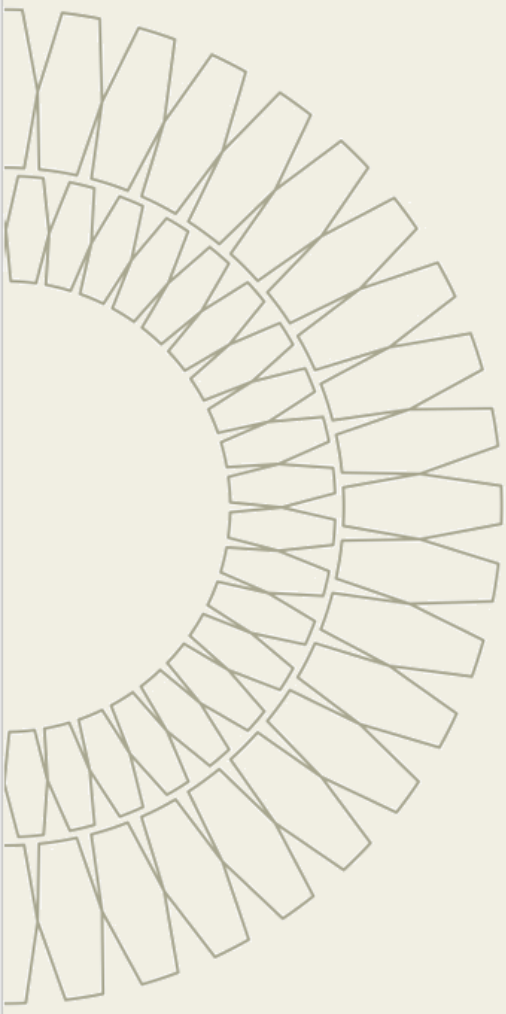




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ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS



REPORT:
FINANCIAL STABILITY OF THE AMERICAS

MEXICO CITY, MEXICO

2017

REPORT: FINANCIAL STABILITY OF THE AMERICAS

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ABBREVIATIONS

Anti-Money Laundering/ Combating the Financing of Terrorism	AML/CFT
Economic Policy Uncertainty	EPU
Economic Policy Uncertainty	EPU
Emerging Markets and Developing Economies	EMDEs
European Union	EU
Financial Soundness Indicators	FSIs
Gross Domestic Product	GDP
International Monetary Fund	IMF
Latin America and the Caribbean	LAC
Non-Performing Loans	NPLs
North American Free Trade Agreement	NAFTA
Return on Assets	ROA
Return on Equity	ROE
Risk-Weighted Assets	RWA
Total Gross Loans	TGLs
Total Gross Loans	TGL
World Economic Outlook	WEO

I. INTRODUCTION

Since the 2008 crisis, the region's growth rate has consistently decreased. In the last years, this slowdown has been driven by the end of the commodities' price boom, severe but isolated inflation problems—Venezuela— and spillovers from economic crises in major economies—Argentina and Brazil—. However, Latin America and the Caribbean are slowly recovering, but are facing several obstacles in an uncertain environment. The new U.S. administration contemplates potential changes to economic and financial policies, thereby raising uncertainty as measured by some indices. This is accentuated by the upcoming elections in the continent, possible protectionist measures around the world, and uncertainty about the recovery of the prices of commodities.

Further sources of instability arise from the de-risking process across the region, mainly in the Caribbean. De-risking is hindering corresponding banking relationships, and damaging tourism flows—an important source of revenue in the Caribbean— along with international trade. Further consequences of the de-risking process include driving customers, who search for alternatives to the reduction of services provided in less regulated areas, such as shadow banking and fintech.

Fintech is another source of potential disruption. Innovation is permanent in the financial sector; however, in this technological era, services are changing and evolving faster than ever before, and regulation has not been able to keep up with these changes. While these technology-based products and services offer efficiency gains and contribute to increasing the reach of financial services, technological risks pose a critical threat to the financial system from different perspectives: reputation, information and identity theft, classified information leaks, lack of consumer protection frameworks, and overall uncertainty on how these services operate.

The purpose of this report is to provide supervisors and regulators insight on the events and factors that might affect financial stability in the Americas, as well as contributing to identifying areas of opportunity in the implementation of international standards, and assessing financial stability indicators.

The report proceeds as follows. Section II presents and analyzes economic indicators to understand the macroeconomic environment the region has faced after the crisis. Section III gives insight about the overall resilience of the financial system of the region from two perspectives. First, it presents and evaluates information on several of the IMF's Financial Stability Indicators. Second, it shares information from ASBAS's survey on the current state of implementation of Basel standards across the region. Section IV explores several events that might pose a risk for financial stability in the Americas. Finally, section V wraps up the document by assessing financial stability in the region.

II. MACROECONOMIC ENVIRONMENT

Over the last years, Latin America and the Caribbean have gone through a significant economic slowdown. Recovery is expected; although, at a slower pace.

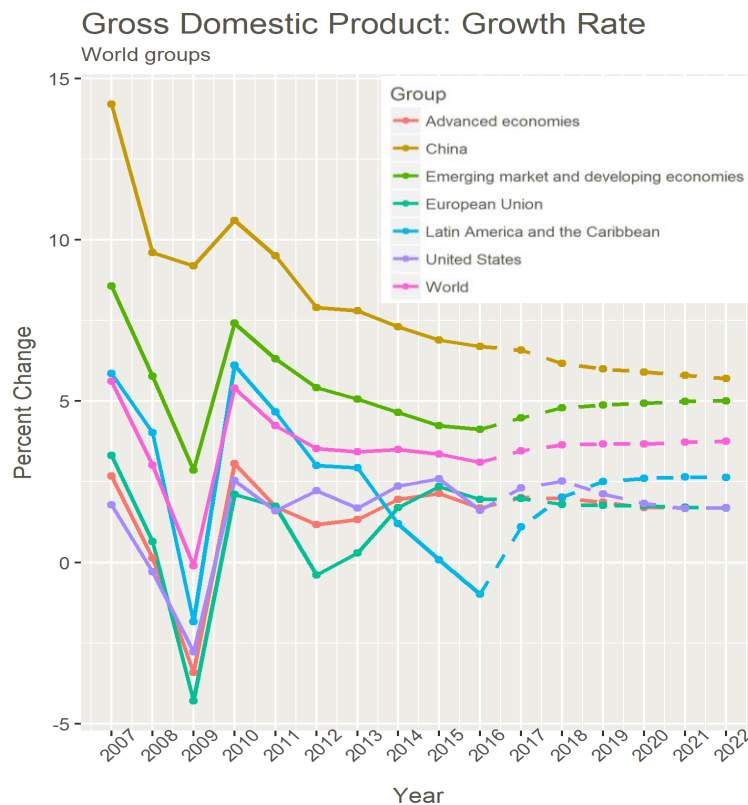
The 2008 crisis reduced global economic growth rates significantly. This tendency was reversed in 2010, bringing the world economies to a low growth environment. Indeed, except for China and the emerging and developing countries, growth rates have not gone over 4%.

Emerging Markets and Developing Economies (EMDEs) are still growing near 5% per year despite the effects of the economic crisis; however, Latin America and the Caribbean (LAC) are an exception. Although in 2010, LAC and EMDEs were growing at near 7.5% and 6% rates, respectively, the former

experienced a rapid decrease through 2016. This decrease may be explained by China, Brazil, and Argentina's slow down. Indeed, Brazil and Argentina, two of the most significant economies in the region, have suffered economic contractions over recent years, affecting the region due to economic linkages. Albeit the latter, the World Economic Outlook (WEO) forecasts a fast recovery in GDP growth for LAC over the following years, in comparison to the rest of the world.

North America has kept a stable GDP growth while Central America presents a slight slowdown; in contrast, the Andean, Caribbean, and Southern Cone regions have experienced critical economic slowdowns.

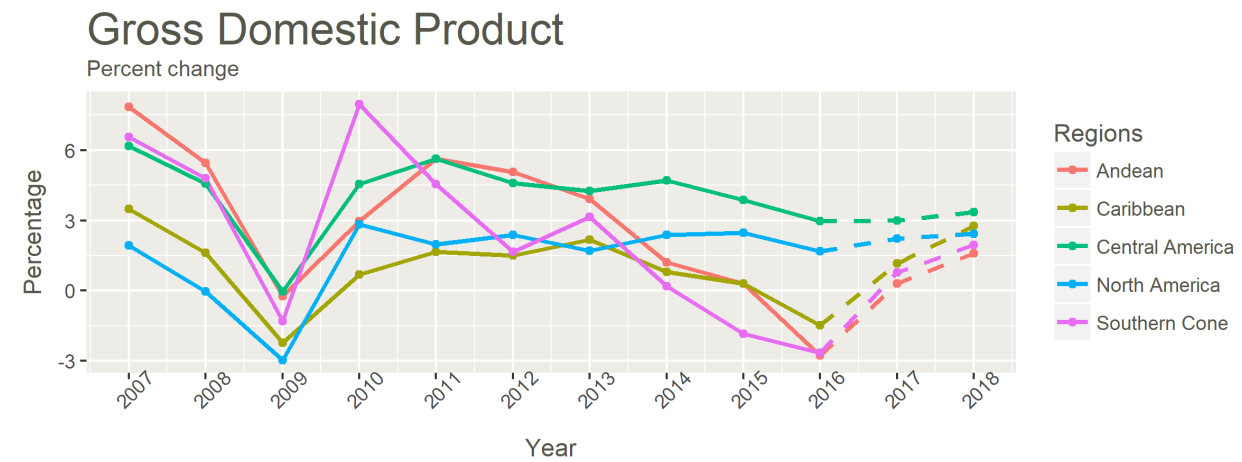
Within the Americas, regions can be categorized into two groups. The first group, which includes North and Central America, has not experienced important slowdowns over the years following the crisis. The second group, which includes the Andean, Caribbean, and Southern Cone regions, has been profoundly affected, facing negative GDP growth since 2015.



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

Within the first group, North America GDP's growth ranged between 1.5% and 3%. The Central American Region grew faster, between 3% and 5% since 2010, but faced a stronger slowdown than the former region. However, predictions from the WEO suggest that the trend in Central America will reverse during 2017.

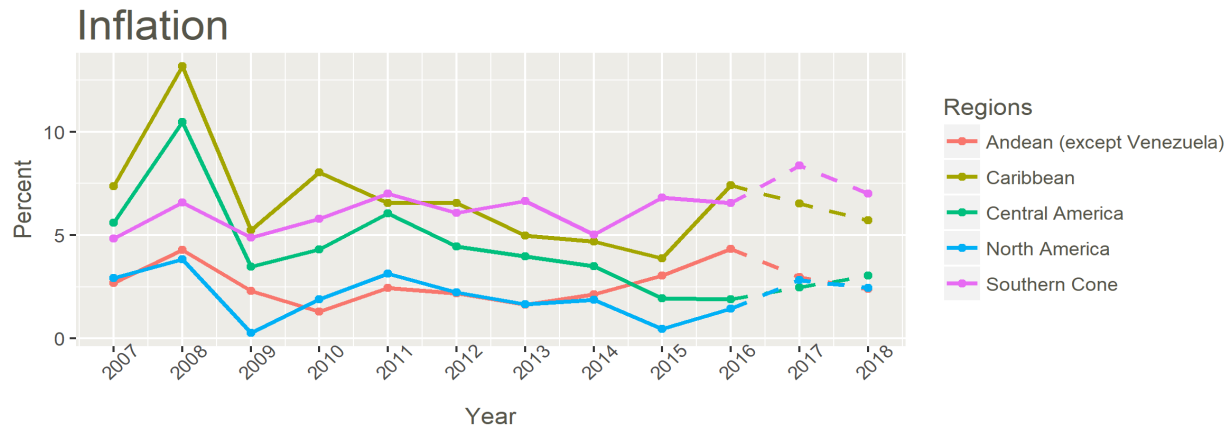
In 2016, the Andean, Caribbean and Southern Cone regions' GDP decreased around 3%, 1.5%, and 3%, respectively. These regions have faced adverse conditions over the last years, although expectations show that these economies will grow again this year. The Southern Cone had two important economic crises in their largest economies —Brazil and Argentina— which might explain the decline in the region. The Andean Region decline may be explained by the depression in Venezuela. Finally, the decline in Caribbean growth might be explained by Venezuela's crisis spillovers to the region, and a decline in tourism in some countries of the region.¹



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

¹ Royal Bank of Canada, *Caribbean Economic Report*, June 2017.

After the 2008 crisis, inflation rose until 2011. Afterwards, inflation has been stable or has decreased in almost every region in the Americas, except for the Andean Region.

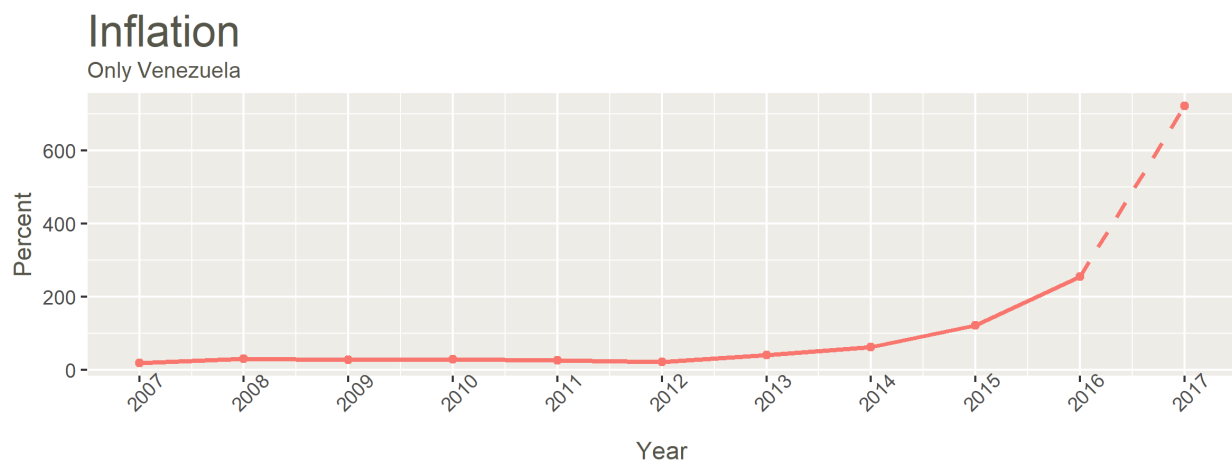


Own elaboration with data from: FMI. *World Economic Outlook 2017*.

North America’s inflation has ranged between 0% and 3% in the years following 2011. This is the region with the lowest inflation in 2016. The Andean region —without Venezuela— had similar inflation rates; however, since 2014 inflation in this region began to increase, nearly reaching 4% in 2016. Venezuela is a particular case in the Andean Region with inflation rates higher than 200% during 2016.

Both, Central America and the Caribbean regions had similar tendencies between 2009 and 2015, with decreasing inflation rates. Nevertheless, during 2016 inflation rose to around 7.5% in the Caribbean and decreased to about 2.5% in Central America —an inflation rate close to North America’s—.

The Southern Cone is the only region with stable, although high, inflation ranging between 5% and 7.5% since 2007.



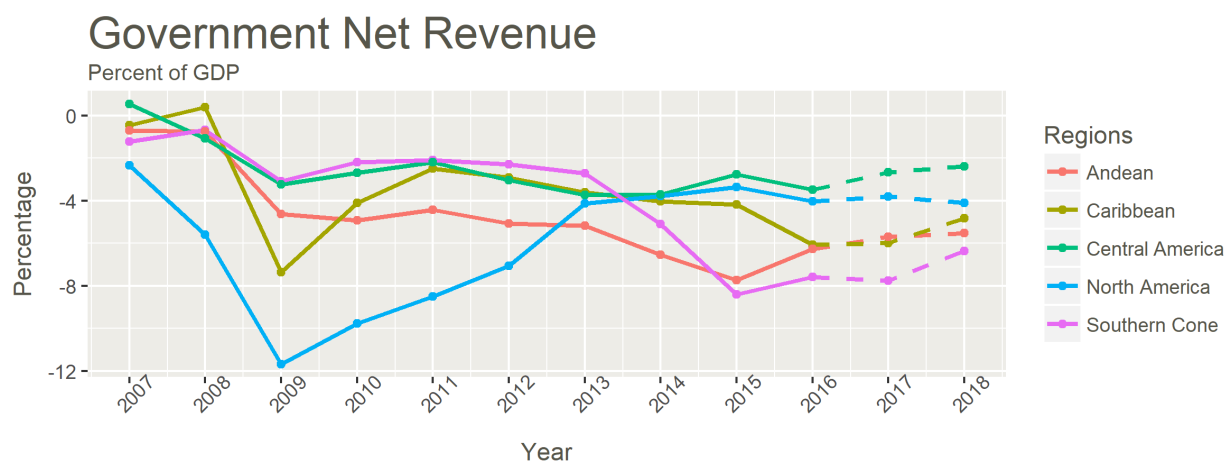
Own elaboration with data from: FMI. *World Economic Outlook 2017*.

After the 2008 crisis, LAC fiscal deficit increased, except for North America. The Caribbean, Andean and Southern Cone regions present higher increases in fiscal deficits in recent years, while North and Central America have kept constant fiscal balances.

After the 2008 global crisis, fiscal deficits started to loom within the Americas. The highest increase was North America's, which went from around 2% of GDP in 2007 to 12% in 2009. Despite this increase, this region brought its deficit down to 4% of GDP by 2016, which was lower than those recorded by the Andean, Caribbean, and Southern Cone regions. Central America is the region with the lowest fiscal deficit, ranging between 2% and 4% of GDP.

The region with the highest fiscal deficit is the Southern Cone. This region reached a deficit close to 8% of GDP. Although the region did not have a considerable increase in its deficits during the financial crisis, it began its scaling up since 2015, due to the fiscal problems in Brazil and Argentina.

The Caribbean region's fiscal surplus before the crisis turned into a deficit close to 7% of GDP in 2009. By 2011, its deficit was reduced to near 3% of GDP; however, in recent years the region's fiscal deficit has increased, reaching 6% of GDP in 2016.



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

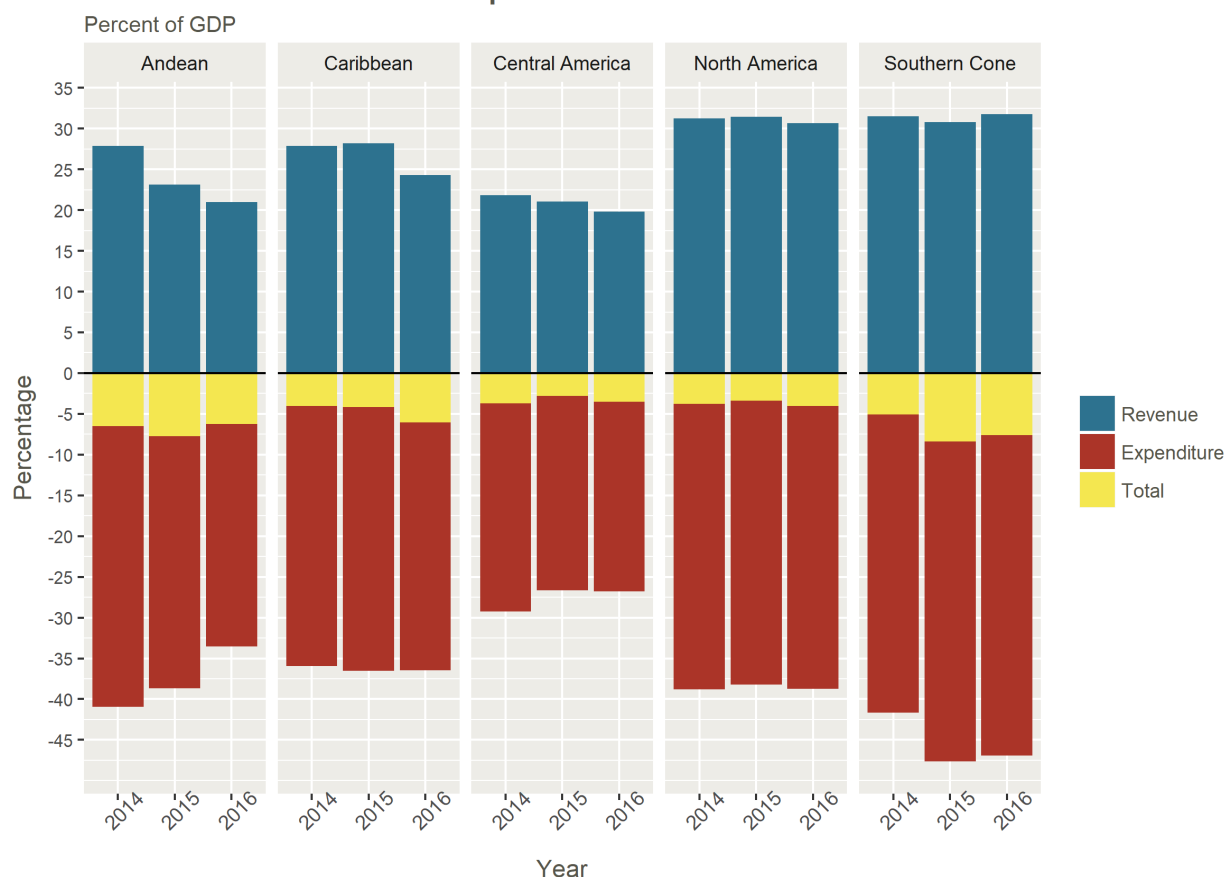
The regions with the highest revenue, as a proportion of GDP, are North America and the Southern Cone; however, the regions with the lowest deficit are North and Central America.

Across the Americas, government expenditures are greater than revenues. The proportion of these expenses to GDP varies across regions. For instance, North America and the Southern Cone are the regions with the highest revenues as a proportion of GDP, while the Southern Cone, along with the Andean region, spends more in comparison to the rest of the regions.

Central America is the region with the lowest revenue as a proportion of GDP in the Americas. Nevertheless, their fiscal deficit as a proportion of GDP is relatively small, reaching levels similar to North America's.

The Caribbean is the region with an intermediate fiscal deficit as a proportion of GDP. Also, the Caribbean is an intermediate region regarding revenue and expenditure levels as a proportion of GDP.

Net Revenue and Expenditure



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

After the 2008 global crisis, unemployment rates decreased in the Americas. However, this trend reversed in recent years for the Andean and Southern Cone regions.

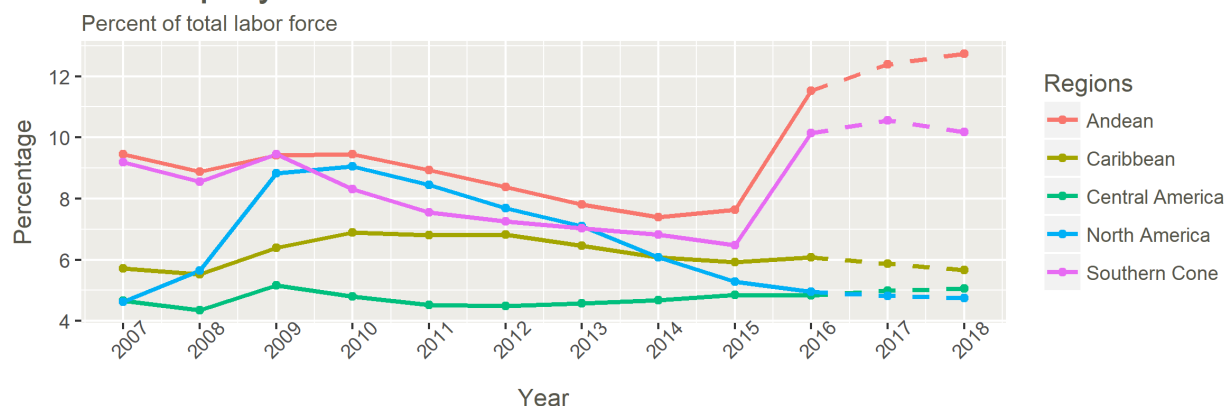
North America is the region where unemployment increased the most after the crisis; however, it has been consistently decreasing since 2010, moving from 9% to about 5%. The IMF forecasts that unemployment will stabilize near 4% in this region during 2017 and 2018.

In the Caribbean, the unemployment rate ranged between 6% and 7%. Forecasts predict that this indicator will slightly decrease in 2017 and 2018.

Central America is the region with the lowest unemployment rate, which has not risen above 5% since 2009; however, the reader must bear in mind that data are gathered only for a few cities within these countries. The forecast indicates that the unemployment rate will remain stable at around 4%.

The Andean and Southern Cone regions show a similar pattern. The unemployment rate decreased every year between 2010 to 2015, when this trend reversed and unemployment rates increased from 7% in the Southern Cone and near 8% in the Andean to near 10% and 12%, respectively. For the Southern Cone, this deterioration is related to the contractions in Brazil and Argentina. For the Andean region, the crisis in Venezuela and linkages to the Southern Cone might explain the increase in unemployment rates.

Unemployment Rate



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

Capital outflows have been greater than capital inflows in emerging economies, except for Latin America during the last three years.

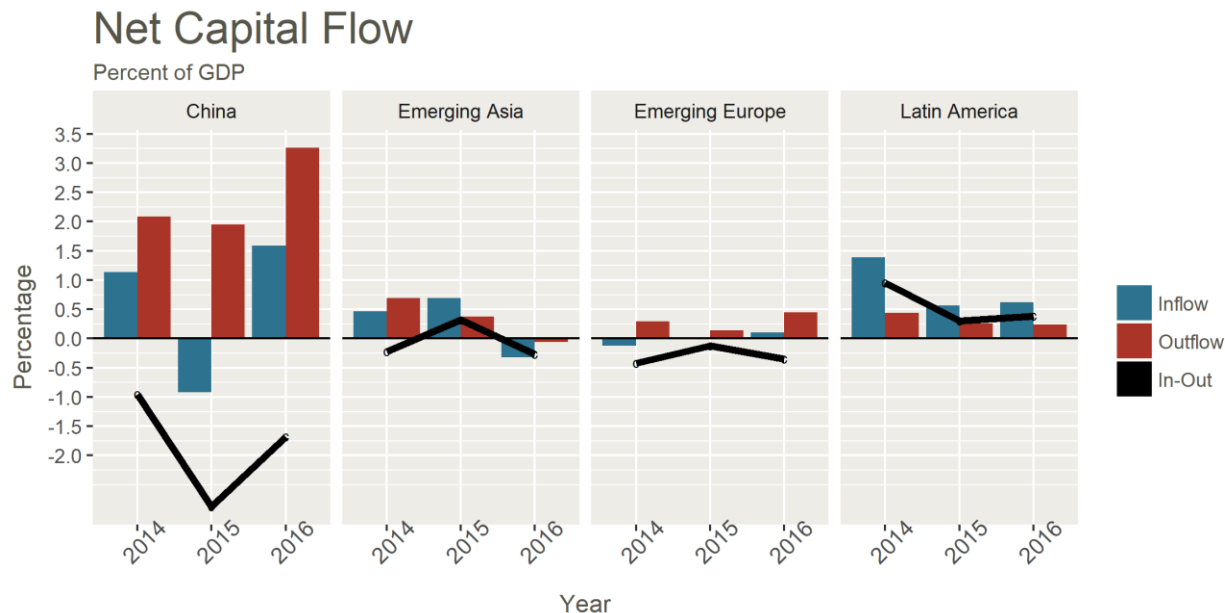
Capital inflows and outflows behavior have varied among emerging markets. For instance, Latin America registered positive net capital flows in recent years, while other emerging economies such as China, Emerging Asia, and Emerging Europe experienced negative net capital flows.

China is a country with significant capital inflows and outflows as a percentage of GDP in recent years. Most of China's outflows to LAC have been directed to Cayman Island, Guyana, Virgin Island, and Suriname.² Furthermore, foreign investors sell the yuan as China's economy slows down while the dollar rallies and domestic households buy other currencies, thus pressuring the yuan's exchange rate, leading to increasing outflows.³

Net capital flows to emerging markets decreased significantly during 2016, leading to negative flows in Emerging Asia and Emerging Europe; however, Latin America was more resilient to this phenomenon. This reduction in capital flows to emerging markets could have been due to the increase in the U.S. interest rate in late 2016 and during 2017, encouraging investors to withdraw capital from EMDEs and invest it in the U.S.

² "Renminbi Diplomacy? The Limits of China's Influence on Latin America's Domestic Politics" https://www.brookings.edu/wp-content/uploads/2016/11/renminbi-diplomacy_harold-trinkunas.pdf

³ <https://www.bloomberg.com/news/articles/2017-01-13/what-s-causing-those-capital-outflows-from-china-quicktake-q-a>



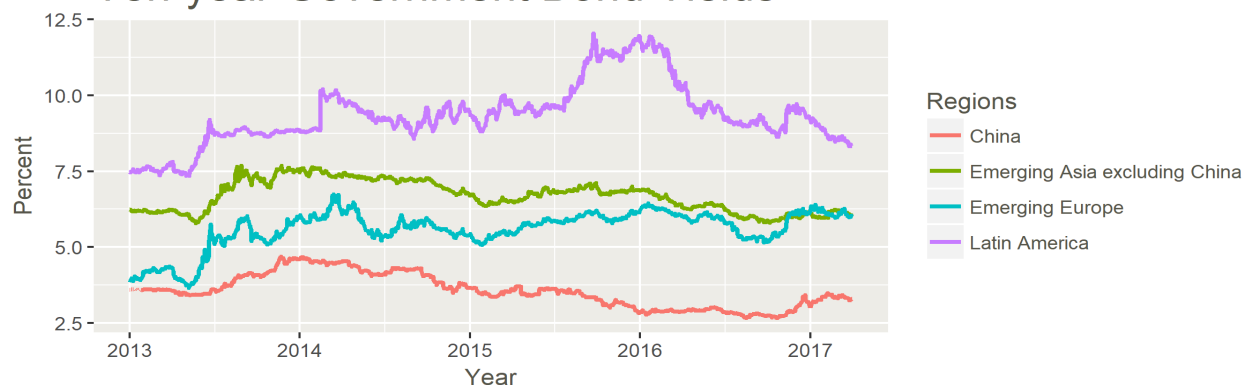
Own elaboration with data from: FMI. *World Economic Outlook 2017*.

Ten-year government bond yields are considerably higher in Latin America than in other emerging regions.

Ten-year government bond yields reflect a return on investment in government bonds. When demand for government bonds increases, their price increases resulting in a lower yield. When government yields are high, investors tend to buy government bonds instead of acquiring riskier assets. Thus, government bond yields are used as a proxy measure of investors’ confidence in the economy.

Government bond yields in Latin America have been higher than in other emerging economies in the last four years. The yields of Chinese government bonds decreased from 2014 through the end of 2016 due to monetary easing policies aimed at stimulating growth via credit expansion. However, recent monetary tightening policies, particularly the rise of U.S. interest rates, increased yields in late 2016. Latin American government bond yields decreased due to the reversal of the most recent monetary tightening implemented to control higher inflation expectations.

Ten-year Government Bond Yields



Own elaboration with data from: FMI. *World Economic Outlook 2017*.

III. HEALTH OF THE FINANCIAL SYSTEM

FINANCIAL SOUNDNESS INDICATORS

This section employs the IMF's Financial Soundness Indicators (FSIs) to provide insights into the financial health and soundness of a country's financial system.⁴ This IMF database was last updated in March 2017 and contains data from 2016 for most countries.

The analysis focuses on Core and Additional FSIs for Deposit Takers using data from Argentina, Brazil, Chile, Colombia, El Salvador, Guatemala, Mexico, Peru, and Trinidad and Tobago. Based on the availability of information, the data for Guatemala and Mexico correspond to 2015. The country selection followed three criteria: first, to select at least one country from each region in the Americas;⁵ second, to privilege larger economies within each subregion; and third, to include countries with available information.

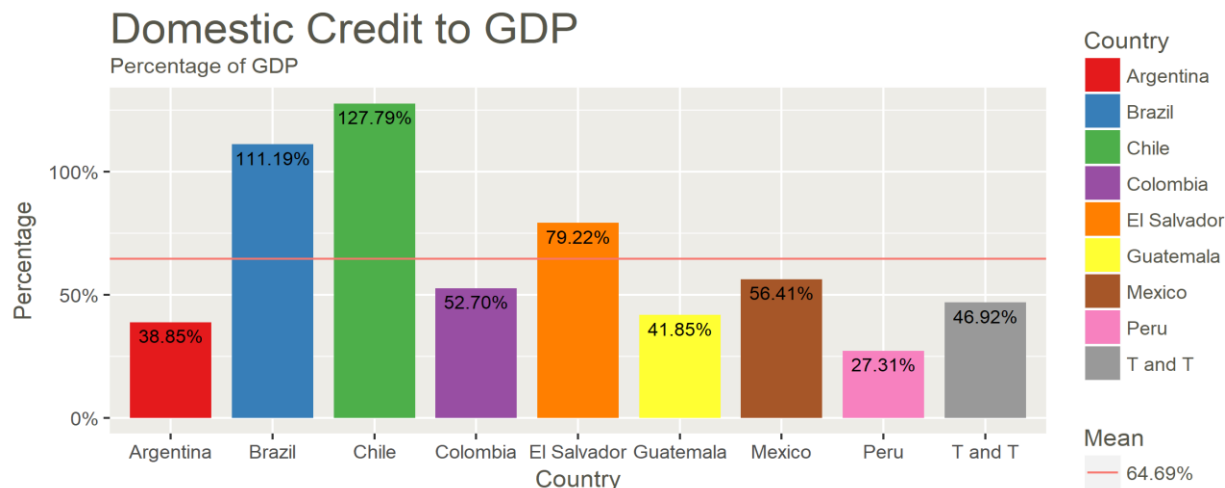
SIZE OF THE FINANCIAL SYSTEM

The region's financial systems are underdeveloped in comparison to financial systems in advanced economies.

The domestic Credit-to-GDP ratio is generally used as a proxy for the development of a country's financial system. Advanced economies display significantly larger ratios than less developed economies. For instance, U.S. ratio is 242.6%, while the sample's mean is 64.7%. According to this measure, the region's most developed financial system is Chile's followed by the Brazilian system.

⁴ International Monetary Fund, *Financial Soundness Indicators and the IMF*, <https://www.imf.org/external/np/sta/fsi/eng/fsi.htm>

⁵ For ASBA, regions in the Americas are North America, Central America, Caribbean, Andean, and Southern Cone.



Own elaboration with data from: World Bank. *World Development Indicators*. 2017

CAPITAL ADEQUACY

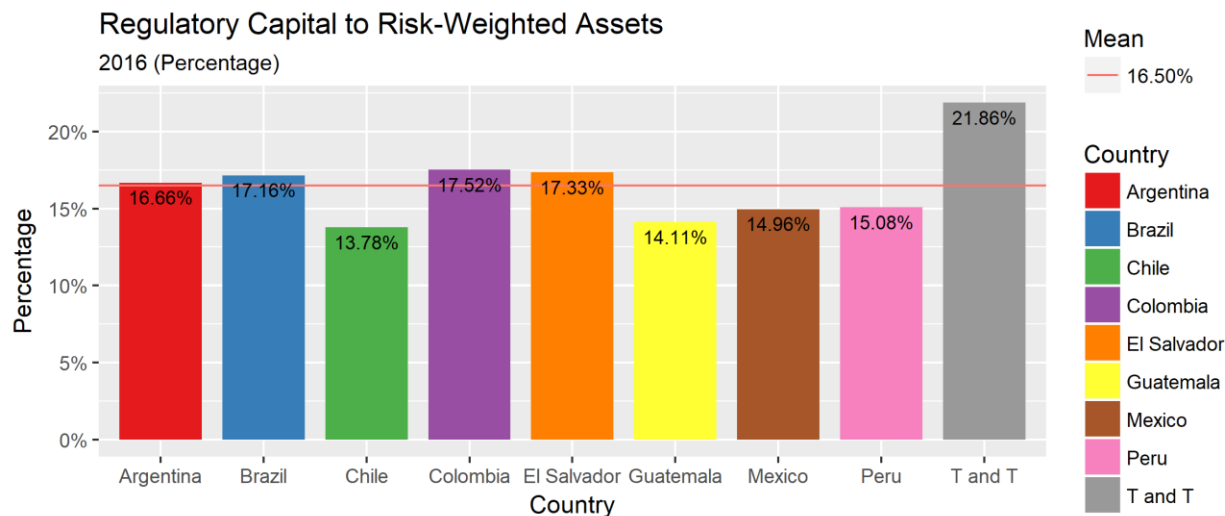
Capital adequacy ratios are above the Basel recommendations in the Americas, showing levels higher than 12% and 10% for Regulatory Capital to Risk-Weighted Assets (RWA) and Tier 1 Capital to RWA, respectively. Furthermore, most assets in the region are funded by third-party resources.

In the selected LAC countries, capital adequacy ratios are above 12% for regulatory capital to RWA and 10% for Tier 1 capital to RWA. The mean regulatory capital to RWA is 16.5%. Capital adequacy ratios are well above Basel requirements. Therefore, according to Basel guidelines, aggregate banking systems in the region should have enough capital to absorb reasonable losses and provide sufficient cushion for protecting consumer deposits, fostering financial stability.

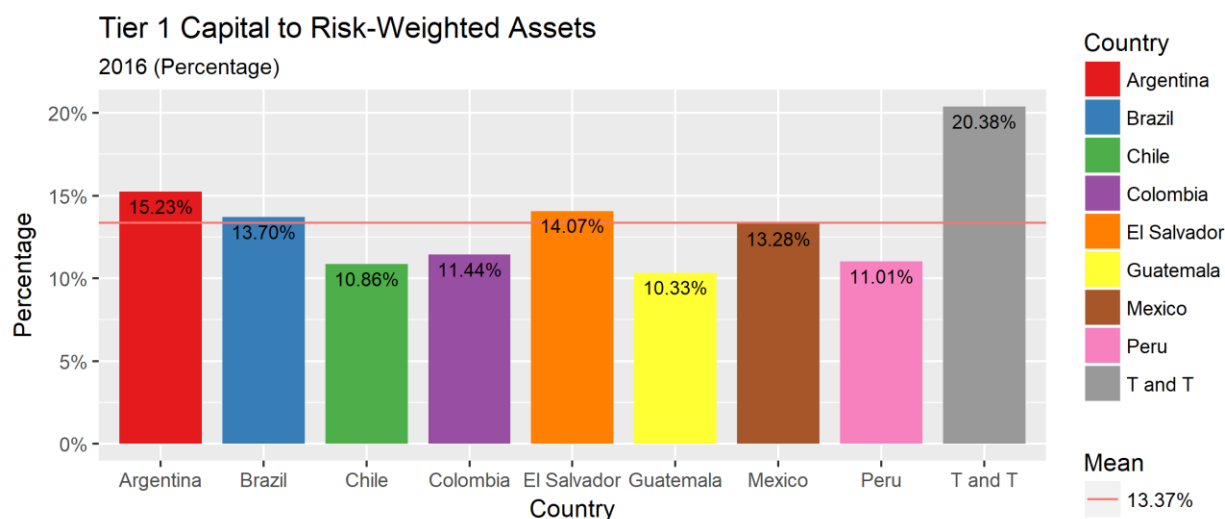
In particular, Trinidad and Tobago has unusually high capital adequacy ratios. These higher ratios might be influenced by more stringent requirements stemming from Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) policies.

Despite facing economic crises, Argentina and Brazil keep similar capital adequacy ratios as other countries. This might be explained by a reduction in loans in these countries since there is evidence that banks have a strong incentive to reduce assets rather than increase the quantity and quality of capital in slowdowns or recessions.⁶

⁶ Hanson, S. G., Kashyap, A. K., & Stein, J. C. (2011). A macroprudential approach to financial regulation. *The Journal of Economic Perspectives*, 25(1), 3-28.



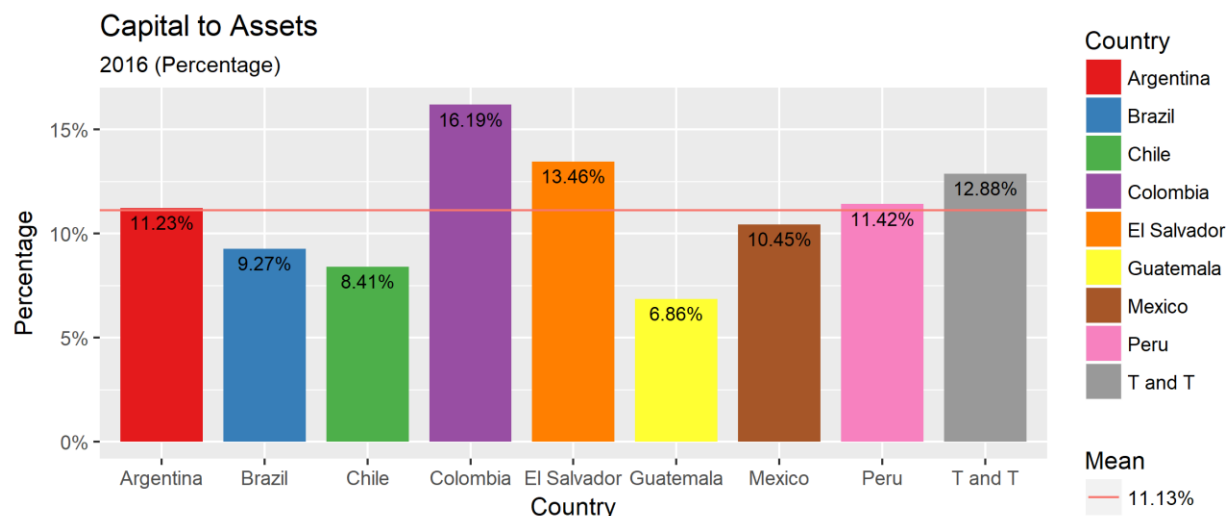
Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

The Capital to Assets FSI is inversely proportional to leverage. That is, the indicator is lower (higher) the more (less) leveraged are financial institutions. The indicator informs about the extent to which assets are funded by sources other than equity, i.e., customer deposits, credits borrowed from other entities, among others. This FSI complements the information provided by the capital adequacy ratios because it is unaffected by accounting manipulations.

The sample's mean ratio is 11.1%, which means that sources other than equity funds most of the assets in the region's markets; however, the ratios are higher than the minimum Basel requirements set at 3%. Guatemala has the lowest Capital to Assets ratio in the region with 6.86%, while Colombia has the highest ratio of 16.19%.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

NON-PERFORMING LOANS

Most countries in the sample hold enough provisions to cover nonperforming loans' (NPLs) expected losses. While Brazil and Peru might be facing credit deterioration episodes, the Caribbean is the most vulnerable region.

The Nonperforming Loans to Total Gross Loans ratio is used to identify problems with the quality of the loan portfolio since a higher ratio usually reflects deterioration in the credit portfolio. This indicator is calculated dividing NPLs by total gross loans (TGLs). The sample's mean is 2.7%.

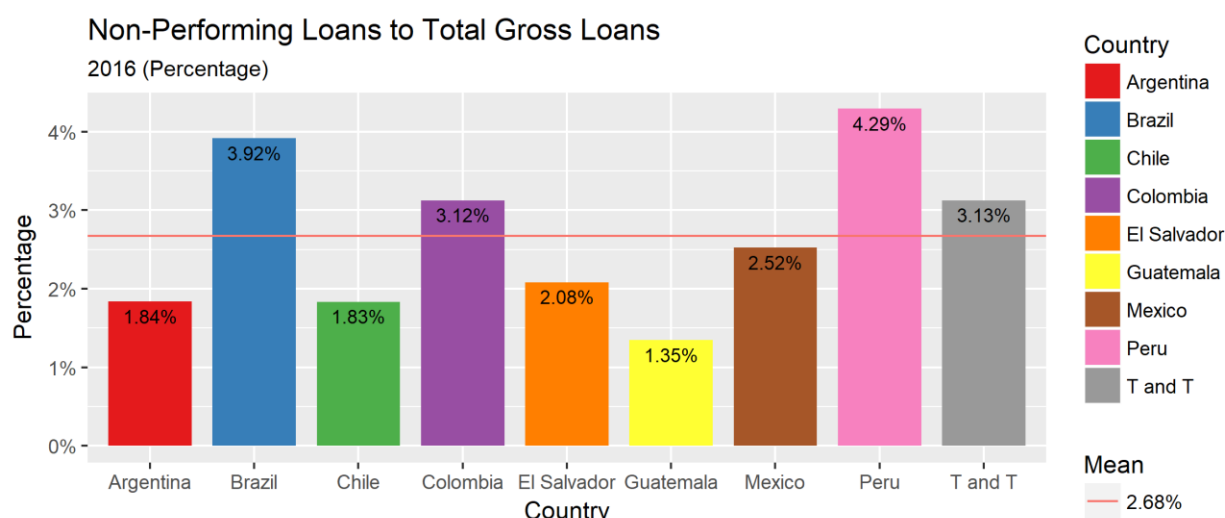
The countries with the lowest NPLs to TGLs are Guatemala, Chile, and Argentina, with ratios below 2%. Meanwhile, the countries with the highest ratios are Peru and Brazil. Higher ratios may signal either unexpected stress in the real sector, or a relatively high risk-taking approach by financial institutions, or both.

The FSI on Non-Performing Loans Net of Provisions to Capital is calculated by, first, subtracting provisions from the value of non-performing loans, and, second, dividing the result by capital. Therefore, if provisions are smaller (greater) than the value of NPLs, the ratio will be greater (smaller) than 0. Thus, a more negative value depicts greater coverage against losses. There are no recommendations as to the ratio's optimal value since the ratio depends on banks' risk-bearing strategies. The sample's mean is -3.1%, which indicates that provisions are higher than the value of NPLs for most countries in the region.

On the one hand, Brazil has the most negative ratio among the sample. While holding capital constant, this situation may be either an indicator of firms' widespread perception of vulnerability where firms are setting aside a considerable amount of funds in the form of provisions to protect themselves against a high probability of losses, or an indicator of an effective conservative risk management.

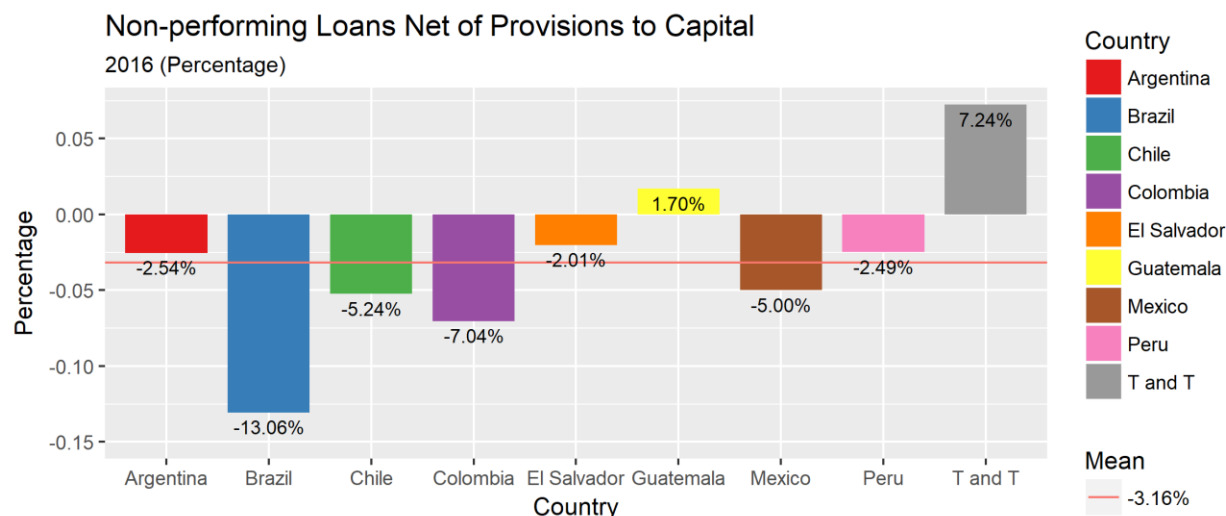
On the other, Trinidad & Tobago’s NPLs exceed provisions by the most significant margin among countries in the region. The case of T&T reflects a general situation in the Caribbean, where Eastern Caribbean Currency Union (ECCU) banks have experienced substantial financial distress after the 2008 crisis, with a significant increase in non-performing loans. The deterioration in asset quality across the Caribbean region reflects the need to strengthen their financial infrastructure through improvements in credit risk management, collateral use, and market discipline to help banks enhance their financial risk management.⁷

Simoustanteously interpreting the Nonperforming Loans to Total Gross Loans ratio and the Non-Performing Loans Net of Provisions to Capital ratio can shed light on banks’ risk-bearing strategy. For instance, Brazil and Peru have similar Nonperforming Loans to Total Gross Loans ratios, with 3.9% and 4.3%, respectively. However, Brazil, with -13.0%, has a lower Non-Performing Loans Net of Provisions to Capital ratio than Peru with -2.5%, reflecting that Peruvian banks may have less conservative strategies than Brazilian banks.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

⁷ Beaton, K., Myrvoda, A., & Thompson, S. (2016). Non-Performing Loans in the ECCU: Determinants and Macroeconomic Impact. International Monetary Fund.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

BANKS' PROFITABILITY AND INCOME SOURCES

Return on Assets (ROA) and Return on Equity (ROE) vary widely across the regions' banking systems. Argentinean banks' high profitability stands out while Central American banks are the least profitable in the region. Also, interest rate margin is the main source of income in all of the region's countries, except for Argentina where banks earn more from government bonds returns than from interest rate margins.

ROA is obtained by dividing net income by the value of total assets. Thus, albeit imperfect, this is a measure of efficient use of resources by financial institutions. The sample's mean ROA is 2.2%. Argentina's banks have the highest ROA, followed by Colombia's. In contrast, the banking sectors of El Salvador, Brazil, and Chile display the lowest ROA in the sample. Banking systems in Central American countries stand out as having average to low profitability.

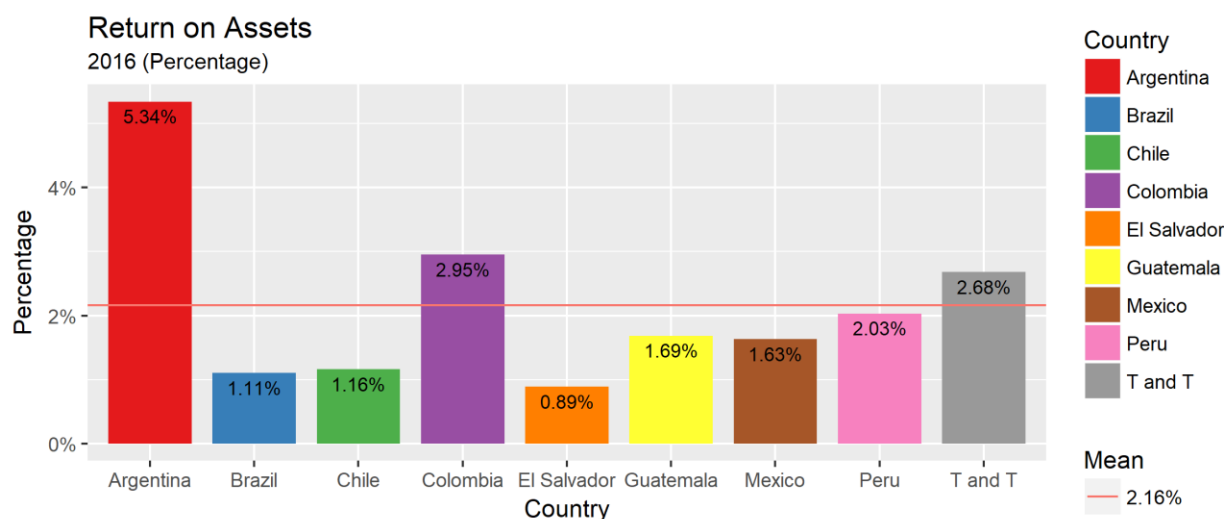
In Argentina, the banks' high ROA is explained by windfall profits from inflation, obtained because interest rates charged to borrowers are high and interest rates paid to depositors are low,⁸ and the higher interest rates paid by domestic government bonds. In contrast, the relatively high Colombian banks' ROA stems from the bank assets' growth experienced in recent years.⁹

⁸ Banco Central de la República Argentina, "Financial Stability Report - Second Half of 2016", 2017

⁹ OECD, "Colombia: Review of the Financial System", 2016 <https://www.oecd.org/finance/Colombia-financial-markets-2016.pdf>

Regarding countries with low ROA, the recession in Brazil is partly responsible for the downward path experienced by the ROA in this country. However, profitability is expected to recover in line with the recent decrease in loan delinquencies.¹⁰ Similarly, the economic slowdown experienced by Chile since 2014 has affected its banks' profitability through slower-than-expected credit growth.¹¹ Finally, the relatively low profits of Central American banking systems might be driven by the higher administrative costs associated with controlling reputation risk.

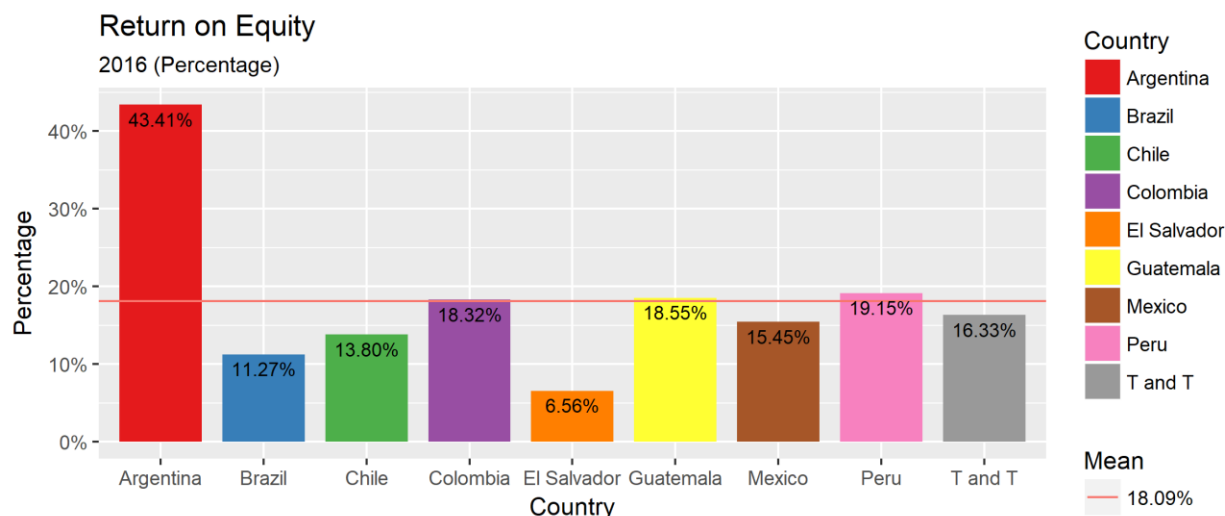
ROE is calculated by dividing net income by the value of capital in a period. This indicator measures how efficiently banks manage their capital. However, this indicator needs to be interpreted jointly with adequacy indicators because a high ROE might reflect either high profitability or low capitalization. The sample's mean ROE is 18.1%. ROE ranges between 11% and 20% in the region, except for El Salvador (6.6%) and Argentina (43.4%). Usually, countries with higher ROA display higher ROE and the drivers of ROA and ROE are the same within a country.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

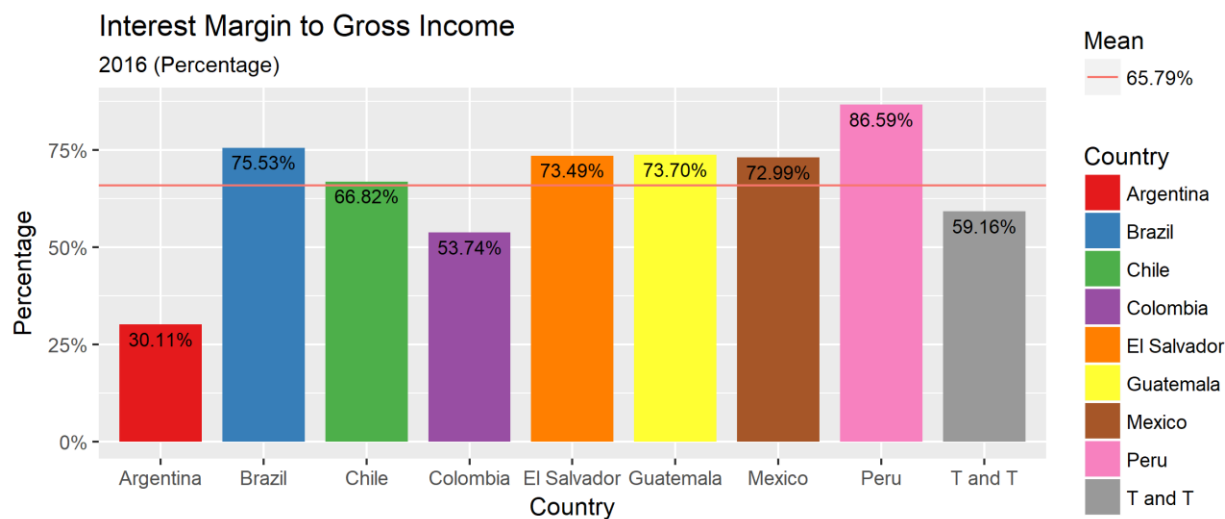
¹⁰ Central Bank of Brazil, "Financial Stability Report", April 2017

¹¹ Reuters, "Fitch: Chilean Banks Well-Positioned to Face Slowdown", <http://www.reuters.com/article/idUSFit94077320151207>, Accessed: 8/29/2017



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

The Interest Margin to Gross Income ratio is computed by dividing the difference between interest income from loans and interest payments to depositors and lenders by gross income, which is defined as interest margin plus other sources of income¹². The sample's mean is 66.8%. Interest margin is the primary source of income in all of the region's countries, except for Argentina where banks earn more from government bonds returns than from interest margins.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

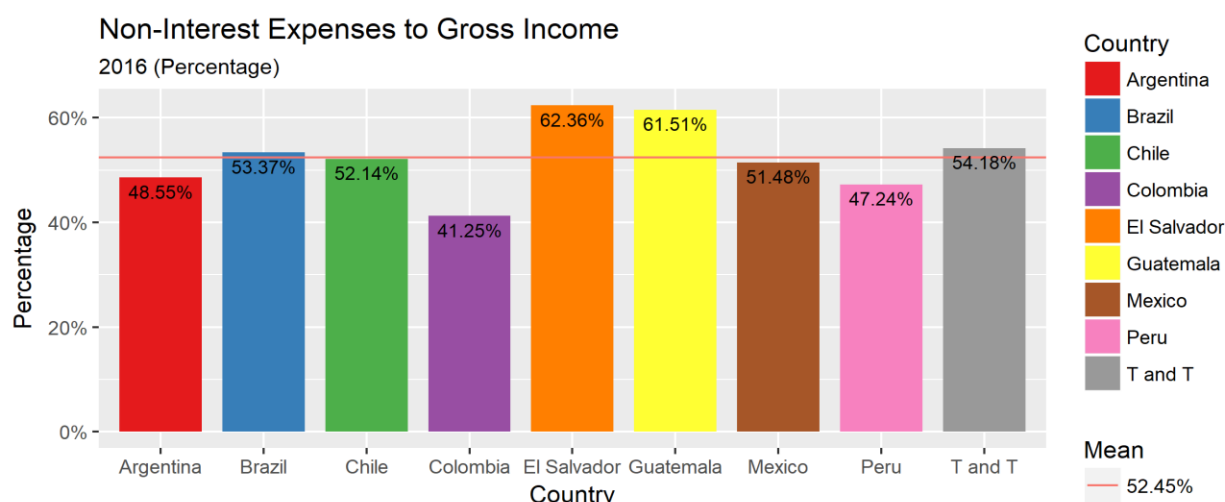
¹² According to the IMF, other sources of income consist mainly of fees and commissions, gains or losses of financial instruments, and prorated earnings.

BANK EXPENSES

About half of gross income is destined to administrative expenses in the banking systems of the Americas. Personnel expenses represent over 47% of these administrative expenses on average.

Noninterest Expenses to Gross Income measures the proportion of gross income destined to administrative expenses¹³. In general, the lower this indicator is, the more efficient the administrative processes are. Administrative costs represent about half of the gross income in most banking systems in the region. The sample's mean is 52.5%. The banking systems of Central American countries, which display average to relatively low profitability, have the most significant ratios of non-interest expenses to gross income.

The Personnel Expenses to Non-Interest Expenses ratio measures the proportion of administrative costs corresponding to personnel expenses. Personnel expenses include wages and salaries, paid leaves, bonuses, allowances for housing and transport, subsidies, and social security. The sample's mean is 60.1%, a coefficient larger than the United States' 46.9%.

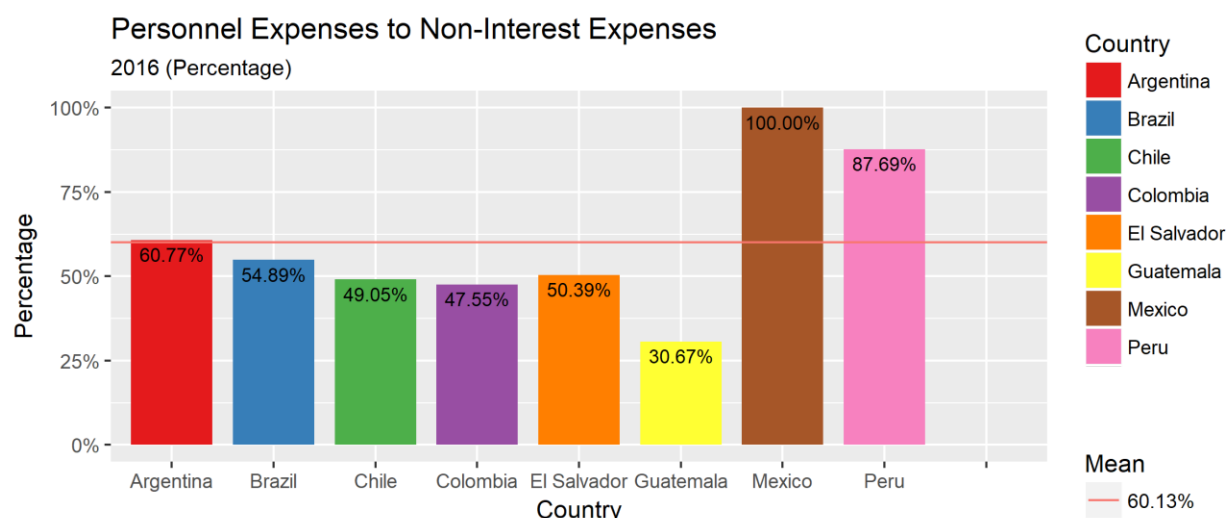


Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

Guatemala has the lowest relative personnel expenses, which represent only 30.7% of their administrative expenses. This implies that most of their administrative outlay is used to withstand a heavy burden of operational costs; thus, care is advised to avoid inefficiencies. Mexico and Peru have the highest average personnel expenses among the countries of the sample, which means that their operational costs might not represent such a burden. Nevertheless, it is unlikely that 100% of administrative costs in Mexico's banking system are destined to personnel expenses, which leads to the

¹³ Administrative expenses are comprised of personnel costs, expenses for property and equipment, purchases of goods and services, royalties, taxes other than income taxes.

conclusion that this percentage originates in a reporting error. Finally, the IMF's FSIs database does not report data on personnel expenses to non-interest expenses for Trinidad and Tobago. The difficulties to measure costs in Caribbean banking systems reflect the region's financial system's relative opacity.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

LIQUIDITY

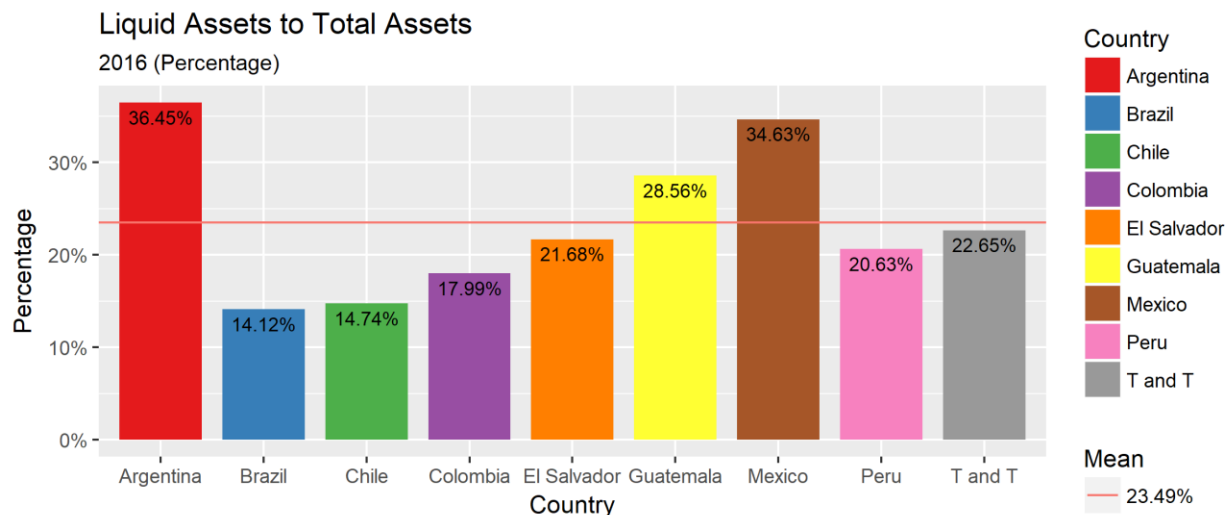
The region's financial systems hold sufficient liquid assets to withstanding unexpected shocks to liquidity. Argentina and Mexico have the highest ratios of liquid assets over total assets, while Brazil is readier to withstanding short-term liabilities.

The Liquid Assets to Total Assets ratio is related to liquidity risk in a jurisdiction. A higher indicator implies that banks are more capable of withstanding sudden deposit withdrawals. This indicator varies widely across advanced economies, for instance ranging from 12.8% in the United States to 44.8% in Germany. The sample's banking systems average liquid assets to total assets ratio is 23.5%, which represents a sufficient cushion to coping with moderate shocks to liquidity.

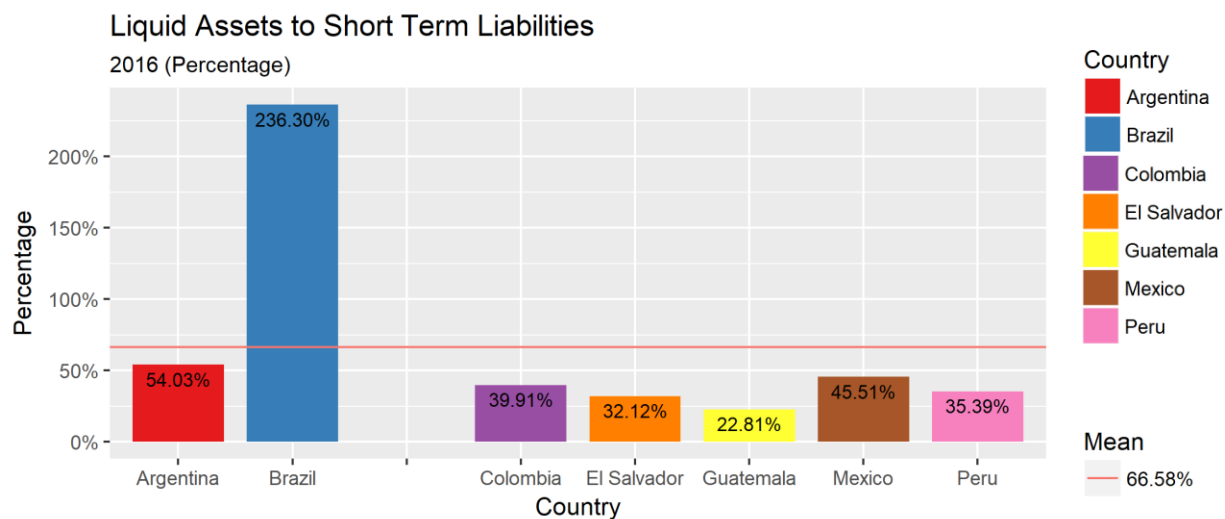
The countries with the highest ratios are Argentina (36.5%) and Mexico (34.6%). The South American country's banking system holds excess cash reserves because, in addition to the stagnation of the credit-to-GDP ratio, the Central Bank refuses to take additional deposits in both local and foreign currencies¹⁴. Meanwhile, Mexico's relatively high ratio is related to the recently reversed expansionary monetary policy. Conversely, Brazil and Chile display the lowest liquid assets to total assets ratios among the sample.

¹⁴ <https://www.infobae.com/economia/finanzas-y-negocios/2017/02/08/los-bancos-no-saben-que-hacer-con-los-pesos-y-los-dolares-que-les-sobran/>

The Liquid Assets to Short-Term Liabilities ratio points out the extent to which banks are prepared to face short-term obligations without facing liquidity problems. A higher indicator means that banks sufficient liquid assets to withstanding sudden deposit withdrawals. Brazil's outstandingly high ratio may be related to the recent implementation of regulations aimed at increasing liquidity.

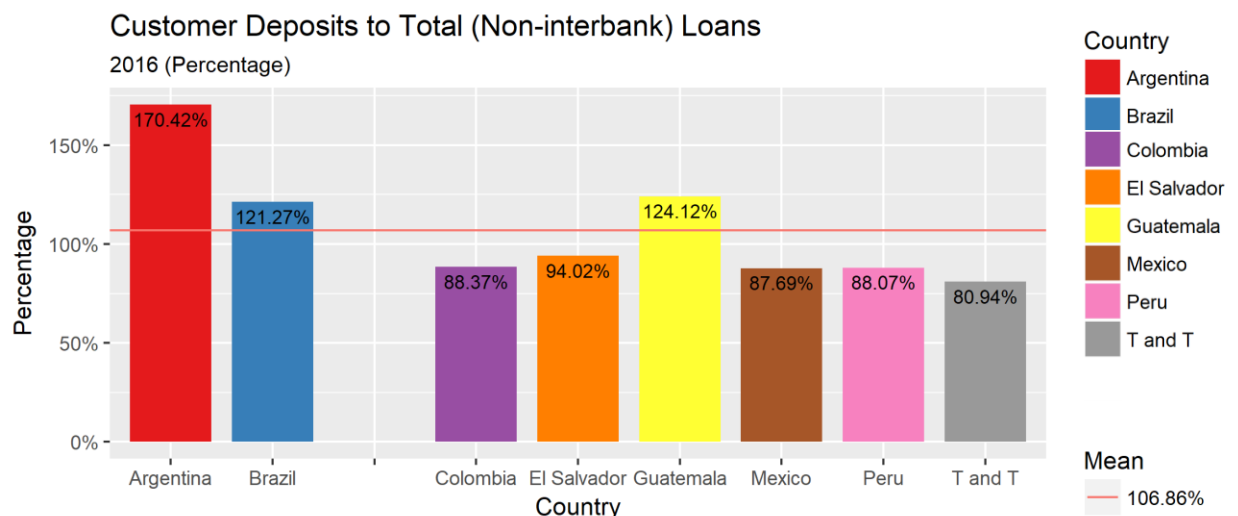


Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

The Customer Deposits to Total Non-Interbank Loans ratio is another measure of liquidity. The higher the ratio is, the more liquid a country's banking system. The sample's mean is 106.9%. Countries experiencing economic recessions or contractions register larger ratios because credits diminish and deposits increase as a proportion of GDP during downturns. The ratio is unusually high, surpassing 100%, in Argentina and Brazil, countries facing severe recessions in recent years.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

DERIVATIVES

While the region’s derivatives markets remain underdeveloped in comparison to markets in advanced economies, Brazil, Chile, and Mexico hold significant gross asset and liability positions in financial derivatives.

Within a financial system, Gross Asset Positions in Financial Derivatives refer to the book value of all derivatives owned, while Gross Liability Positions in Financial Derivatives refer to the book value of all derivatives owed by the institutions. The gross asset position in financial derivatives and the gross liability position in financial derivatives are similar within a country. Meanwhile, the gross asset and liability positions in financial derivatives vary widely accros countries, depending on the degree of development of the derivatives’ markets.

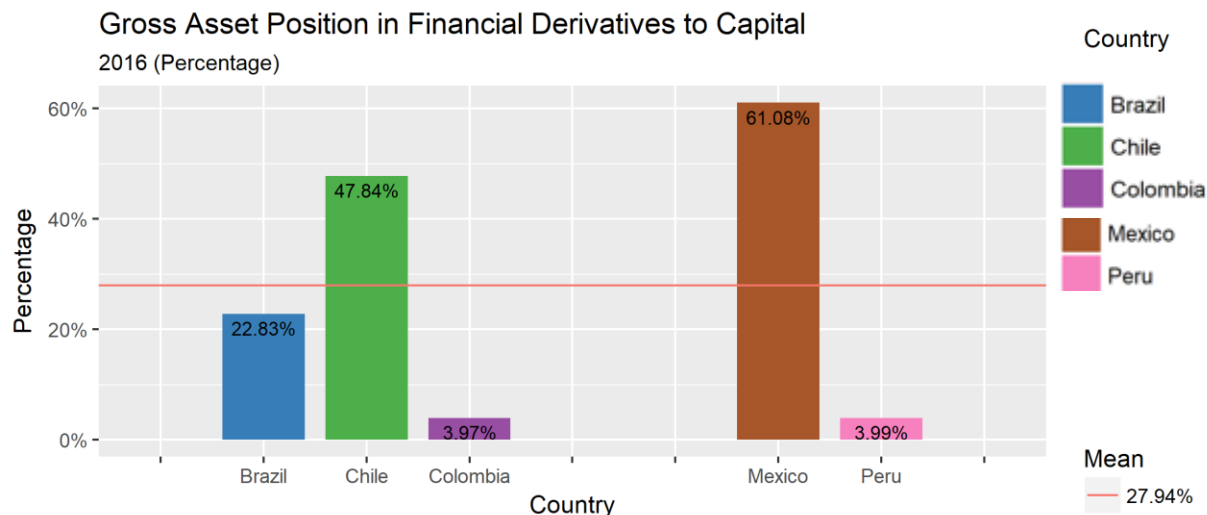
A few countries in the region hold significant gross positions in financial derivatives. For instance, Brazil hosts the region’s largest derivatives market in terms of traded volume;¹⁵ however, its financial system’s gross asset and liability positions as a proportion of capital are only slightly above 20%. At the same time, Chile’s financial system holds proportionally larger gross asset and liability positions in financial derivatives than Brazil, each accounting for about 45% of its capital. The Mexican financial system’s position as a share of capital is the largest in LAC, with both positions surpassing 60%.

The rest of the region’s financial systems host negligible or unexistent derivatives markets. Gross asset and liability positions as a proportion of capital reach between 3% and 4% in Colombia and Peru.

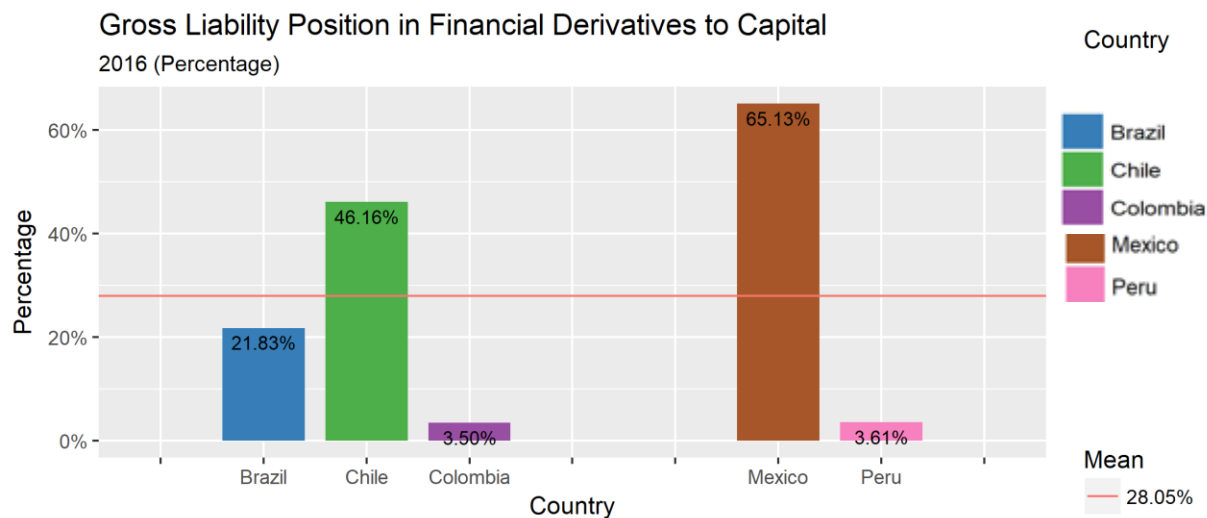
¹⁵ Celent, “OTC Derivatives in Asia and Latin America: Evolution and Regulation”, <https://www.celent.com/insights/154228396>, Accessed: 08/30/2017

Argentina did not report information on these positions, possibly because it opened its derivatives market to foreigners in December 2016. Other countries' gross positions in financial derivatives are not reported by the IMF's Financial Soundness Indicators database, arguably due to the small volumes traded in their derivatives markets.

The region's derivatives markets are still underdeveloped. For instance, Germany's financial system hosts a highly developed derivatives market. This financial system's gross asset positions in financial derivatives account for 651% of capital, while gross liability positions in financial derivatives account for 663% of capital.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

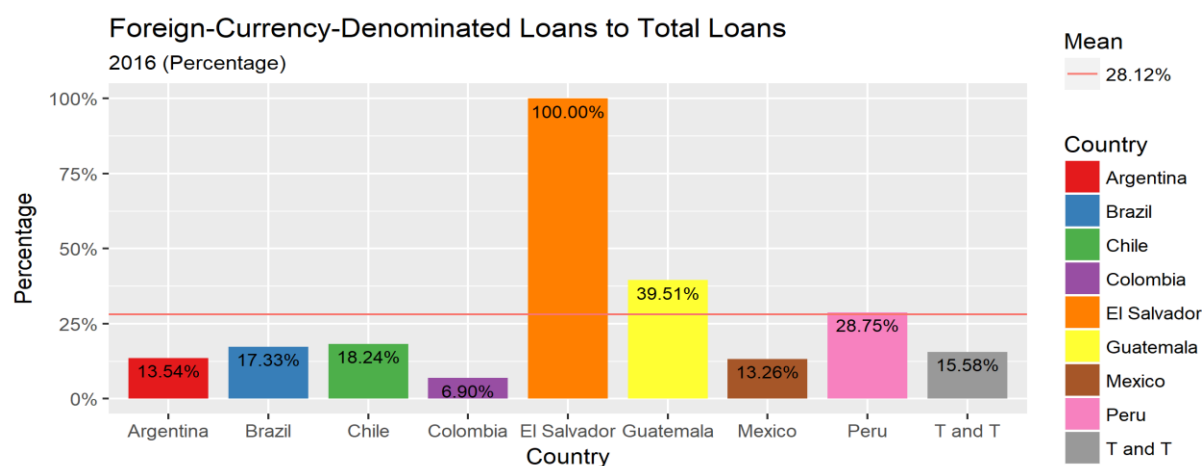
FOREIGN CURRENCY LOANS AND LIABILITIES

The regions' financial systems are only mildly exposed to exchange rate risk, except for Peru's where the mismatch between foreign-denominated loans and liabilities remains large.

Foreign-denominated Loans to Total Loans and Foreign-denominated Liabilities to Total Liabilities are related to a financial system's exchange rate risk. If a financial system's foreign-denominated bank liabilities substantially exceed foreign-denominated bank assets, or viceversa, a sudden currency devaluation or depreciation will pose a serious risk to the system's stability. This asset-liability mismatch was a driver of the financial crises in emerging market economies during the mid-1990s and early 2000s—including Argentina in 1995, Russia in 1998, and Argentina in 2001.¹⁶

Currency mismatches have a dual role in emerging economies: “On the one hand, currency mismatch has been a prime vehicle for agents to take on insolvency risk and has resulted in large exposures to systemic risk for the economy as a whole. On the other hand, it has been an engine of growth that has allowed new and small firms to finance profitable investment projects”.¹⁷

The average gap between the foreign-denominated loans to total loans ratio and the foreign-denominated liabilities to total liabilities ratio is 3.8%. All of the region's financial systems have minor asset-liability mismatches, except for El Salvador and Peru. The difference between the two ratios is 0% in El Salvador since this country dollarized its economy in 2001, and 15.9% in Peru¹⁸. The Peruvian financial system's sizeable asset-liability mismatch exposes the country to potentially pervasive exchange rate risk.



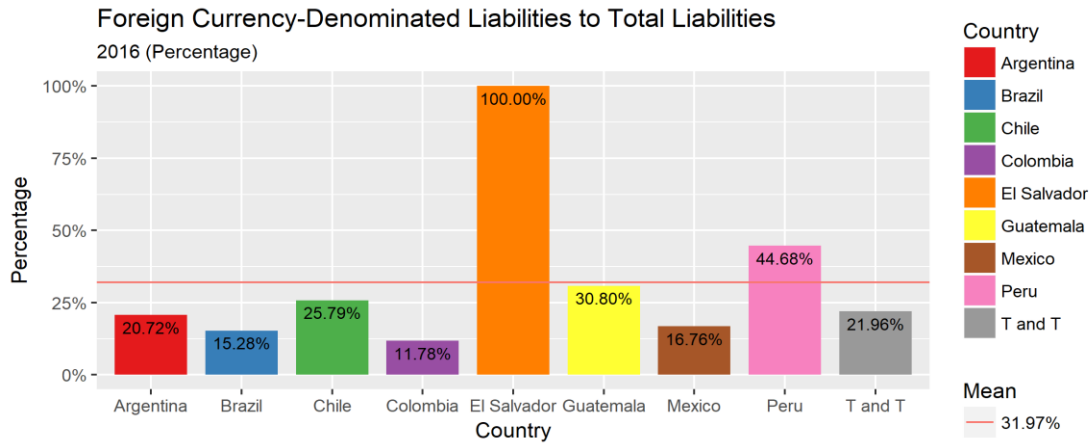
Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

¹⁶ <http://www.imf.org/external/pubs/ft/fandd/2016/09/catao.htm>

¹⁷ Ranciere, R., Tornell, A., & Vamvakidis, A. (2010). Currency mismatch, systemic risk and growth in emerging Europe. *Economic Policy*, 25(64), 597-658.

¹⁸ Nearly 85 percent of bank deposits and 80 percent of bank loans in Peru were denominated in dollars by the late 1990s.

Own elaboration with data from: FMI. *Financial Soundness Indicators 2015*.



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

IMPLEMENTATION OF INTERNATIONAL STANDARDS

In January, ASBA distributed a Survey on Regulatory and Banking Supervision Expectations for 2017 among its members. The survey addressed a variety of topics that might have repercussions for financial stability in the region. The survey asked questions about the degree of adoption and compliance with Basel II and Basel III standards. The Association obtained responses from 25 countries¹⁹. The graphs and information in this section come from ASBA's Regulatory and Banking Supervision Expectations in the Americas.²⁰

BASEL II. PILLAR 1

Most countries have implemented, or are implementing, a method for managing market, operational, and credit risks.

Basel II Pillar 1 has three risk management areas to assess credit, operational and market risks. For each of these risks, ASBA's survey asked which approach of the corresponding pillar was implemented or was being implemented.

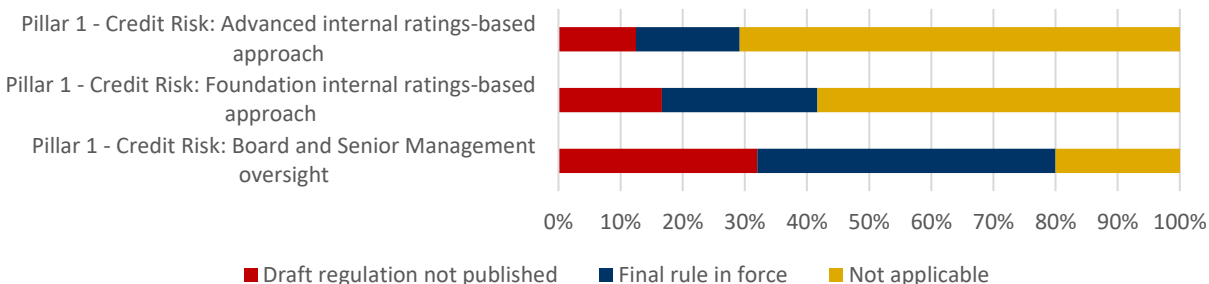
About credit risk, 48% of participants reported to have a final rule in force for Board and Senior Management Oversight for Credit Risk, 32% reported being in the process of implementing such a process, while 20% reported this standard as not applicable in their jurisdiction. For the Foundation Internal Ratings-Based approach, 24% reported having a final rule in force, 16% reported being in the implementation process, and the remainder claimed it as not applicable in their jurisdiction. Finally, 16% have established a rule for Advanced Internal Ratings-Based Approach, 12% are in the implementation process, while the rest reported such rule is not applicable to them.

Considering each of these approaches, 20 countries (80%) have implemented or are implementing at least one credit risk management approach, while some countries apply more than one approach in their jurisdiction. However, the Board and Senior Management Oversight approach is the one most widely adopted.

¹⁹ Belize, Bolivia, Brazil, Colombia, Costa Rica, Eastern Caribbean Currency Union, Ecuador, El Salvador, Spain, Guatemala, Guyana, Haiti, Honduras, Caiman Islands, Turks and Caicos Islands, British Virgin Islands, México, Nicaragua, Paraguay, Peru, Dominican Republic, Republic of Panama, Suriname, Trinidad and Tobago, and Uruguay.

²⁰ ASBA, *Regulatory and Banking Supervision Expectations in the Americas*, 2017

Basel II Implementation. Pillar 1 - Credit Risk

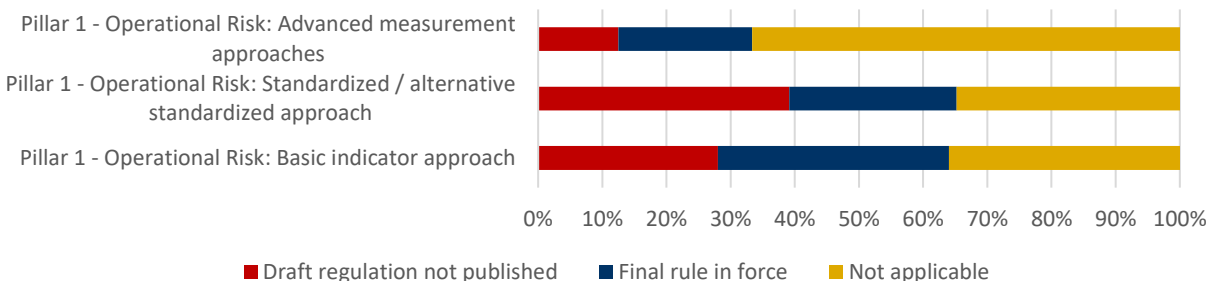


ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

For operational risk, 36% of the countries have set a rule for the Basic Indicator Approach, and 28% are in the implementation process. For the Standardized or Alternative Standardized Approach, 25% have established a rule, 36% are in the implementation process, and the rest reported this standard as not applicable in their jurisdiction. Finally, 20% of participants have implemented advanced measurement approaches, 12% are in the implementation process, while 68% have not yet implemented such method.

About the three approaches for managing operational risk, twenty-one countries have or are implementing at least one approach. The most popular approaches for managing operational risk are the Basic Indicator and the Standardized/Alternative Standardized approaches.

Basel II Implementation. Pillar 1 - Operational Risk

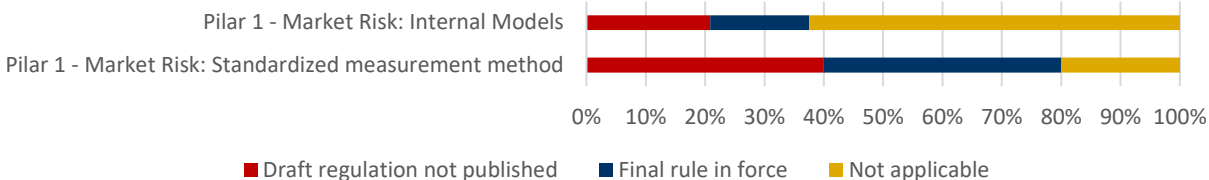


ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

About market risk, 40% of participants have implemented the Standardized Measurement Method, 40% are in the implementation process, and 20% reported the approach as not applicable in their jurisdiction. For Internal Models, 16% have a final rule in force, 20% are in the implementation process, and 64% reported it as not applicable.

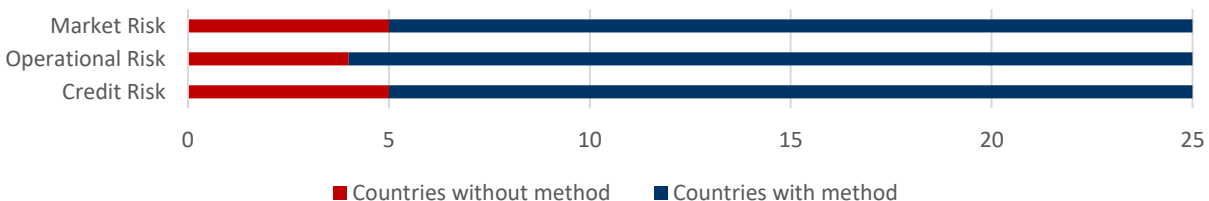
If we consider both approaches, twenty countries have implemented at least one method for managing market risk. To control this risk, the Standardized Measurement Method is the approach that most countries have adopted.

Basel II Implementation. Pillar 1 - Market Risk



ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

Countries with a method implemented (or in implementation process) for risk management (Number of countries n=25)

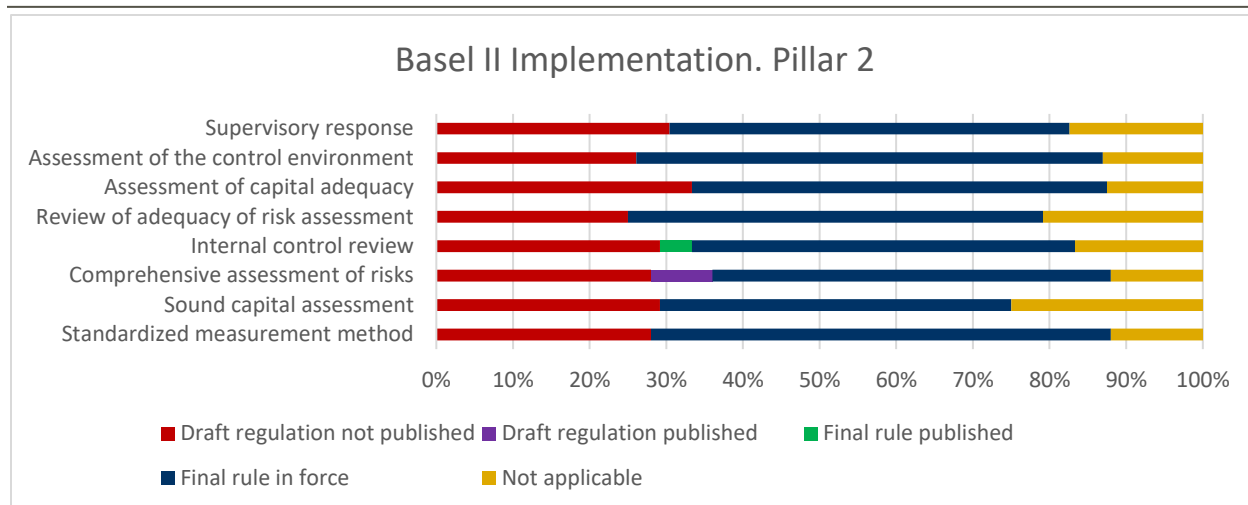


ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

BASEL II. PILLAR 2

The region has progressed substantially in Basel II. Pillar 2 implementation, with a high degree of adoption among ASBA members.

Basel II Pillar 2 components have been adopted or are in the implementation phase in most of the surveyed countries. The components with the highest adoption rate are the assessment of the control environment, the assessment of capital adequacy, the comprehensive assessment of risks, and the standardized measurement method. On the other hand, Sound capital assessment and Review of adequacy of risk assessment are the least implemented areas of this pillar. Nevertheless, these last two aspects have been implemented in more than 70% of the region.

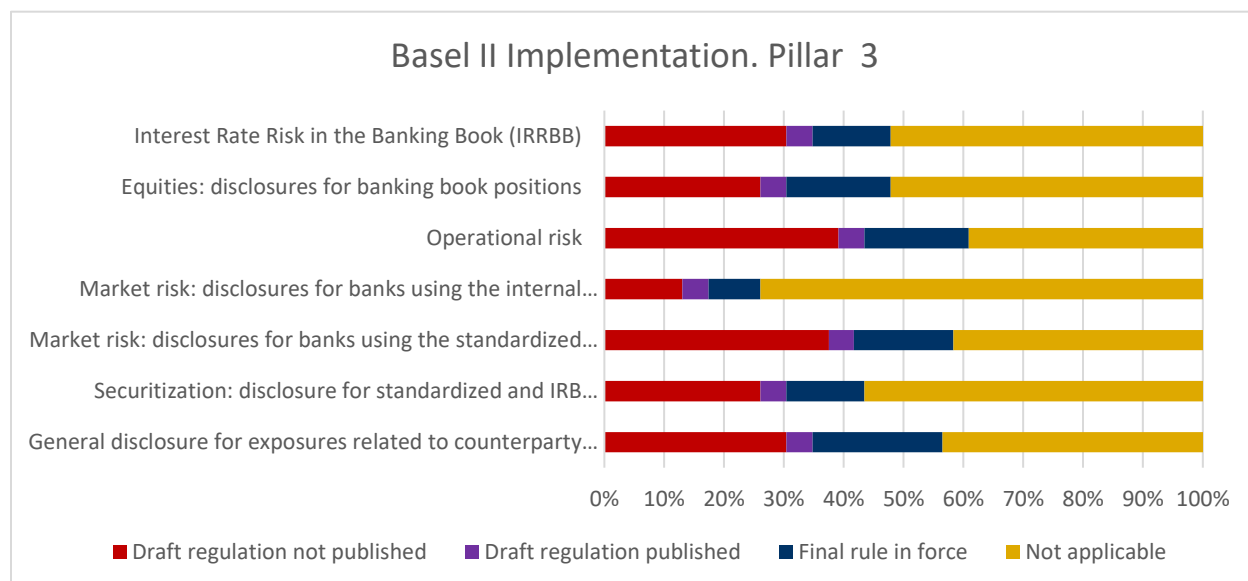


ASBA. Regulatory and Banking Supervision Expectations in the Americas, 2017.

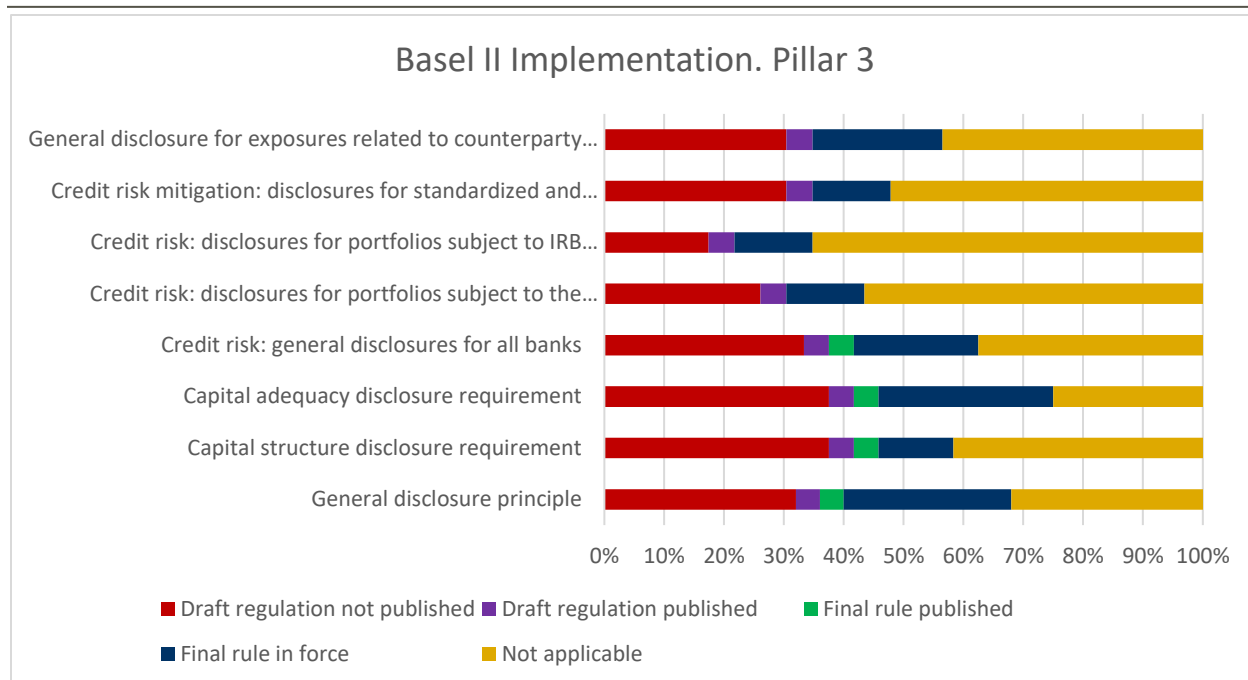
BASEL II. PILLAR 3

The region has an opportunity to develop transparency and information disclosure frameworks to foster financial market discipline.

The region shows a much lower degree of adoption of the third Pillar of Basel II than Pillars 1 and 2. Implementation of this Pillar’s components ranges between 35% and 75%. The most notable progress has been achieved in capital adequacy disclosure requirements, the general disclosure principle, operational risk, disclosures for banks using the standardized approach for market risk, and general disclosure for exposures related to counterparty risk. However, the region needs to work on developing transparency and information disclosure requirements to foster financial market discipline.



ASBA. Regulatory and Banking Supervision Expectations in the Americas, 2017.

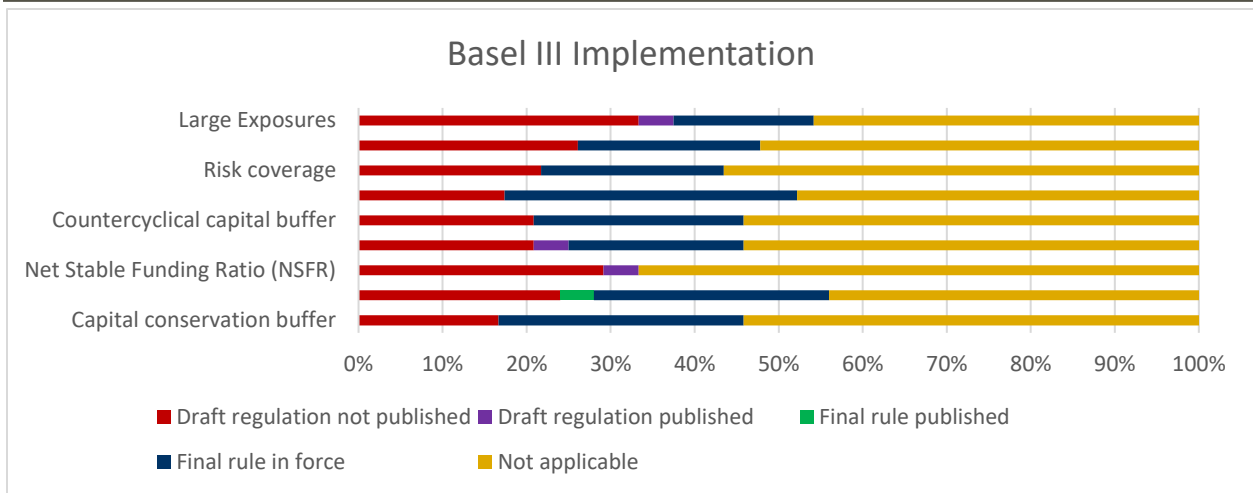


ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

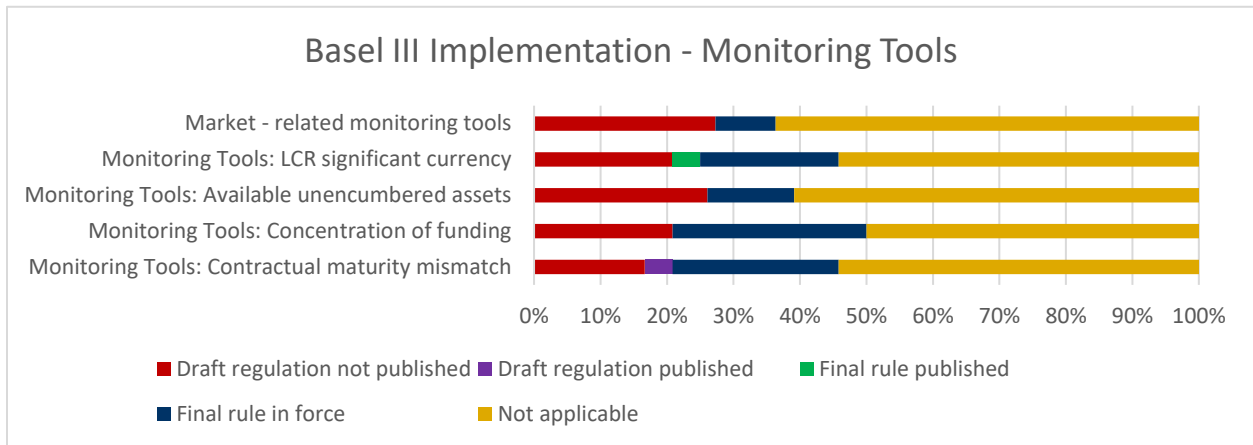
BASEL III

The region shows a much lower level of adoption of Basel III principles in contrast to Basel II; this might be due to the degree of development of some markets in the region.

The region is still at an early stage of adoption of Basel III. Between 20% and 60% of ASBA’s members have adopted some principles of this framework. Some of the aspects with a higher degree of implementation are large exposures, the definition of capital, and the Liquidity Coverage Ratio. The limited implementation of Basel III may be explained by the low complexity of the region’s financial systems, which operate under traditional intermediation models.



ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*



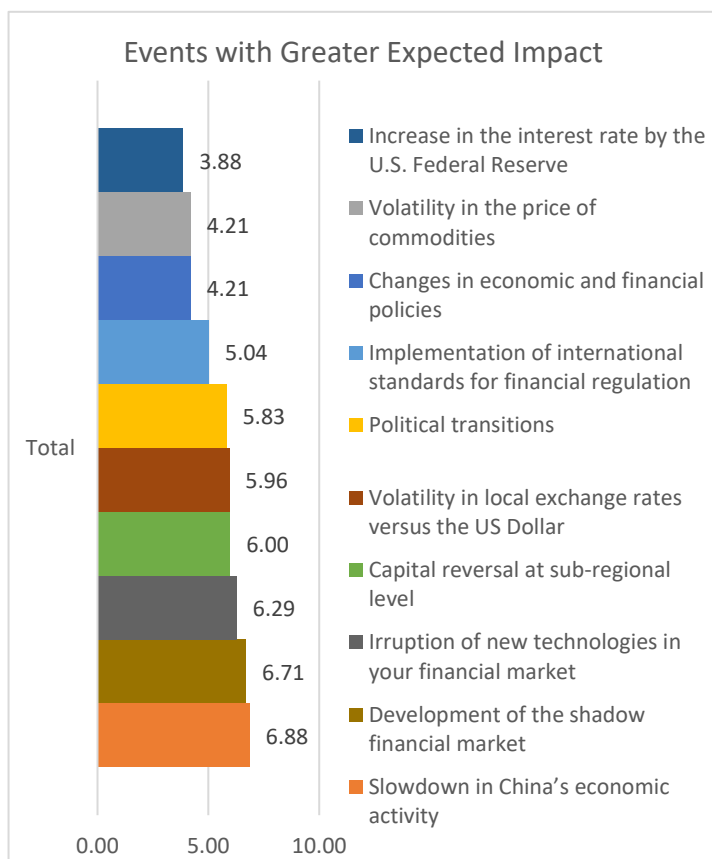
ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

IV. RISKS AND EVENTS

ASBA’s Survey on Regulatory and Banking Supervision Expectations for 2017 also included questions about expectations on events which might impact financial stability, the evolution of financial system variables, and the outlook of risks’ materialization. This section presents some of the region regulators expectations and addresses risks and events that might affect financial stability. Additional data sources for this section are the IMF’s International Financial Statistics database, the World Bank’s Commodity Markets Outlook, the U.S. Congressional Research Service, and Economic Policy Uncertainty.

EXPECTATIONS

ASBA’s Members perceived that the most impactful events during 2017 would be the increase in the U.S interest rate, the volatility in the price of commodities, and changes in economic and financial policies. The members rated credit, operational, legal and liquidity risks as the most likely to materialize.



ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

ASBA’s Survey on Supervisory Expectations asked Associate Members to rank a series of events based on their perceived impact on the financial system for the current year.

Events were ranked from most important to least important (1 to 10). Afterwards, the simple average rank for each option was calculated to determine which events were the most relevant for the region’s supervisors in 2017.

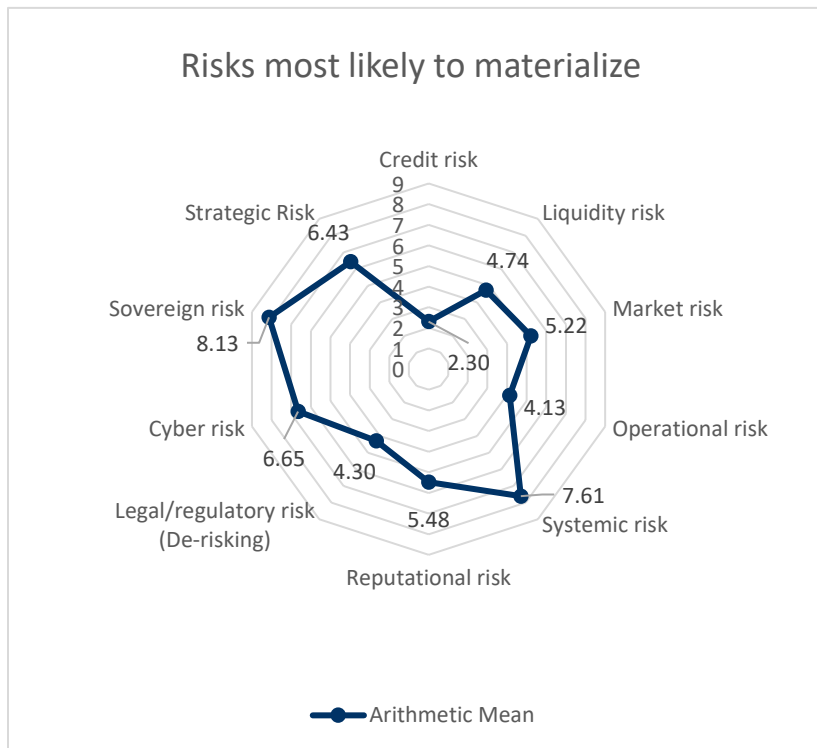
The most important events were the increase in the interest rate by the U.S Federal Reserve, volatility in the price of commodities, and changes in economic and financial policies.

Additional concerns that were not listed but some Members highlighted was the *de-risking* or withdrawal of correspondent banking relationships mainly in the Caribbean.

The survey also asked ASBA’s Members to rank a set of risks according to their perceived materialization probability. A simple average was calculated to aggregate information. The results of this exercise are

presented in the following graph. A value closer to 1 depicts a greater materialization probability. Under

this measure, credit, operational, legal and liquidity risks were perceived as the most likely to materialize (Figure).



ASBA. Regulatory and Banking Supervision Expectations in the Americas, 2017.

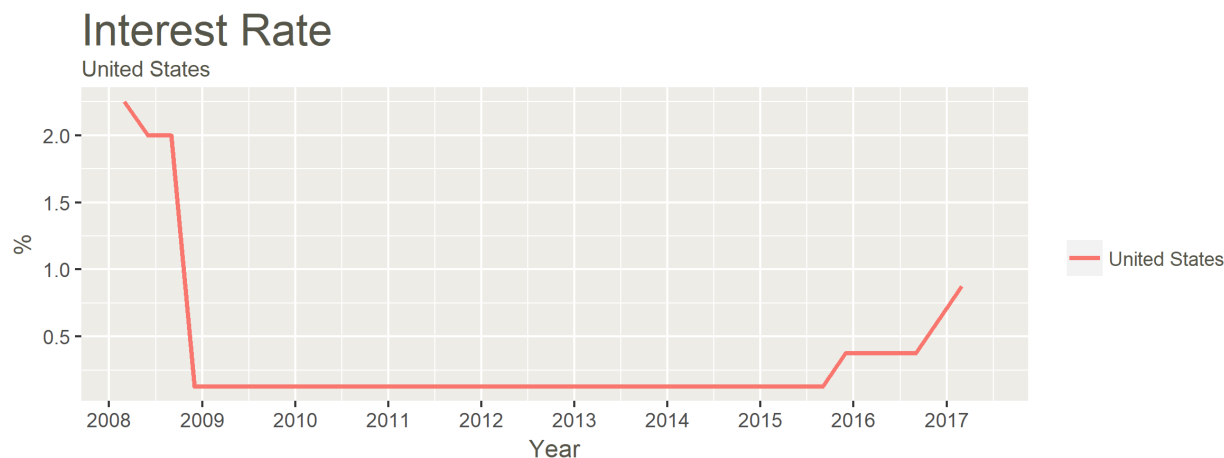
U.S INTEREST RATES

The Federal Reserve increased the U.S. interest rate, which might drive capital flows towards the U.S. and raise other countries' interest rates.

The loose monetary policy conducted by the U.S. Federal Reserve has injected liquidity into global financial markets, and driven capital flows towards emerging economies. This policy, however, is being reversed. On the one hand, if the monetary tightening runs faster than expected, interest rates and demand for U.S. treasury bills would rise, increasing borrowing costs and driving capital flows away from LAC. On the other, the reversal is appreciating the U.S. dollar, which may boost demand for Latin American exports.

While individual effects of higher interest rates, reversed capital flows, and higher exports on both the region's financial systems and its real economies may be forecasted, their aggregate effect cannot be anticipated, as variables have effects in different directions and unpredictable magnitudes. Thus, the rise in the U.S interest rate poses a challenge for the region due to this policy's uncertain aggregate effects.

Monetary policy normalization in the United States and some other advanced economies could trigger a faster-than-anticipated tightening in global financial conditions.²¹



Own elaboration with data from: IMF. *International Financial Statistics*. August 2017.

COMMODITY PRICES

Commodity prices fell during 2014. The energy was the most affected sector with two shocks: one in 2015 and one in 2016. However, commodity prices are recovering.

The robust economic growth experienced during the first decade of the 2000's in Latin America and the Caribbean was mostly due to a boom in commodities' prices and exports. The region proved to be resilient to the 2008-2009 crisis, but vulnerable to the end of the commodity super-cycle in 2014.

Since 2014, energy, metals, agriculture and food price indices fell. The most significant downfall was in the energy sector with two critical collapses in 2015 and 2016. Bolivia, Brazil, Ecuador, Mexico, Peru, and Venezuela are countries with fiscal and budget policies dependent on energy commodities. Thus, these countries were affected during the last years by falls in energy prices.

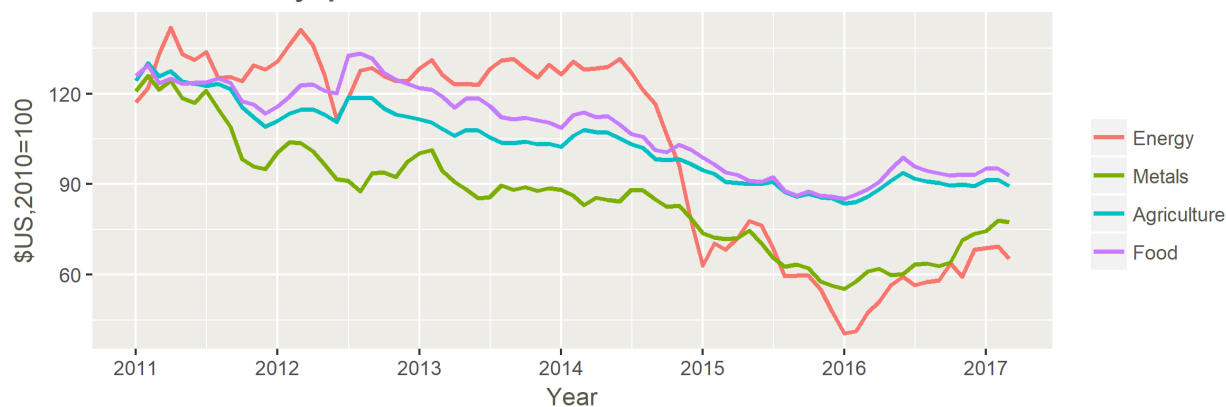
The commodity prices drop has had a significant direct and indirect impact on the fiscal accounts of most countries within the region which were forced to increase borrowings and adjust their current account through dramatic currency depreciations, and registered lower growth rates (e.g., Mexico, Brazil and Colombia). Since most of the debt in Latin America and Caribbean countries is denominated in foreign currency, the real exchange rate depreciation may increase the burden of payments in terms of local

²¹ International Monetary Fund, *World Economic Outlook Update: A Firming Recovery*, July 2017.

currency, increasing the risk of default. In the hypothetical case of a country defaulting, its real and financial sectors would suffer costs associated with the default and lose access to markets.²²

The region will face major challenges to stimulate growth and investment if commodity prices remain low. Nevertheless, according to the World Bank, energy prices are projected to increase 26% during 2017 and an additional 8% during 2018.²³ Therefore, energy commodities exporting countries are expected to recover. Nevertheless, it is important to monitor commodity prices changes.

Commodity price: Indices



Own elaboration with data from: World Bank. *Commodity Markets Outlook*. April 2017.

GEOPOLITICAL RISK

Economic policy-related uncertainty has risen since 2015, while market uncertainty has been less volatile. Thus, geopolitical risk does not necessarily imply bearish market expectations. It is important to monitor the wave of political change over the globe and its repercussions for financial stability.

The region faces concerns stemming from the perceived unpredictability of U.S. fiscal and trade policies, and the uncertainty surrounding the results of some of the several elections that will be held in Latin America in the following years.²⁴ For instance, there is uncertainty about the results of the presidential elections in Mexico and Brazil in the second semester of 2018

²² Asonuma, M. T., *Sovereign defaults, external debt, and real exchange rate dynamics*, 2016.

²³ "Commodity Market Outlook", World Bank, 2017 <http://pubdocs.worldbank.org/en/174381493046968144/CMO-April-2017-Full-Report.pdf>

²⁴ 2017: Chile, Honduras, Bahamas.

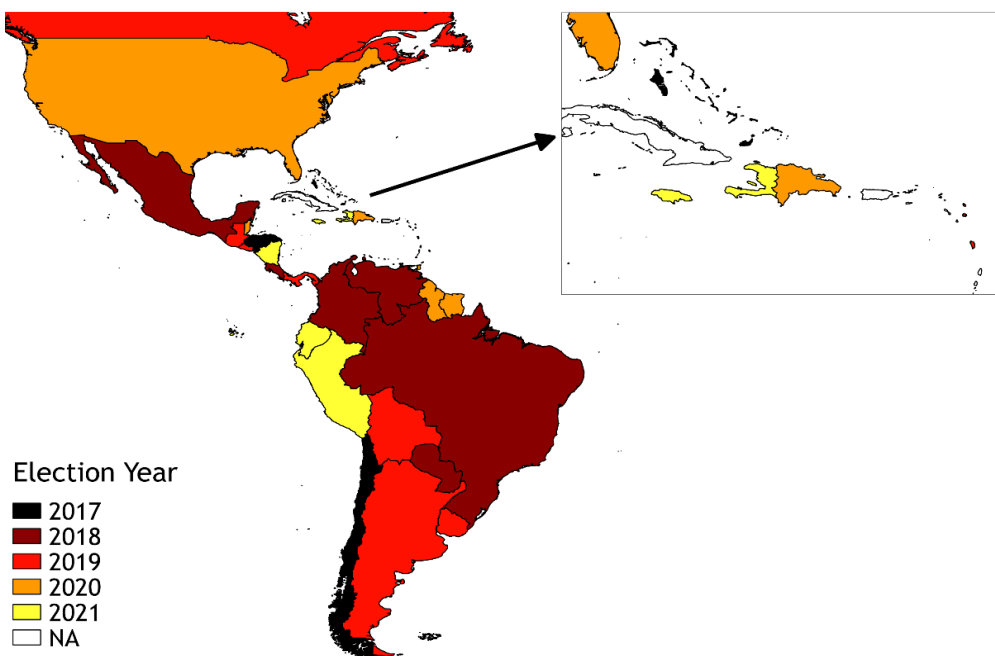
2018: Barbados, Brazil, Colombia, Costa Rica, Grenada, Mexico, Paraguay, Venezuela.

2019: Antigua and Barbuda, Argentina, Bolivia, Canada, Dominica, El Salvador, Guatemala, Panama, Uruguay.

2020: Belize, Dominican Republic, Guyana, Suriname, Trinidad and Tobago, USA.

2021: Ecuador, Haiti, Jamaica, Nicaragua, Peru.

Elections in America



Own elaboration with data from: Congressional Research Service. *Latin America and the Caribbean: Facts on Leaders and Elections*. April 2017.

Other South American countries have held elections recently or will conduct elections soon. Argentina renewed between a third and a half of its two legislative chambers in October. Chile will elect a new president in November 2017. Colombia will hold legislative elections, while Venezuela, and Paraguay will conduct presidential elections in 2018.

Because trade tightly links the U.S. and Mexico the renegotiation of NAFTA is critical for North America. Although the Mexican currency appreciated during the first semester of 2017, new worries emerged after the U.S. trade representative laid out the modifications to the deal sought by his government. New NAFTA terms will influence the Mexican real economy and, if unfavorable, affect the country's financial sector.

Economic and geopolitical risk factors are reflected by the Economic Policy Uncertainty (EPU) index,²⁵ which increased in 2015, 2016, and 2017. The European Migration Crisis probably drove the 2015 sharp increase in uncertainty during the second half of the year. The 2016 uncertainty spike stemmed from Brexit. Finally, the uncertainty peak in 2017 was driven by U.S elections and political relations with the rest of the world. However, uncertainty has decreased after the U.S elections perhaps due to the

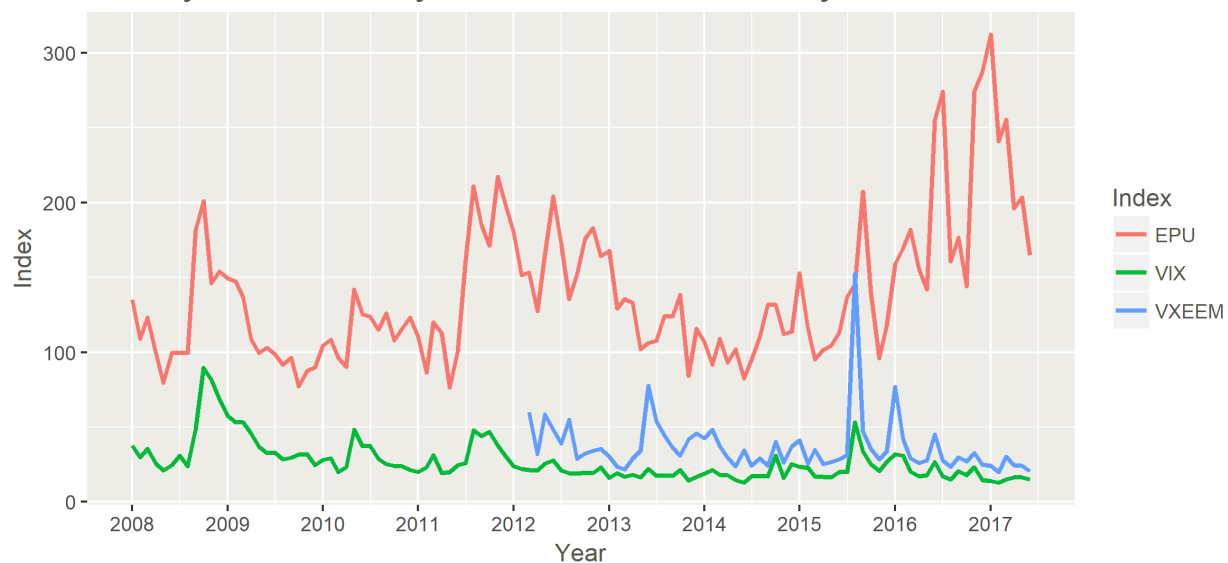
²⁵ This index is constructed from three components: newspaper coverage of policy-related economic uncertainty; number of tax code provisions set to expire in future years; and disagreement among economic forecasters. <http://www.policyuncertainty.com/methodology.html>

challenges it may face developing and getting the approval of the new legislation. The difficult-to-predict U.S. regulatory and fiscal policy changes, negotiations of post-Brexit arrangements, and other geopolitical risks might harm confidence and weaken economic growth in the region.²⁶

About market volatility, the VIX and VXEEM indices increased alongside the EPU index in 2009. This means that the markets reacted to the European Migration Crisis. Nevertheless, unlike the EPU index, market volatility indices did not react to Brexit nor the U.S. elections. Therefore, market volatility remained unaffected by the two most recent major political events.

If political transitions and economic policies bring significant changes in the economy, then uncertainty might rise or present peaks. These factors might affect financial stability, especially if cooperation and integration become less feasible due to abrupt changes in the geopolitical system. Failure to make growth more inclusive and hinder market-friendly reforms might disrupt global supply chains and lower global productivity.²⁷

Policy Uncertainty and Market Volatility



Own elaboration with data from: Economic Policy Uncertainty. *Global Economic Policy Uncertainty Index* and Yahoo Finance

²⁶ International Monetary Fund, *World Economic Outlook Update: A Firming Recovery*, July 2017.

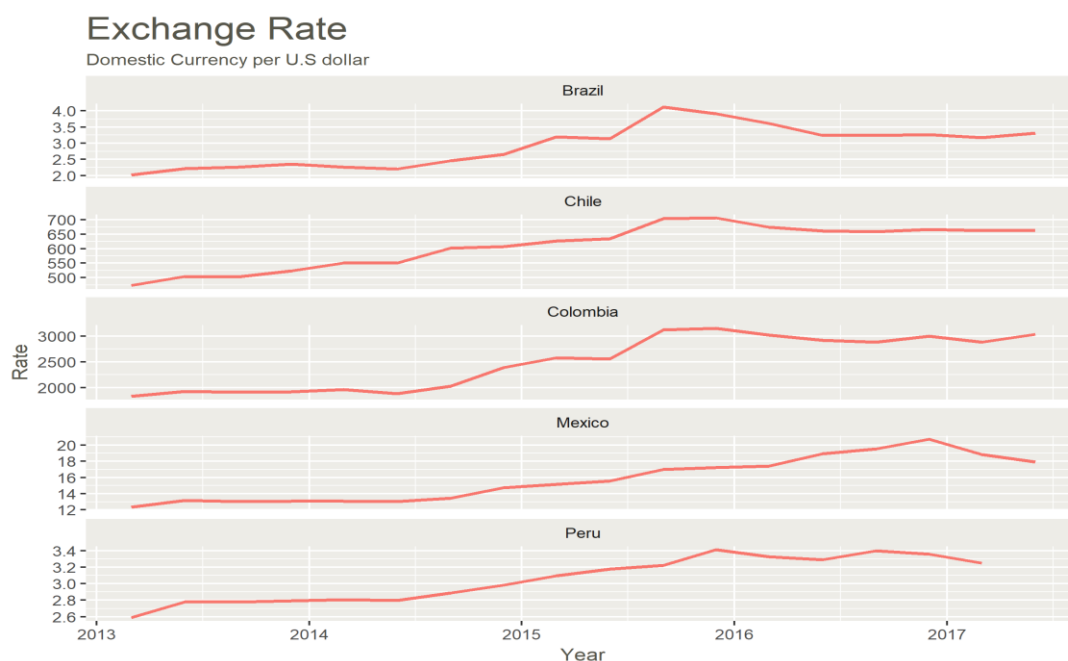
²⁷ International Monetary Fund, *World Economic Outlook Update: A Firming Recovery*, July 2017.

EXCHANGE RATES

Exchange rates remained stable or appreciated during the first semester of 2017. However, there are still concerns on foreign credit and exchange markets due to political and economic uncertainty.

During the first semester of 2017, the exchange rate has appreciated significantly in Mexico, has remained relatively stable in Chile, Paraguay, Peru, and Uruguay, and has depreciated in Brazil, Colombia (influenced by the fall in oil prices) and in Argentina (due to the high inflation).²⁸ However, there are still concerns in the foreign exchange market within the region due to political and economic global uncertainty.

The greatest concerns about exchange rates in LAC stems from the region’s high exposure to foreign credit and exchange markets. Many papers have found that “currency devaluations can be contractionary, cause or worsen currency crises and create systemic risk. Also, they may feed back onto bank balance sheets through higher credit risk, causing a reduction in cross-border lending”.²⁹ Continuous monitoring and prudential action are recommended in case some of these risks materialize.



Own elaboration with data from: IMF. *International Financial Statistics*. August 2017.

²⁸ https://www.bbvarsearch.com/wp-content/uploads/2017/07/2017.07-Situacion-LATAM_vf_EN.pdf

²⁹ Schmidt-Eisenlohr, T. (2017). Foreign Currency Loans and Credit Risk: Evidence from US Banks.

FINTECH

Innovative technology-based financial product and services have many potential advantages but also bring about market disruptions and new risks. Regulation must ensure that fintech's benefits outweigh their risks. The registering and regulation of fintech are still in an early stage in the region.

Financial products and services whose provision is based on technology, or fintech, have boomed in recent years. The development on fintech is and will continue changing the financial ecosystem. Fintechs offer a variety of services, ranging from digital wallets and payment systems to crowdfunding and services aimed at helping with the compliance process.

Fintech products and services entail advantages such as real-time access to mobile banking services, tailored services, greater access to trade services for small investors, peer-to-peer interaction across the globe, reducing intermediaries, and an overall increase in efficiency and quality in financial services. Nevertheless, fintech products and services can carry potential risks such as potential technological attacks, fraud, information theft, and cybersecurity issues.

There is a concern about the conduct of fintech providers. For instance, fintech companies could retain consumer funds while leaving the market if no binding mechanism enforces payment or compensation to consumers. An appropriate regulatory framework on consumer protection must be developed.

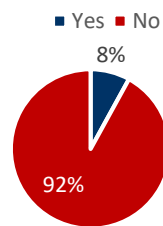
Another concern is the global scope of fintech. These products and services will probably have to comply with requirements from different legislations across countries, which might difficult the interoperability reducing their potential efficiency. Also, some products, such as cryptocurrencies, make it impossible to trace transactions, increasing risks of AML/FT.

ASBA's Survey on Regulatory and Banking Supervision Expectations in the Americas asked if the respondent's jurisdiction had a registry of Fintech companies. The results of the survey showed that only 8% of respondents had some type of registry.

Regulation of fintech is still at an early stage; however, legislation regarding this matter is already under development in some countries such as Mexico.³⁰ Nevertheless, it is essential to understand, the benefits, the risks, and the scope of fintechs to enforce regulatory frameworks and supervisory processes.

³⁰ FORBES. *Ley Fintech ¿Cómo vamos? April 21, 2017*

Is there a registry of Fintech companies that operate in your jurisdiction?



ASBA. *Regulatory and Banking Supervision Expectations in the Americas, 2017.*

DE-RISKING / REDUCTION OF CBRS

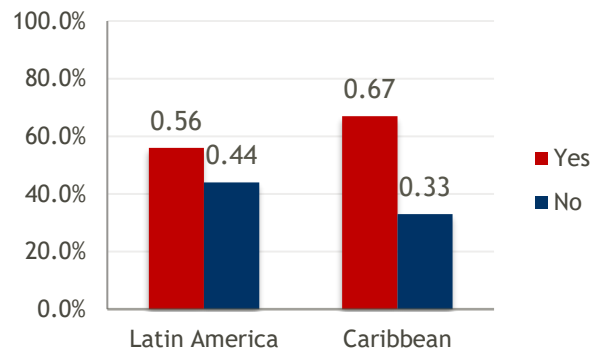
De-risking is a problem in the region, especially for the countries in the Caribbean and Central America. This process is driven by a combination of costly and time-consuming compliance processes and low margin business lines.

Caribbean banks rely on their relationships with foreign banks and international networks to perform cross-border payments. These types of relationships are known as corresponding banking relationships (CRBs) and are important for the region since they facilitate transactions such as remittances, which represent up to 17% of GDP in Caribbean countries such as Jamaica.

Banks in advanced economies have been withdrawing their correspondent services from the Caribbean probably due to more stringent AML/CFT regulations, which have increased the compliance costs or perceived risks. These withdrawals are part of *de-risking*, which is defined as the process in which financial institutions abandon or significantly reduce certain business lines to avoid regulatory and compliance risks.

De-risking is driven by a combination of Customer Due Diligence (CDD) and Know Your Customer (KYC) requirements that increase compliance costs and are time-consuming and low profit business lines, which depend on high volume traffic to be profitable.

Existence of *De-risking* (% of ASBA's members)



Source: Michaela Erbenova et al., *The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action* (IMF, June 2016), 11.

De-risking is widespread across the region but is particularly critical in the Caribbean. *De-risking* could frustrate financial inclusion, increase the demand for unregulated payment services, and promote transitions to the informal economy. While some initiatives have been put forth to counter the effects of *de-risking* in the Caribbean, several other measures must be taken. These measures include coordination between regulators, education regarding the compliance of AML/CFT regulations, and initiatives to reduce the cost of know-your-customer practices.

Consequences of *de-risking* include hindering tourism, which is an essential source of revenue for the Caribbean, due to lower access to foreign currency. Cross-border services trade is also affected by the withdrawal of letters of credit and contract guarantees. *De-risking* also implies that customers that are not granted services by large banks must rely on less experienced banks or entities operating in less regulated environments such as shadow banking and fintech, resulting in less control of and knowledge of transactions.

NON-PERFORMING LOANS

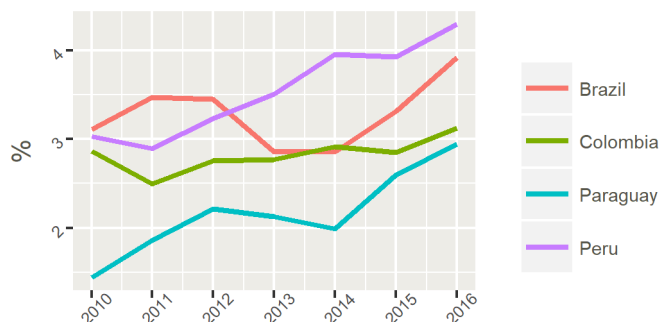
Sustained growth of non-performing loans is a matter of concern especially in the Andean and the Southern Cone regions. Elevated levels of non-performing loans may, directly and indirectly, impact both the financial and the real sectors.

There is an increasing trend of non-performing loans amongst some countries, especially in the Andean and Southern Cone regions. The weakening of borrowers' repayment capacity is an indication of heightened GDP contraction, together with a depreciated currency, and tight economic conditions.

Loans are one of the leading components of banks balance sheet, and its entire structure can be affected due to a change in this component. Sustained growth of non-performing loans is an issue of primary supervisory concern in any financial system.

There is empirical evidence which indicates that elevated levels of non-performing loans have direct and indirect effects on both the financial and the real sectors. Direct effects include credit contraction and increased loan interest rates in an attempt to minimize losses.³¹ Therefore banks' profitability is affected as interest income erodes. Finally, effects can spread through the real sector, contracting economic activity and increasing unemployment rates.³²

Non-performing loans
to total gross loans



Own elaboration with data from: FMI. *Financial Soundness Indicators 2017*.

³¹ Matu (2001) "The Applicability of Financial Crisis Predictive Models to Bank Failures"
Unpublished MBA Project, University of Nairobi.

³² Klein, N. (2013). Non-performing loans in CESEE: Determinants and impact on macroeconomic performance.

V. CONCLUDING COMMENTS

General economic and financial conditions in the region seem favourable for the coming years. There are economic growth expectations (particularly important for the Southern Cone, Andean Region and the Caribbean, which have faced contractions since 2014); inflation and unemployment rates remain stable (with the exception of Venezuela and the Southern Cone); capital outflows as a proportion of GDP are not as significant in LAC in comparison to other emerging markets, and financial indicators are in general acceptable. Nevertheless, these optimistic expectations are taking place amidst political uncertainty and global risks.

The region faces an uncertainty challenge regarding U.S. economic policies (immigration policies, renegotiation of NAFTA, and increases in interest rates). In fact, this was the primary concern of ASBA's membership in 2017. The rise in the U.S. interest rates might be one of the leading drivers of capital inflow reduction in EMDEs during 2016, including Latin America. Reduction in capital flows may push economies to increase their interest rates to attract foreign investment, thus making borrowing more expensive and fostering savings, which in the long run may affect banks' profitability.

Further, uncertainty was reflected in currencies which depreciated early in the year, although some recovered during the first semester of 2017. The upcoming elections in the region, combined with a global environment of protectionist policies can increase the uncertainty mentioned above. Another issue of concern in the region is the collapse of the commodity prices, which began its reversal in 2016; nevertheless, they have not recovered their pre-2014 levels. Given that low commodity prices could directly impact the financial system, countries in the Americas must implement policies to foster economic growth while decreasing dependency on capital inflows, government expenditure, trade with the U.S and borrowing, and to face a reduction in China's demand for commodities.

Regarding Financial Soundness Indicators, banks seem to hold adequate levels of capital and liquidity as well as an adequate level of provisions to withstand significant losses or large withdrawals. Capital adequacy ratios are higher than 10%, well above the Basel requirements, meaning that the region is prepared to absorb losses in adverse scenarios. Albeit, it is necessary to pay attention to inefficiencies in the financial system since they are the drivers of unusually high adequacy ratios. Although Peru, Brazil, and some countries in the Caribbean are facing credit deteriorating episodes, most countries in the region hold enough provisions to support expected losses deriving from a noticeable increase of nonperforming loans during the last six years.

About liquidity, the region is prepared to withstand moderate liquidity shocks. Brazil and Argentina, along with Guatemala, have customer's deposits to total loans ratios over 100%. The rest of the countries have a lower proportion of deposits, which implies a higher credit risk and a likelier dependence on third-party funding entities to increase liquidity. Despite this, indicators show there should not be liquidity constraints under normal conditions.

Derivatives' markets in the region are still in an early development stage, with Brazil, Mexico, and Chile having the most developed markets in the Americas. The rest of the countries have practically inexistent derivatives' market, which explains the low complexity and size of their financial markets as well as the lower adoption level of the Basel III framework.

Although the region's stability perspective is adequate, there are sub regional issues that require further attention. Understanding their determinants and implications of financial stability and resilience is essential to prevent contagion to other financial markets.

Bank profitability varies across the region. Some countries facing economic slowdowns have a low ROA indicator. ROE is below 20% for most of the countries in the sample. Most of the gross income consists of interest margin in all countries except for Argentina. The remaining gross income comes from bonds.

Operating costs are high despite large profitability margins. To provide context, the U.S. banking system's ROE is 3.2%, while the average ROE of the region's banking systems is 18.1%. Furthermore, half of these operating costs are absorbed by personnel expenses in most countries. This might be related to the burden of compliance costs, which is particularly high in the Caribbean. High compliance costs are one of the main drivers of the de-risking problem in the region.

A primary regional concern is the restructuring of the financial system. Technology is being used to provide financial services such as crowdfunding, payments, mobile banking, trading and investment services and cryptocurrencies. Fintech companies bring efficiency gains to the financial system, but also new risks. New business models must be understood to build a proper regulatory framework which should mitigate new risks while allowing innovation to continue growing.

Although the region shows significant progress, it must make greater efforts to adopt and implement international regulatory and supervisory standards. The highest degree of adoption is found in Basel II Pillar 1. Most countries have implemented at least one method for managing each risk (credit, market, and operational), or are conducting implementation processes. Substantial progress has been made in the adoption of Basel II Pillar 2, with high rates of implementation in several countries across the continent. In fact, about 70% of ASBA's Members have implemented, or are in the process of implementing, the components of this Pillar.

Basel III requirements, when appropriate for markets, transparency, and market discipline represent clear areas of opportunity for most countries and must be addressed to ensure the soundness of the financial system and fostering confidence in financial institutions. Authorities must have to bear in mind that adoption and implementation of international standards may not be sufficient without an appropriate risk-based supervisory framework.

The region seems resilient at the macro level. Nevertheless, specific issues that should be tackled to support stable financial markets arise at the sub regional levels. A bottom-up approach seems adequate to assess further the financial stability in the region and to deal with sub regional challenges.

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