration. All those elements were very important in the EU integration experience (Belfrage, 2013).

From the operational perspective, regional financial integration may follow three different pathways: the enlargement of cross-border business, the increase of participation of foreign financial institutions in domestic markets or, the integration towards a single market. They differ from each other on the institutional development that will precede and follow integration and on the linkages that are established among investors, markets and institutions from different countries.

The enlargement of cross-border business or in the participation of foreign financial institutions may require a minimum institutional development in terms of regulation, supervision and market infrastructure. Therefore, it is less dependent on political and strategic decision of governments. However, as markets will remain divorced from each other, a number of costs, both transaction and operational, might result from these kinds of integration. If the business benefits compensate those costs, integration may move further; otherwise there will be no economic incentive for that to happen.

When the single market alternative is the path chosen, such transactional and operational costs tend to disappear as a result of market consolidation. Borders lose meaning and markets become one. Nevertheless, this option depends not only on economic decisions but, most of all, on political will. This will require more time, work and, probably, investment. In some cases, these costs could be prohibitive. Therefore, the strategic decision on the type of regional financial integration to follow will necessarily have to weight costs and benefits related to each path.

This above cost-benefit analysis is a simplification of reality. Financial integration depends on a number of quantitative and qualitative variables that transcend economic analysis. Nevertheless, this rationale is embedded in decision makers’ minds, especially private stakeholders, which tend to give to business variables a heavier weight.
In terms of geographic dimensions, a process of regional integration for Brazil will only make sense, from the viewpoint of business opportunities, if, the Chilean, Peruvian, Colombian and Mexican markets are involved. The inclusion of other countries of Latin America in this strategy from the first moment would only make the initiative more difficult to implement.

This strategy is very different from the European for many reasons. The factors that drove Europe in to a more inclusive continental integration process are not present in Latin America. Among the differences, one important historical factor is that Europe is undergoing a broader unification process as a response to the wars that for centuries has been ravaged the continent. Financial integration is one of the pillar of the European along with, trade, investment and labor.

Latin America (LA) has not gone through any similar political project. The region has been relatively peaceful. Trade and investment within the region is not very deep. The national economies have much larger trade and financial flows with the developed countries than among themselves. Therefore, geopolitical motivations are not the same.

The choice of financial integration between Brazil and the PA countries should take in to account what real economic and political opportunities are involved. There has been a macroeconomic convergence between Brazil and the PA countries since late 1990s. They all implemented policies focused on the connection of their economies to the global financial markets, trying to avoid destabilizing factors.

This convergence was achieved through macroeconomic and microeconomic reforms. These included, on one hand, the adoption of some version of the ‘macroeconomic tripod model’, based on inflation target regime for monetary policy, floating exchange rates (more or less managed) and primary budget surpluses, particularly during the bonanza of the years of the commodities boom (2002-2008). Liberalization of the capital accounts was another measure associated to those reforms².

From the microeconomic point of view, there were - and still are - differences between regulatory, taxation and foreign capital regimes adopted by each country. However, all of

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² In the Mexican case, its liberalization reforms went further than the other Latin American countries and its currency, the Mexican Peso, became fully convertible in 1994.
them converge, at least, in one important aspect. They focused on creating a domestic capital market that could be considered friendly to foreign investors, adopting some of the best practices of international markets, including the liberalization of foreign exchange controls.

Another relevant factor for this group of countries was the rapid growth of market capitalization of their stock exchanges. As shown in Table 1, they all grew at a fast rate along the 2003-2007 period, led by large foreign investors. In January 2015, the World Federation of Exchanges ranked BM&FBovespa as the world's 20th largest, in market capitalization and by far the largest - and the most liquid - in Latin America (See Section 3).

Among the other Mercosul countries, the only stock exchange that has a reasonable size is Argentina. However, in terms of macro and microeconomic reforms, the country followed a different path as compared to PA countries and Brazil. This evolution is illustrated on Table 1. The Argentinean stock market was larger than its Brazilian counterpart (BM&FBovespa) as late as 2001. However, since then, it shrunk continuously. As a result, in 2014, its market capitalization was smaller than the Peruvian one, the smallest member of the PA group.

Table 1: Market Capitalization Latin American Countries (USD bi)

<table>
<thead>
<tr>
<th>Year</th>
<th>Brazil</th>
<th>Mexico</th>
<th>Chile</th>
<th>Colombia</th>
<th>Peru</th>
<th>Argentina</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>186</td>
<td>126</td>
<td>56</td>
<td>13</td>
<td>11</td>
<td>192</td>
</tr>
<tr>
<td>2002</td>
<td>124</td>
<td>103</td>
<td>48</td>
<td>10</td>
<td>13</td>
<td>103</td>
</tr>
<tr>
<td>2003</td>
<td>235</td>
<td>123</td>
<td>86</td>
<td>14</td>
<td>16</td>
<td>39</td>
</tr>
<tr>
<td>2004</td>
<td>330</td>
<td>172</td>
<td>117</td>
<td>25</td>
<td>20</td>
<td>46</td>
</tr>
<tr>
<td>2005</td>
<td>475</td>
<td>239</td>
<td>136</td>
<td>46</td>
<td>36</td>
<td>61</td>
</tr>
<tr>
<td>2006</td>
<td>711</td>
<td>348</td>
<td>175</td>
<td>56</td>
<td>60</td>
<td>80</td>
</tr>
<tr>
<td>2007</td>
<td>1,370</td>
<td>398</td>
<td>213</td>
<td>102</td>
<td>106</td>
<td>87</td>
</tr>
<tr>
<td>2008</td>
<td>589</td>
<td>233</td>
<td>132</td>
<td>87</td>
<td>56</td>
<td>52</td>
</tr>
<tr>
<td>2009</td>
<td>1,167</td>
<td>341</td>
<td>209</td>
<td>133</td>
<td>70</td>
<td>49</td>
</tr>
<tr>
<td>2010</td>
<td>1,546</td>
<td>454</td>
<td>342</td>
<td>209</td>
<td>100</td>
<td>64</td>
</tr>
<tr>
<td>2011</td>
<td>1,229</td>
<td>409</td>
<td>270</td>
<td>201</td>
<td>79</td>
<td>44</td>
</tr>
<tr>
<td>2012</td>
<td>1,230</td>
<td>525</td>
<td>313</td>
<td>262</td>
<td>97</td>
<td>34</td>
</tr>
<tr>
<td>2013</td>
<td>1,020</td>
<td>526</td>
<td>265</td>
<td>203</td>
<td>81</td>
<td>53</td>
</tr>
<tr>
<td>2014</td>
<td>844</td>
<td>480</td>
<td>233</td>
<td>147</td>
<td>79</td>
<td>60</td>
</tr>
<tr>
<td>2015</td>
<td>491</td>
<td>402</td>
<td>190</td>
<td>86</td>
<td>57</td>
<td>56</td>
</tr>
</tbody>
</table>

Since 2012, both market capitalization and turnover of the stock exchanges of Brazil and the PA countries have decreased. The deflationary pressures in all of those markets are mainly a consequence of the more cautious behaviour of foreign investors in the region.

Looking to each of the Pacific Alliance countries, one will inevitably find different markets when comparing size and complexity. More specifically, there are several significant asymmetries among their financial structures, including the size of financial and capital markets, the degree of development of each market segment and the ‘menu’ of financial services. This is explained by each country’s own historical and economic contexts.

### 2.2 Brief Historical Overview

The first wave of private financial internationalization after World War II started in the late 1960s with the development of offshore dollar denominated markets, particularly in Europe, which resulted in the Euro-dollar market. The City of London was its center. From the perspective of the Latin America countries, this innovation allowed many of their sovereigns and large companies to access, for the first time, foreign private long term bank loans. These loans were mostly denominated in USD and indexed to a flexible short term interest rate, the London Interbank Offered Rate (Libor).

The price shocks of the 1970s led to the accumulation of large foreign debts by the Latin American governments and corporations, increasing the fragility of their external accounts. The collapse of this first wave of financial globalization was triggered by the Volcker Shock of the early 1980s, when the interest rates in the US were raised to more than 20% a year. This was the beginning of the “lost decade” for LA. In most countries, growth rates plunged, inflation skyrocketed, and the capacity to finance deficits ceased as the result of a severe external debt crisis.

The Volcker Shock was also the starting point of the second wave of financial internationalization in modern times: globalization. This time, there was a complete change in the architecture and in the "rules of the game" of the international monetary and financial systems (McKinnon, 1993).
Financial globalization has had four main characteristics, the 4 D’s. The first one was the de-segmentation of the different domestic financial markets areas. Until then, entry regulatory barriers divided short term from long term operations, banking from capital markets etc. During the 1990s, these barriers were removed, stimulating competition among different financial companies (commercial banks, investment banks, security companies etc.) and markets (banking and capital). The second one was the deregulation. Price ceilings were removed and financial institutions were allowed to enter new markets and offer create new financial products, which paved the way for speeding financial innovations. The third was disintermediation: banks lost part of their leading position in credit to the capital markets as bond markets increased at a fast rate and securitization became an important strategy for all financial institutions.

Finally, the fourth characteristic was denationalization. Domestic financial markets, by then mostly closed, were connected to the main financial hubs of the global markets. Foreign exchange controls were removed or relaxed. Capital markets were modernized alongside the public debt management. Finally, international best practices were introduced, in order to attract foreign investors to buy shares and bonds denominated in local currency in the domestic markets. (Aglietta, 2010; Torres, 2014).

At the same time, a new international regulatory framework was established, based on the cooperation of national governments and regulators. Initially, new regulatory bodies were created to provide a level playing field for global financial players, such as the Basel Committee of the Bank of International Settlements. Afterwards, the emphasis of those new regulators moved towards preventing destabilizing effects of private competition in the new international system. The three generations of Basel Agreements signed by the world's central banks are the most important examples of this kind of international regulation (Helleiner, 1994).

The integration of Latin American countries to the global financial system was delayed for some years as a consequence of the long duration of the external debt crisis. When this obstacle was removed in the early 1990s, they introduced many reforms to take part
of the new international financial system but followed a center-periphery perspective\(^3\). Each country managed to link its domestic financial system to the main global hubs, as New York, London etc. The reforms of the regulatory framework in foreign exchange, taxation and financial markets were different in each country, making it a very heterogeneous process within the region. The main objective was to attract foreign investments. It also opened the way for large Latin American corporations to the international financial markets. At that time, to connect to the other financial markets of the region was not regarded as strategically relevant, once they were all small, illiquid and volatile.

Financial integration in Europe was a totally different process. The integration of the various national markets to the international center of the continent, London, was implemented alongside with the creation of a regional integrated market. There were two main reasons for that. The first one was the response of the European authorities to the challenges brought by the financial liberalization process taking place in the United States. The initial measures taken by the Europeans to adapt their multicurrency system to the flexible exchange regime of the dollar failed - the Exchange Rate Mechanism (ERM) and the Exchange Rate System (ERS). At the same time, the Europeans wanted to revitalize their financial markets in order to compete with the US. In order to achieve that, they needed to promote more scale and competition in Europe. Therefore, regional financial integration was the essential part of the European road to globalization and one of the four economic freedoms included in the European Act of 1986 (Belfrage, 2013).

The Latin America experience of financial integration, differently from the European one, was less ambitious and more spasmodic. Some economic treaties, which are still in place, were signed to cover trade preferences (ALADI)\(^4\) and currency convertibility between

\(^3\) The centre–periphery model, according to the Economic Commission for Latin America and the Caribbean (CEPAL) is a spatial metaphor which describes the structural dependence relationship between the advanced countries(centre) and the less developed economies (periphery).

\(^4\) The Latin American Integration Association (ALADI) was established in 1980 with the main objective of promoting the creation of an area of economic preferences, aiming to develop a Latin American common market, through three trade mechanisms: a) a system of regional tariff preferences; b) regional scope agreements (common to all member states); and c) partial scope agreements, with the participation of two or more countries of the area.
some of the Central Banks of the region (Convênio de Créditos Recíprocos - CCR)⁵. However, until today, those instruments have a very limited effect on trade and financial integration within the region. This agenda became more active from the 1990s on with the Mercosur Agreement, among the South Cone countries of South America, and more recently with the Pacific Alliance.

Differently from the European and Latin American past experiences, regional financial integration initiatives in LA in recent years have been mostly led by local private financial institutions. The two main projects implemented in this regard were BRAiN - Brazil Investments & Business (Box 1) and the Mercado Integrado Latinoamericano (MILA) or Latin American Integrated Market (Box 2), which includes all the Pacific Alliance countries.

Private stakeholders sponsored these initiatives due to two reasons. The first one was the rapid growth of the stock exchanges of the five countries in the 2000s (Table 1). As they had successfully integrated their local financial markets to the global financial system, there was a strong inflow of foreign investments and foreign liquidity towards buying financial assets denominated in local currencies, mainly stocks and public debt. As a result, the price of these assets, the income of local financial service providers and the value of the local financial institutions increased very fast.

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⁵ Reciprocal Credit and Payments Agreement (CCR) was signed on August 25, 1982, under ALADI. The CCR was designed to facilitate regional trade by reducing international transfers in the foreign currency shortage scenario that marked the 1980s. For more details see: [http://www.bcb.gov.br/rex/CCR/resumo_CCR.asp](http://www.bcb.gov.br/rex/CCR/resumo_CCR.asp).
Box 1: BRAiN– Brazil Investments & Business

Founded in March 2010, BRAiN has the mission to articulate and catalyze the consolidation of Brazil as an international business and investments hub, with a regional focus in Latin America, but with global connections and projection.

Conceived by three domestic key-entities of the financial and capital markets—ANBIMA (Brazilian Association of Financial and Capital Market Entities), BM&FBOVESPA (Securities, Commodities and Futures Exchange) and FEBRABAN (Brazilian Federation of Banks) – BRAiN is an association representing several sectors of society and has the sponsorship and participation of various private institutions.

In this sense, one of the organization’s goals is consolidating the Brazilian position as one of the international sectors for investments and business for Latin America basically by:

• Expanding the Brazilian banking sector throughout the region.

• Attracting the management of Latin American assets to Brazil, which is in part performed in North America and Europe.

• Support the international expansion of Latin American multinational companies.


The second reason was a wave of mergers and acquisitions (M&A) of stock exchanges around the world. This stimulated the appetite of the local players. Regional expansion was regarded as a "natural" frontier of expansion. In this sense, BRAiN's aim was the extension of the financial services provided from São Paulo to the rest of the continent. MILA’s objective was to strengthen the market power of the PA's local stock exchanges while there was initiatives to promote mergers and acquisitions. Brazilian BM&FBovespa, for example, is the owner of almost 10% of the Santiago Stock Exchange.

As a consequence of the 2008 international crisis, BRAiN's ambitious initial scope - a comprehensive work for making São Paulo an international financial centre - was refocused. Nowadays, its main activity is financing comparative research on regulation and taxation among Brazil and Latin American countries and on specific subjects aiming to increase the competitiveness and the attractiveness of the country.

MILA, however, moved forward. The three Andean countries achieved the operational connection of their stock exchanges in 2012. Mexico joined the initiative in 2014. Since then, it is possible for any investor of those nations to buy shares from any of the other
countries through a specific electronic platform. However, as will be discussed in Report 8, there are still many difficulties in the post-trade arrangements and the volumes of trade remain insignificant.

**BOX 2: MILA – Latin American Integrated Market**

MILA - the Latin American Integrated Market is the result of an agreement signed by the Santiago Stock Exchange, the Colombia Stock Exchange and the Lima Stock Exchange, along with Deceval, DCV and Cavali - the Central Securities Depositaries -, who in 2009 started the process of setting up a regional market to trade equities from the three countries. It began operating on May 30th, 2011. In December 2014, the entry of Mexico to MILA was made official, with the inclusion of Mexican Stock Exchange and Indeval.

MILA is a cross border initiative to integrate equities markets, without any sort of merger or global corporate integration, using only technological tools. One of the most important characteristics of MILA is the fact that markets keep their independence and their regulatory autonomy. Likewise, all MILA transactions are performed in the respective local currency without the need to leave the country, and with book-entry through the local broker.

The Chilean, Colombian and Peruvian brokers may negotiate instruments listed on foreign exchanges directly through HT Telepregón markets as well as any other instrument listed locally. For Mexican brokers there is a special trading venue called Sentra, through which they could buy or sell any equity listed in other three markets.

Orders to buy or sell instruments listed on a stock market of the Integrated Market will be paid directly to the market where these instruments are listed in the local currency of the country where it is listed.

All equities registered on the exchanges of Chile, Colombia, Mexico and Peru shall follow the existing regulations for the negotiation of foreign securities listed on the local market.

They shall be negotiated by a local broker that ought to have a contract with a foreign broker who will be its counterparty. Therefore, each operation is settled bilaterally without the interference of a CCP - Central Counterparty.

Each exchange must manage its own market. As the negotiations of the instruments are local, the exchange must ensure that all participants are in compliance with its own trading rules. The local intermediary where the securities are listed and traded is responsible for foreign exchange, market and settlement obligations.

In fact, integration in MILA is mainly a 'software screen' that allows a broker in one country to buy equities in an exchange of one of the other countries of Mercado without real integration of their infrastructure.

Meanwhile, supervision of issuers will be provided by the authority of the country in which the respective issuer and/or value is registered and/or listed.
Recently, there has been an increased interest for financial integration in LA, among some
governments and international institutions. The InterAmerican Development Bank, for
example, is financing the research projects of BRAiN. This renewed interest in the subject
was a consequence of the challenges created by the 2008 Crisis. As already stated, volume
and liquidity in the stock exchanges in the region are decreasing as investors reduced their
exposure to the continent (Table 1).

Additionally, new regulations in the developed countries have made mandatory to the
banks to increase their debt-to-equity ratio and to implement a more severe - and costly -
"know-your-client" directives. As a consequence, some foreign banks, that entered LA
markets in the 1990s, are selling their operations to local banks. An example is the recent
purchase of HSBC’s operations in Brazil, announced in July 2015, by Bradesco, one of
Brazil’s largest banks. This has already become a major problem for smaller countries.
The Brazilian Representative at the IMF, Otaviano Canuto (2015) recently called
attention to the effects of the exit of the foreign banks from the region risks to completely
de-link small states from the global finance map.

From this point of view, regional financial integration among Latin American countries
is being regarded as a policy that could, at least partly, compensate for the negative
consequences of the 2008 crisis and to the new regulations which are constraining the
international banks and investors. A regional market could facilitate inward investment,
enable some markets to achieve minimum viable size, and gain the benefits from
economic stability of other countries in the region. This view, however, is too optimistic
and does not take in to consideration the real world of financial integration in Latin
America (See sections 3 and 4).
3 Latin American financial and capital markets: an overview

A comprehensive overview of Latin American financial and capital markets should take into account the common patterns and the singularities of each country economic structure and financial system development. Those aspects are intrinsically linked with the role of Latin American countries in the global economy and reflect their peripheral insertion in the global division of labour – and, subsequently, in the hierarchy of the global financial system (Prebisch, 1981; Jiménez and Manuelito, 2011; Vera and Titelman, 2013).

During the bonanza of the commodity cycle of the 2000s (2003-2007), the PA countries and Brazil reached impressive levels of macroeconomic performance compared to the average of the Advanced Countries (FMI, 2015). Their growth rate was much higher. Their public deficit and debt to GDP ratios were lower, except for Brazil until 2008. Although inflation rate was continuously higher, their inflation rates were kept under one-digit a year after 2004.

Indeed, despite this impressive evolution, Latin American financial and capital markets have played a limited role in providing finance and funding for economic development (Jiménez and Manuelito, 2011; Vera and Titelman, 2013). With some few exceptions, those markets are usually categorised as ‘underdeveloped’, i.e. limited in size and depthness, number of market participants and financial instruments’ complexity. As Jiménez and Manuelito (2011: 47) summarize:

‘Latin America’s financial systems are considerably less developed than those of more developed countries, and even those of other countries with similar levels of per capita income. They also lack the complex structure of financing generation and capture seen in the developed countries, although certain components are evident in some cases. Instruments for transferring and covering credit risk and financial risk in general (loan securitization, futures and other derivatives) and their related markets are, with few exceptions, fairly underdeveloped if they exist at all. Only a few countries have seen significant development of institutional investors. Financial markets in the region are dominated by commercial banks, whose portfolios retain much of the risk of...
their loans and are funded basically by deposits and bond issues; some of them also draw upon resources from the international financial system.

The comparative analysis in this section is very relevant to set the stage for our analysis. Latin American financial and capital markets still have a long road ahead in order to achieve the level of development already seen in developed countries’ markets. Financial integration, in this context, could be particularly helpful and the creation of large regional financial hubs is an important issue.

Financial integration could take many forms, following different paths according to the characteristics of each country’s financial and capital markets. Common patterns are relevant to give an overview of those markets, setting the common grounds over which a regional financial system can emerge. Nevertheless, it is the singularity of each country’s experience that will pave the way to integration among countries in the region: those singularities will define relevant markets that could be integrated, the relevant actors in this process and the structures needed for this end.

For the purposes of this report, there are four common tendencies observed in the markets of Brazil and the PA countries (World Bank, 2012: 2-4). First, the adoption of financial liberalization policies aimed at alleviating ‘financial repression’. This provided a rapid growth of financial and capital markets since then, though not without a number of crises, and stimulated a process of financialization in the region. Second, and given the crisis of the end-1990s associated with liberalization, the deliberate efforts which were put together to achieve macroeconomic stabilization, under the umbrella of market-friendly macroeconomic policies. Third, local financial regulations converged to international standards (Basel accords, IOSCO’s principles and recommendations⁶, etc.). Fourth, financial inclusion policies were broadly adopted in the region, stimulated by multilateral agencies, such as the World Bank.

The analysis of the different segments from 2004 on is a good way to show how the financial markets evolved in Latin America. The topics of cross listing of debt and equity will be amid this context. The geographic scope includes as the main countries of interest

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Chile, Mexico, Peru and Colombia, alongside with Brazil. Additionally, Mercosul is also included as a group (Argentina, Paraguay and Uruguay) for comparison purposes.

### 3.1 Equity markets

Traditionally, Latin American financial systems have been characterised by the dominance of banks, instead of capital markets. Finance and funding in these economies were usually provided through banking assets and equity, while other securities have played a very limited role on development financing. Chart 1 illustrates the discrepancy between the stock of banking credit and equities in GDP terms in 1988, before financial liberalisation took place. In general, credit as percentage of GDP was ten times larger than equity capitalisation in the region. Although this difference was not relevant in some countries, the size of equities remained limited in absolute terms.

With capital account liberalisation, from the end-1980s on, financial flows from ‘developed’ to developing markets resumed contributing for capital market development in the region, particularly of stock markets (Hermann and Montani Martins, 2012). As illustrated by Chart 2, which shows the same figures for 2012, stock markets became much more important than before, overcoming the percentage of credit in some countries, especially Chile, Colombia and Peru. Nonetheless, in aggregate terms, domestic credit remains more relevant as a source of finance and funding for economic development in Latin American, and particularly in Mercosul. The influence of Brazil should not be neglected in these results, as the country appears as the largest financial system of the region, by far.
Chart 1: Stock Market Capitalisation vs. Domestic Credit in 1988 (% GDP)

Source: World Bank, World Development Indicators. Stock market capitalisation data was not available for Paraguay, Peru and Uruguay. *Includes Latin America and Caribbean.

Chart 2: Stock Market Capitalisation vs. Domestic Credit in 2012 (% GDP)

Source: World Bank, World Development Indicators. *Includes Latin America and Caribbean.

Nevertheless, from an international perspective, Latin American stock markets remain small. Chart 3 shows the evolution of stock market capitalisation for the world and selected regions in the period 1988-2012. For the sake of uniformity in data analysed
herein we used the World Development Indicators database, provided by the World Bank. This database covers the period from 1988 to 2012.

In 1988, the aggregate stock market capitalisation in the world accounted for USD 9,728 trillion, while in the Latin American and Caribbean countries it summed USD 59 trillion or 0.6% of the total. In 2012, the aggregate stock market capitalisation in the world accounted for USD 53,164 trillion. OECD’s stock markets represent 75% of this sum, while the Latin America and the Caribbean respond for only 4.8%. It remains marginal in an international scale, though the weight of LA markets relative to the world has scaled up by 4.2 percentage points in those twenty-four years.

Chart 3: Stock Market Capitalisation (USD Trillion)

Aggregate figures, however, hide important aspects regarding the size of stock markets in Latin America. While the region as a whole is not relevant at the international level, Brazil had the 10th greatest stock market capitalisation in the world ranking, as of 2012 (Chart 4), overcoming the size of its Latin American neighbours: Mexico held the 23th position, and Chile the 30th.

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7 According to the World Development Indicators database of the World Bank.
This heterogeneity indicates an important imbalance between Brazil and other LA countries that should be taken into account when analysing a possible regional market integration process. Historically, this difference was not so prominent, as we can observe in Chart 5. However, since the adoption of a liberalised regime that attracted foreign investors to Brazil – introduced during the 1990s and finalised in 2000 –, and due to the macroeconomic performance of the 2000s, Brazilian market capitalization scaled up seven times in a five years period (2003-7). Other countries in the region presented an expansion in the same period, but lagged far behind from Brazil. This picture is fundamental to understand the possibilities of – or at least the interests behind – integration in equity markets in Latin America.

**Chart 4: Stock Market Capitalisation in 2012 (USD Trillion)**

Source: World Bank, World Development Indicators.
The imbalance between the Brazilian stock market capitalisation and other markets in the region is one of the reasons of initiative of creating MILA. Negotiations began in 2009 and preparations in 2010, and the Latin America Integrated Market (MILA) became active in March 2011, based on the unification of equity trading platforms of Peru, Chile and Colombia stock exchanges. The integration of those markets created a potential, but limited rival for Brazil. To illustrate, in 2012, the sum of Chilean, Colombian and Peruvian markets accounted for 55% of the Brazilian market, as shown in Chart 68.

8 The intense fall of the exchange rate of the Brazilian Real in 2015 reduced the gap between the Brazilian and the other Latin American Stock Exchanges.
The initiative gained substance when the Mexican Stock Exchange joined the initiative in 2014. The figures indicate a potential rival for Brazil in terms of size.

Another indicator of size, the number of listed companies, as illustrated in Chart 7, reveals a similar picture of this imbalance. Brazil presents a decreasing number of listed companies from the 1990s to the 2000s, a small reversion of this path between 2005-8, and the resume of the decreasing path from 2009 on. Other countries in the region also present a decreasing path in the number of listed companies, but with less intensity when compared to Brazil.

Though Brazil has the highest number of listed companies in Latin America, when we compare MILA and Brazil according to this indicator, the sum of Mexico and Andean countries’ companies listed in stock exchanges is much higher (about the double) than in Brazil (Chart 8). This reinforces the conclusion that MILA has a relevant size and that integration in the region with MILA is meaningful. In this context, one can ask: if MILA was created as a regional hub to compete with the Brazilian market and if it has relevance in terms of size, what are the reasons to integrate?
Until now, this analysis has focused on the size of stock markets, measured by market capitalisation and listed companies. However, other indicators reveal that competition between MILA and Brazil is rather virtual than actual. First, the average size of a listed company in Brazil is much larger than in MILA, as showed in Chart 9. This means that higher volumes are at stake in the Brazilian market. In other words, companies that have
access to the Brazilian market are larger and are able to raise more capital than in other Latin American markets (Charts 10 and 11 also support this view).

Second, as illustrated by charts 10 and 11, equity issuances in were much larger than in its neighbours in the past years - from 2000-2014. It is worth noticing that Mexico has experienced a very prominent volume of issuance from 2012 to 2014.

Chart 9: Average Market Capitalisation (USD Trillion)

Source: World Bank, World Development Indicators. Indicator calculated as the ratio between total market capitalisation and the number of listed companies.

Chart 10: Equity Issuance (USD Million)

Source: International Monetary Fund (IMF), Global Financial Stability Reports.
Third, liquidity indicators in Latin American markets indicate that Brazil is by far the largest equity market in the region in terms of liquidity (Chart 12). From 2008 on, Brazil concentrates more than 80% of liquidity of Latin American equities.

**Chart 11: Equity Issuance Aggregated from 2000 to 2014 (USD Billion)**

![Chart 11: Equity Issuance Aggregated from 2000 to 2014 (USD Billion)](image)

Source: IMF, Global Financial Stability Reports.

**Chart 12: Stocks Traded (USD Billion)**

![Chart 12: Stocks Traded (USD Billion)](image)

Source: World Bank, World Development Indicators. MERC: Mercosul ex-Brazil (includes Argentina, Paraguay and Uruguay).
MILA’s liquidity cannot be compared to the liquidity of the Brazilian stock market: the total trade in Brazilian stocks is more than four times the total trade in Chile, Colombia, Mexico and Peru, combined. As shown in Chart 13, total trade in Brazilian stocks reached USD 834 billion in 2014, while PA countries accounted for USD 196 billion in the same year.

The main conclusion resulting from this analysis is that, from a Latin American perspective, there is no real integration of stock markets without Brazil. From a Brazilian perspective, an integration process with Latin American neighbours without involving MILA countries would be meaningless. In this sense, competition or integration between Brazil and MILA should be the driving forces in the development of equity markets in the region.

**Chart 13: Stocks Traded – 2014 (USD Billion)**

![Chart 13: Stocks Traded – 2014 (USD Billion)](image)

Source: World Bank, World Development Indicators. Mercosul ex-Brazil includes Argentina, Paraguay and Uruguay.

Nonetheless, despite the real potential for integration of Latin American stock markets, important economic benefits in the short period are not so clear from the Brazilian perspective. Integration could expand size and the number of companies with access to stock markets in a relevant way. In rough terms, the size of the relevant market could double if Brazil integrates with MILA, reaching a size that loses only large economies, China and Hong-Kong in terms of market capitalisation (Chart 14).
However, this possibility could lead to the establishment of an unbalanced relationship. MILA’s companies will have direct benefits from the liquidity of Brazilian markets (Chart 15), being able to access higher volumes of capital through equity issuances. However, the benefits from the viewpoint of Brazilian companies will depend on the conditions of access to new funding pools of local investors.

**Chart 15: Selected Stock Market Indicators for Latin America – 2014**

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.
They could also benefit from additional foreign investors funds attracted to the new integrated market. In a successfully integrated regional market, Brazil could work as a regional platform to attract foreign capital flows that will be divided by Latin American markets. However, risks involved in monetary and foreign exchange policy management in addition to those associated to money laundering, among others, will fall mostly on Brazilian authorities. How to share those risks is one of the main questions to be answered.

From a cost-benefit analysis perspective, Brazilian stakeholders should have in mind some important issues. First, the size of the new investments from the main financial centres – outside Latin America due to integration. Second, the impact, for Brazilian companies, of the potential spill over of liquidity from the Brazilian markets to other markets in the region. Third, the potential risks in term of monetary and foreign exchange policies and money laundering. In addition, Brazilian authorities should envisage how to share those risks with other Latin American counterparts.

3.2 Corporate debt markets

The fragility of corporate bond market is another relevant constraint of Latin American capital markets for local economic development. Though loans provided by banks usually are the most important source of finance in Latin American economies, the issuance of corporate debt could play a complementary role in the provision of finance to companies.

For reasons of public availability of data they have been used throughout this section for corporate debt markets data: the Bank of International Settlement (BIS) Quarterly Review database, the Financial Development and Structure Dataset built by World Bank associates, and the International Monetary Fund Global Financial Stability Report data.

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9 As compared to data available for equity markets, there is no consolidated database for corporate debt securities. This occurs because corporate debt securities are not necessarily traded in exchange environments: over-the-counter markets are usually the most relevant trade environments used by corporate debt market participants. Moreover, debt issuances could occur in domestic or foreign over-the-counter markets, creating another difficulty for gathering and aggregating data comprehensively.

10 Databases are not complete, but combined provide a good picture of debt securities markets in the region.
An international comparison among corporate debt markets resembles the picture of equity markets: considering domestic markets, Latin America in aggregate is very small for international standards taking the total of the BIS database as reference – a comparison with developed countries is not possible due to the lack of data (Chart 16). The same holds for international outstanding corporate debt (Chart 17).

**Chart 16: Domestic Non-financial Debt Securities Outstanding (USD Billion)**

Source: BIS.

**Chart 17: International Non-financial Debt Securities Outstanding (USD Billion)**

Source: BIS.
The same discrepancy between Latin America and the rest of the world holds when analysing corporate bond markets data as a percentage of GDP. According to the Financial Development and Structure Dataset, the average private domestic debt securities issued by financial institutions and corporations as a share of GDP for the region was 9.7% of GDP in 2011. Brazil occupied the first position, with 21.7% of GDP, while Mexico and Chile present an indicator around 15% in the same year. On a comparative basis, the US presented a 91.9% indicator. Chart 18 illustrates the evolution of this indicator across the time.

**Chart 18: Private domestic debt securities issued by financial institutions and corporations as a share of GDP (%)**

![Chart 18: Private domestic debt securities issued by financial institutions and corporations as a share of GDP (%)](image)

Source: Financial Development and Structure Dataset.

Turning back to the BIS database, an analysis of the corporate debt market in the region shows that Brazil has the largest domestic market in Latin America (Chart 19). In 2014, Brazilian debt securities outstanding in the domestic market reached USD 151 billion, while the sum of the rest of Latin American countries reached about a half of this value (USD 78 billion). It is worth noticing that when analysing debt securities issued internationally, Mexico takes the prominent position, accounting for three times the Brazilian international corporate debt outstanding in 2014 (Chart 20).
International issuance, however, differs from domestic markets. As such, the integration of corporate debt markets in Latin America should be viewed from the viewpoint of the local markets, instead of the foreign ones. Perspectives of regional integration in the corporate debt market are certainly affected by the available alternative of direct
integration with international and even off-shore debt markets. International hubs for corporate debt present smaller transaction costs than the average Latin American markets, provide a huge pool of liquidity and foreign exchange hedge is easier, due to the use of international currencies.

In spite of the alternative paths to financial integration in Latin America, *hacia dentro* or *hacia fuera*, corporate bond markets in the region shared a common expansionary trajectory in recent years. Despite the 2008 global financial crisis, corporate debt issuance of companies from the region expanded a lot since 2008, as showed in Chart 21. Thus, one can envisage more years of expansion in this market, which creates opportunities of integration at both regional and international levels. In other words, both types of integration could occur in the near future.

**Chart 21: Market Private External Financing Bonds by Country (USD Million)**

![Chart 21](image)

Source: IMF.

Nevertheless, when analysing the possibility of regional integration within Latin American boundaries, one should take into account that domestic corporate bond markets are very idiosyncratic. For instance, the Brazilian corporate bond market development showed in the Charts above hides an important characteristic: the majority of non-financial debt securities are issued by leasing companies and these operations represent
the exploitation of regulatory arbitrage, instead of representing actual demand for long term funds of non-financial companies to investors. Torres and Macahyba (2015: 22; our highlights) describe this mechanism:

‘Almost all of the debentures issued by leasing companies were bought by the banks of the same conglomerate. After receiving these funds, the leasing company lent them back to their owner’s bank through the interbank market. In fact, it was only a booking operation within the same financial conglomerate with the only purpose of originating a security that could be used to carry out repo operations between the banks and their clients. The debenture of the leasing company replaced the traditional Certificate of Deposit issued by the banks. The reason for that was to avoid the taxes and the reserve requirements that affected CDs but not the repos of debentures, which were supposed to be “long term securities”. Therefore, the fast growth of the corporate bond market in Brazil in the second half of the 2000s was not a real development of the non-financial corporate bond market, but just a way for the banks to intermediate funds […] efficiently.’

Therefore, from a Latin American perspective, integration among corporate debt markets with Brazil could be more difficult than it might looks at first glance. The pool of resources that seems to be available in Brazil, which is very attractive in the equity market case, is actually directed to regulatory arbitrage operations. When considering this fact with the alternative of international integration, which is currently used by Mexico, potential for cross-issuances of debt in the region is low. This reiterates the information gathered through interviews with private stakeholders:

‘Regarding the integration of the various segments part of capital markets, the general thought is that, in Latin America, the efforts should focus [on] the stock market. There was a consensus that debt-securities in the region are still underdeveloped (small number of issuers, a highly concentrated buy-side and low liquidity in secondary markets). Therefore, there are limitations for Latin American companies to issue large volumes of debt in local markets’.

In this context, integration of corporate debt markets might be considered highly unlikely, except for a small number of companies that have productive operations in more than one
country in the region. Focus on equity markets might be natural, as illustrated by the analysis made in section 2.1. However, it does not need to be exclusive: another possibility may emerge from the mutual funds industry, as we discuss in the following section.

3.3 Mutual Funds

Different from other markets analysed in this report, the mutual funds industry is not only characterised by the assets that are traded within it, i.e. investment fund shares. Rather, it also includes the broad range of services provided by investment managers. Therefore, the possibilities of market integration in this case involve offers of investment fund shares and the provision of portfolio management services. The scenario of Latin American investment fund industry is very similar of those of Latin American equity markets.

When comparing to the global scenario, the total net assets of mutual funds in the region is very small, USD 1.2 trillion in 2014, representing only 3.8% of the total net assets in the world, which totalled USD 31.4 trillion in 2014 (Chart 22).

Chart 22: Total Net Assets of Mutual Funds by Group – 2014 (USD Trillion)

Source: Investment Company Institute (ICI). Latin America calculated by the sum of countries as described in Chart 20.
Nevertheless, Brazil is again a relevant industry from an international perspective, while the remaining Latin American countries have no international prominence. By the end of 2014, as Chart 23 shows, the Brazilian industry was the world’s seventh largest in terms of net assets.

**Chart 23: Total Net Assets of Mutual Funds by Country – 2014 (USD Million)**

The number of existing mutual funds is also significantly high in Brazil, when compared to the rest of the world: it is only overcome by the number of funds in the Republic of Korea and Luxembourg, as Chart 24 shows. It is worth noticing that Chile has also a high number of mutual funds. Nevertheless, this is not a perfect indicator of size, as it might reflect only market’s institutional characteristics, namely if it presents a master-feeder structure or a multi-classes fund structure. In Brazil and Chile, the former structure prevails, explaining the greater number of funds observed in the market.
When analysing the integration of investment funds in the region, it is important to mention again the imbalances potentially brought by the discrepancy between Brazil and other Latin American economies. Similar to stock markets, the difference between the Brazilian funds industry and that of its neighbours grew stronger throughout the 2000s, when assets under management or net assets scaled up more than six times in a five year period (2003-7). Again, although other countries in the region presented an expansion in the same period, these lagged far behind from Brazil. We should highlight that the starting point of this difference in 2000 was much higher than in the equity market case. Chart 25 shows how net assets have evolved over time in each country.\(^\text{11}\)

At first glance, one can expect the same dilemma of equity market heterogeneity or imbalance should apply to the case of investment funds. Indeed, if investment fund managers from Brazil want to offer Brazilian investment funds in other countries in Latin America, they will find a very limited market in terms of size.\(^\text{12}\)

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\(^\text{11}\) Data from the Investment Company Institute was complemented by different sources to include Colombia and Peru.

\(^\text{12}\) Potential demand could be relatively greater than the figures presented here, as portfolios could be relocated in the direction of Brazilian funds shares, but this possibility should not be overestimated.
Chart 25: Net Assets Mutual Funds by Country (USD Million)

Source: ICI for Argentina, Brazil, Chile and Mexico, Asbanc for Peru, and Superintendencia Financiera de Colombia for Colombia (end of year foreign exchange rate, provided by Banco de la Republica).

Chart 26 shows the additional increase of Brazilian investment funds net assets, unrealistically supposing that all other Latin American markets are relocated to Brazilian investment fund shares, in comparison to the countries’ growth rates yearly from 2006 to 2014. The chart shows that in recent years, the incorporation of new markets in Latin America could be a valid strategy to expand the assets under management of Brazilian managers in face of the performance of this indicator in Brazil from 2011 to 2014, especially in the period 2013-4.
Even if not the totality of other Latin America markets are ‘captured’ by Brazilian funds, the expansion of boundaries to other countries could compensate the negative performance of the Brazilian industry in the last two years. In such a case, there would be benefits for fund managers and Brazilian investors in those funds.

The main challenges that would be faced by Brazilian managers in offering Brazilian funds abroad in Latin America relate to complying with different regulatory requirements in each country, what could potentially generate important transaction costs. Those costs include registration and authorisation of managers and funds, fees paid to local regulators, and any ordinary costs associated with running an investment fund, such as mailing. Distribution could also generate costs, depending on the scheme set by each manager or institution. There are also compliance costs, such as developing the knowledge on local regulations, preparing periodic reports etc., and costs of developing the rightful expertise on each country’s investment fund market (preference of investors, marketing etc.).

On the other hand, if Latin American managers offered fund shares in Brazil, a strong demand for funds would coexist with a more challenging competition of Brazilian bond funds. Chart 27 shows the potential additional market growth for other Latin American
countries if they unrealistically ‘captured’ all the Brazilian assets under management, compared to a scenario where they would ‘capture’ only 5%. As shown, the integration could deliver a much higher growth than is obtained by their sole expansion over time. Although the transaction costs applied to Latin American managers in Brazil would be same mentioned for Brazilian managers in Latin America, these would be subject to one of the most the most stringent regulations of this industry in the world (the Brazilian).

As mentioned in the first paragraph of this section, mutual funds are a very particular case, in which the possibilities of integration are not limited to the offering of assets in those markets. Integration in those markets might occur with no cross-offering of investment funds shares. Instead, it could happen via foreign investments in local funds or local funds’ investments abroad. In these cases, transaction costs are smaller, encompassing solely operational costs – compliance with foreign regulators is not necessary. The issue is if a local fund that invests in Latin American assets would be competitive in comparison to other local options. In Brazil, this is particularly relevant, as interest rates are very high, making bond mutual funds very attractive; equity funds that invest in stocks of Latin American companies could find some market, but bonds funds would have a very limited space.

**Chart 27: Additional Market for Latin American Investment Funds in Brazil versus Own Growth year over year (%)**

![Chart showing additional market for Latin American investment funds in Brazil versus own growth year over year.]

*Source: Authors’ elaboration. Expansion to Brazil calculated by the percentage difference between Latin America’s aggregate and Latin America’s aggregate ex-Brazil net assets yearly. Own expansion calculated by the nominal growth rate of net assets yearly.*
Furthermore, integration processes involving no cross-offering or cross-border investment, but only the provision of investment services, can be found in different countries in Latin America. In particular, Brazilian managers understand they are competitive enough to offer their services in neighbouring countries due to the scale and the excellence reached by the country's investment fund industry. In this case, an integration process would bring no further benefits for Brazilian companies, only for Brazilian managers, which would charge fees at local markets. In this sense, the transactions costs related to compliance and to achieving expertise in local markets would be the main barriers. An investment fund passport inspired on the European regulation could help diminishing those costs. However, it would only make sense if the benefits envisaged are considered at least relevant by market players.
4 Regulatory aspects of financial integration in Latin America

4.1 General Overview

One of the most difficult dimensions of any capital market integration process is how to harmonize the regulatory framework concerning the primary and secondary markets of different financial assets. Each country has its own institutional framework and regulations, such as taxation, foreign exchange regime etc. This have to be harmonized if a fully integrated market is to ever emerge, as they are important determinants for a foreign investor.

The identification of those differences is not an easy task. It requires a lot of specialized work, particularly on legal aspects, in different ambiances at the same time. It also delivers a very perishable result, as these rules often change. Given the purpose of this report and the available literature, this section focuses mostly on the trade of equities and funds between Brazil and the four members of the Pacific Alliance.

Due to limited availability of public data, the current section is largely based on Ríos (2015), while tax and foreign exchange regulations are not addressed by this report. Nevertheless, the MILA experience shows that it is possible to start an integration process without major changes on these two areas if the countries involved are already connected to the global markets. Nonetheless, it is almost impossible to start any form on integration without prior adjustments in regulatory frameworks.

The main conclusions of Ríos (2015) can be divided in five topics. The first addresses the requirements for a foreign assets offer. All five countries already allow and have specific rules for that matter. Chile has the most attractive regime, from a market perspective. If the regulator of the investor home country is formally 'recognized' by its Chilean counterpart, the foreign issuer has no obligations to provide additional information to the local authority. This is a unilateral decision, as there are no requirements of reciprocity from the foreign country. The prospectus of the offer does not have to be translated into Spanish, if it had originally been approved in English in its home country. If the original public offer documents are not available in Spanish or in English, the issuance can only be bought by professional investors.
In the case of Mexico, the main difference is that the mutual recognition arrangement among the Securities Commissions must be reciprocal. In other words, where mutual recognition agreements are in place, Mexican companies must enjoy the same facilities when listing assets in foreign markets.

The second issue highlighted by Rios (2015) is requirements to trade a foreign security in a local stock exchange. In Brazil, Chile and Mexico there are no legal impediments for that. In Peru and Colombia, however, only the foreign assets registered in MILA are allowed. In all jurisdictions, only the qualified investors can trade foreign securities.

The third topic is restrictions for investing in foreign securities. In all jurisdictions, there are limitations for investing overseas. In Chile, Colombia and Mexico, pension funds are only allowed to buy foreign financial assets that achieve a minimum classification of risk, according to international rating agencies. In Chile, pension funds are only allowed to buy shares of funds registered in countries that are highly rated by the international rating agencies. (Superintendencia de Pensiones, 2012). This means that they are not allowed to buy directly from other Latin American country. However, in fact, they can do it by means of funds registered in well rated countries, such as Luxembourg in Europe.

The fourth element brought by Rios (2015) is requirements for investment funds, an area in which Brazil differs from PA countries. While in the later fund managers have to contribute directly a minimum amount of the fund’s capital, there is no such obligation in the Brazilian system. In the case of Chile, however, local regulators informed that this asymmetry would not represent a barrier for the unilateral registration of Brazilian funds.

Finally, the last topic is shareholder protection. All jurisdictions have similar rules regarding investor protection, including: the obligation to make public offers for stocks acquisition, the right to redemption, the transfer of control of the company, the disclosed of related transactions undertaken by related parties, among others.
### 4.2 Alternatives for the integration of equity markets

The integration of regional markets does not require that each jurisdiction adopt the same rules. This would only be important if those countries were also seeking political integration, as in Europe. The most relevant factor would be that the general regulatory framework in all of them has the same objective and complies with minimum international standards. As Brazil and the PA countries are already connected to the global market, this pre-requisite seems to be easily fulfilled.

Other important elements for integration relate to the foreign exchange regime and taxation. The liberalization of the exchange market, despite the specificities of each country, has been achieved as an important requirement to accessing the global financial system. Taxation, on the other hand, is a far more complex matter. However, within certain limits, the differences on tax regimes can be adjusted by price expectations. Investors would simply apply a higher discount rate the higher the tax rates.

In this context, this section will focus on different regulatory initiatives that could help integrating Brazil to some of the PA countries.

#### 4.2.1 Mutual Recognition

Mutual recognition seems to be the easier way to move forward the integration among Brazil and other PA equity markets. For the Brazilian market this could be a quick win strategy to amplify the alternatives for the domestic firms to raise funds and vice-versa. The best way to implement it is the Brazilian Securities Commission to sign bilateral agreements with other counterparts which would recognize the procedures already adopted in other jurisdictions without imposing additional conditionalities.

With the Chilean authority, the agreement may be unilateral, i.e., with no reciprocity requirement. With Mexico, however, the local law determines that this kind of agreement needs to be based on reciprocity. Therefore, from then on, a Mexican issuer would have access to a fast track authorization process and be allowed to distribute its assets in the Brazilian capital market and vice-versa.
In Colombia and Peru, however, local laws determine that equity markets are closed to foreign countries unless their shares are traded through MILA. Therefore, mutual recognition with Brazil would require including Brazil in the exception already made to MILA. However, once listed in Chile or in Mexico, Brazilian shares would automatically be tradable in the Peruvian and Colombian stock exchanges through the electronic platform of MILA.

Thus, one of the possibilities to expand the integration of Latin American financial markets would be enhancing the use of mutual recognition tools between local authorities. In this circumstance, Latin American companies and investment funds would be allowed to sell securities or shares in the continent, after registering the operation in its home country, later informing the foreign authorities of this registration and, perhaps, translating the documents into English or Spanish. After that, they would be able to access all types of investors or only the qualified ones, depending on the terms of the agreement between the two regulatory bodies.

It is worth mentioning that the Brazilian Central Bank (BCB) and the Brazilian Securities and Exchange Commission have already adopted the concept of mutual recognition framework with their international counterparts.

4.2.2 Brazil’s adhesion to MILA

When MILA started in 2011-2012, domestic and international press speculated that Brazil would join the initiative in the future. According to Bloomberg News (2011), the President’s Office of Colombia said in an e-mail that "Brazil and Mexico are interested in joining the integrated stock trading exchange known as MILA". Next year, the Chilean press informed that the head of BM&FBovespa, Edemir Pinto, was in talks with the exchanges of Colombia and Peru to find a way for Brazil to join MILA (Andina, 2012).

Despite those initial rumors, there has been no clear decision from the Brazilian authorities or from BMF&Bovespa to take any formal step to join MILA. As previously mentioned, this electronic platform is far from being an economic success, at least so far. From a political perspective, however, it achieved an important goal when in 2014 Mexico joined the initiative, and MILA became one of the focus of the Pacific Alliance.
Research and empirical evidence indicates that the economic benefits of Brazil joining MILA would likely be minor. A further step in this direction, however, might represent a broader political strategy to narrow the relationship with its members. Nevertheless, for preventing it to be meaningless, this would necessarily need to include BM&FBovespa as a main partner. In this context, it is worth mentioning that there may be political resistance by some of the regulators in the region, who fear that more integration with Brazil would generate loss of value and liquidity to their local markets.

### 4.2.3 Latin American Depositary Receipts

A Latin American Depositary Receipt is a security issued by a financial institution. It represents a corporate publically traded security, registered and custodied in a particular market, which could be automatically traded in various jurisdictions of the continent.

Three of the five jurisdictions analyzed in this report have special regulations for of foreign securities certificates of deposit. Brazil, Chile and Mexico are dissimilar in respect to what local markets could be addressed. However, the common decision of standardization from the regulatory bodies of those countries would facilitate the existence of a LADR, although this is not an easy task.

The LADR would be an important initiative to provide international and local investors a Latin American financial product originated in the region. The participation of Colombia and Peru in this kind of initiative would require however, changes in their legal framework.

### 4.2.4 Latin American Passport for Fund Managers

The integration of the fund industry in Europe is based on a set of Directives that established an uniform regulatory regime for the creation, management and marketing of collective investment vehicles in the European Union (EU). The development of the Undertakings for Collective Investment in Transferable Securities (UCITS) consolidated the possibility for fund managers to sell their products in the European Union without the need of specific authorizations from each member State. This mechanism is also called the European Passport for Funds.
This mechanism works as follows. If an European collective investment company decides to sell UCITS shares in any part of the continent, the securities commissions of the country where the asset managers are located have to send a standardized form to the local authority where the security is going to be distributed. The local authority has a short period to ask for further information, after which the asset manager is automatically authorized to distribute shares in this jurisdiction. All rules that the fund managers and other service providers must follow are consolidated at European Commission Directive 2009/65\textsuperscript{13}.

As there are major asymmetries in local regulations in Latin America, the development of a single regulatory framework for the fund industry should not be considered an easy task. The structure of this industry within the region is very heterogeneous in terms of master-feeder or class models, classification and pricing procedures, among other features. Harmonisation would require a lot of time and effort to be accomplished. In this context, bilateral mutual recognition could be seen as a good alternative for integration of the fund industry in the region, at least in the short term.

In this case, it would be prudent to determine that only qualified investors are allowed to buy fund shares issued in other countries, according to the definitions of qualified investors adopted in each jurisdiction.

\textsuperscript{13} See \url{http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1432731300799&uri=CELEX:02009L0065-20140917}.
5 Conclusions

Financial integration is a process that may follow different pathways. The choices differ based on the goals that are pursued and on the benefits and costs envisaged by public and private stakeholders. It is also a long term process that may change its course, depending on the achievements and failures that materialize along its path.

In this sense, the European example reflected a very ambitious target: the creation of a unified capital market that would integrate all members of the European Union. It aimed at creating a single financial market with enough size, deepness and complexity to compete with the US, the world’s main financial hub. It was also part of a political initiative to promote the free circulation of people, goods, services and capital within the Union. Therefore, it required a lot of money, time, work and political will to be achieved. The previous existence of a high volume of cross-border financial activity between the countries involved was also highly important to justify the commitment of both private and public actors.

The Latin American experience of MILA followed a different pathway. The continent has neither the objectives nor the pre-conditions that existed in Europe before unification started. MILA is a geographically limited initiative and Brazil, the largest regional market, by far, is not a participant. The financial markets of the countries involved are relatively small, except for Mexico. Previous cross-border capital market flows were almost negligent.

Due to these reasons, MILA, from an operational point of view, is limited at being an electronic platform that allows the investors of Mexico, Chile, Peru and Colombia to trade stocks cross-border in their own currencies, paying the same fees charged on a domestic trade operation. Transaction are closed and settled bilaterally between brokers located in each of the countries involved. Therefore, it is a relatively cheap and simple project that has required limited legal and regulatory changes. On the other hand, it has been a good response to the appetite of private sector leaders that have supported it. Although the amounts traded within MILA are still very small, the project has been very successful politically and is part of the agenda of the trade bloc that includes those countries - the Pacific Alliance.
Despite being the first real initiative to operationally integrate equity markets in the region, MILA has to compete on a global market that already provides Latin American 'integrated' financial products to foreign investors and LA large institutional funds and wealthy households. The connection of the local financial market to the global system in the 1990s opened the way for international banks and other financial institutions to develop financial products for investors interested in buying Latin American assets. The transaction cost involved in those deals may be high due to regulatory and legal inefficiencies and is compensated by the fees charged in the reliable "integration" services those institutions provide from the large international financial hubs, such as New York and London.

Therefore, financial integration, as the MILA and the European experiences show, should be an initiative that envisages competing directly with international financial hubs for financial assets investors of the region. Therefore, it should focus on attracting the demand related to these financial services to Latin America.

Moreover, in order to be more competitive, a LA integrated market would have to create competitive advantages. This means to be price competitive and, at the same time, to provide high quality and reliable services that could increase global size, deepness, liquidity and complexity of the markets of the continent, attracting more foreign and local investors to the capital markets than there are today. This, however, is a long road that would require a lot of time, money, work and creativity.

A successful regional financial market has also other benefits. It might provide larger and more reliable sources of finance to local corporations. However, it should not be regarded as a powerful and autonomous driver of growth and competition to compensate the downturn of the international economy and the retreat of the foreign banks from Latin America.

A competitive financial integration process would necessarily need the full involvement of the local governments. The potential gains for the public sector could be large, in terms on taxes, high value added employment, local income, technical development etc. Financial integration, as MILA and the European experience show, can also be part of a
broader political agenda and potentially strengthen the dialog among the countries involved.

Financial integration in LA should not adopt the European trajectory towards unification. What is important is that cross-border financial transactions migrates to the new regional trading systems, because it is a better option for them. In order to overcome the asymmetries on regulation, taxation and foreign exchange rules have to be reduced for creating incentives to locals and foreigners to trading through the regional capital market. This also requires that the new regional systems are considered operationally and politically reliable.

This goal can be achieved without compromising the political autonomy of the different nations. The absence of a clear directive of unification however makes it harder to achieve a previous consensus of the various private and public stake-holders on a project of this scale. The interests involved may not necessarily converge, despite the potential benefits in the long period.

From a Brazilian perspective, due to the liquidity and the competitiveness of the local financial industry, the country has some potential advantages if it decides to participate in a broad regional financial market. The road to regional financial integration in the near future has to take into consideration the new reality of the Pacific Alliance. It also has to take in to account that some important private players, such as BM&FBovespa, would have to become important drivers of the process, at least in the future. However, in the short run, the initial steps are mainly on the hands of the government; within it, CVM has a leading position.

Joining MILA should not be the Brazilian immediate target. The approximation should be done step by set. Reaching a multilateral agreement with four different regulators and governments on this issue could be a hard task, as the European experience illustrates. However, becoming an observer on the multilateral forums of MILA, as other countries already are, could be a very positive start.

The alternative is a bilateral approach with MILA partners that are open to the access of foreign securities in their local markets, namely Mexico and Chile. Brazil has a lot to
offer. It has a modern regulatory framework and a large domestic financial market. It is very well connected to the global financial system and could provide for other Latin American companies, among other benefits, a very scarce one: liquidity.

Those two countries are open for mutual recognition agreement with the Brazilian authority, Comissão de Valores Mobiliários (CVM). The connection to the Chilean and Mexican markets automatically provides access to MILA for the Brazilian companies. This is a quick win that can pave the way to more complex forms of integration.

The Latin American Depositary Receipt is a different alternative. It would become important if, within a successful process of integration with MILA countries, there is a demand from investors for a specific Latin American financial product from the region to be traded. Otherwise, if bilateral mutual recognition moves fast would become obsolete as a financial product as the corporations of the regions would be able issue and registry their securities in any regional market directly. This also applies for the suggestion of creating a 'Latin American Passport for Funds'.

Finally, financial integration is not a panacea that can solve the structural problems of Latin America, nor its financial vulnerabilities. It is, foremost, a possible path to increase the local domestic content and to provide better financial services on key economies in the region. It also may represent a positive political agenda and create closer ties among neighbour countries that have historically been very apart from each other.
References


