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Comments to the Flagship Report of The World Bank: "Financial Development in LAC-The Road Ahead"

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Section 1

The document is a good first step

Timely and well focused

- Prudent financial deepening is a must for the region, to set itself on the path towards reaching "**inclusive growth**".
- It is time for Latin America to focus more on "micro" reforms
- A look at agency and collective **frictions** that have to be solved in order to transit from specific financial structures to financial development.
- Detailed review of the **economic literature**
- A great effort to collect and transform information into comparable **statistics** for the region.

Interesting conclusions

- **Policy makers** should close the financial gap and implement prudential measures to avoid future crisis
- It finds that the causality between the **institutional** framework and financial development (and economic growth) is paramount.
- The link with **economic growth** justifies to make a specific focus on financial issues
- The importance of guaranteeing a level-playing field among private and **public banks**
- The importance to apply some regulatory "nudges" to incentive more participation of **auto excluded collectives** from the financial systems.

Section 1

However, some conclusions need some refinement

Shortcomings of the report

- The report does not include **specific policy proposals, and does not exploit differences among countries** to draw lessons
- Some policy recommendations are based on **inconclusive arguments**
  1. **Banking fees** as main determinant of banking gap, not taking demand factors into account
  2. The role of DC **pension schemes**, pension fees and capital markets
  3. Suggestions for policy makers to enforce their role of "**big brother**", without developing the concept. A weird call

Non sufficiently covered issues

- **Not sufficiently outlined:** Institutional factors or foreign banks role
- **Not mentioned:**
  - The role of structural problems, such as the huge **informal sector.**
  - **Bad or at least questionable regulatory decisions**: interest rates caps (e.g. Colombian "tasa de usura"), taxes ...
  - The introduction of **Basel III** as part of new prudential schemes.
  - The role of closer economic integration in the development of **capital markets**, like MILA.
- Data should be available to conduct further analysis

Section 2

Some arguments discussed in the report could be dangerously misleading, using inconclusive arguments

1 Banking fees as the main determinant of the banking gap

LAC banks lend less and charge more than they should." (p. 11)

↕

"The lack of income and self exclusion play a more important role than supply-side considerations, like high fees and stringent documentation requirements" (p. 50)

- Based on estimations relying on supply side arguments, where pecuniary costs (fees) are more relevant that non pecuniary barriers (required documentation).
- Demand side effects need also to be considered.

- Banking fees is a very sensitive topic with a potential to trigger damaging consequences if taken by some regulators as a convenient carte blanche to establish controls.

Section 2

Some arguments discussed in the report could be dangerously misleading, using inconclusive arguments

2 The role of DC pension schemes

- The report signals DC schemes as the main responsible of the slow development of capital markets. There is a minimization of the importance of structural factors and actual regulation:
  - "Buy and hold" is an intrinsic function as the system is focused in the long term;
  - DC mandatory schemes in LAC invest on average 31% in public debt, and this share is diminishing;
  - Very dynamic in equity markets, investing 34% of their portfolio;
  - Pension funds want to invest in longer terms, but regulation requires minimum returns that generate a pervasive herd effect that deter long term investment;
  - Pension funds are leading investors in special financial vehicles related to infrastructure projects that now represent almost 4% of total assets;
  - Benchmarking is necessary but needs careful study about its structure.
- Positive aspects of pension funds :
  - Stability. Not a single case of bankruptcy in 30 years nor cause of any systemic risk.
  - Leading role in the improve of governance, in particular defending minority shareholders/investors.
  - Leading role in the development of long term curves and capital markets
  - Countercyclical role in crisis.

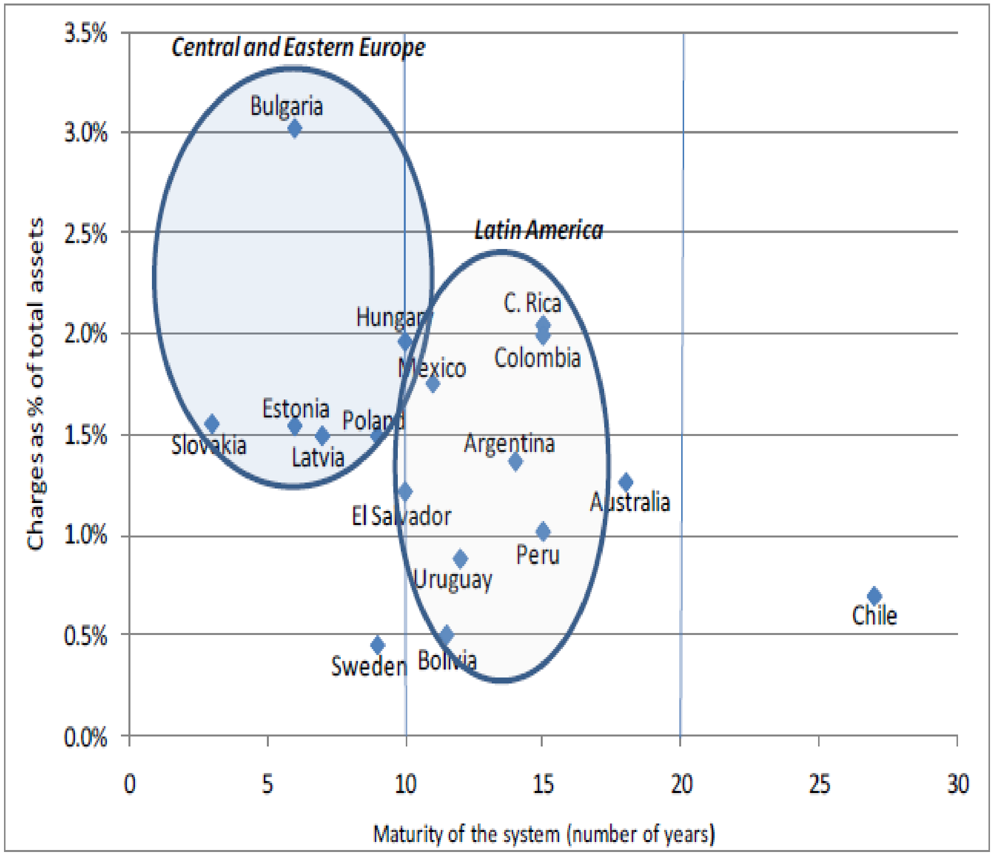
Section 2

Some arguments discussed in the report could be dangerously misleading, using inconclusive arguments

2 The role of DC pension schemes

Pension Fees and Maturity of the System

Source: OECD (2008)



- Pension fees in LAC are not among the highest. OECD (2008) shows that when these charges are measured as a % AUM, fees in LAC are quite consistent with its structural conditions.
- Pension fees are affected by market maturity, low market coverage, and particular tasks required by law.
- The issue of coverage is very relevant in terms of economies of scale. It is not very fair to compare the level of fees charged in Sweden with an 80% share of the labor force, with respect to Peru, where the share is 24%.

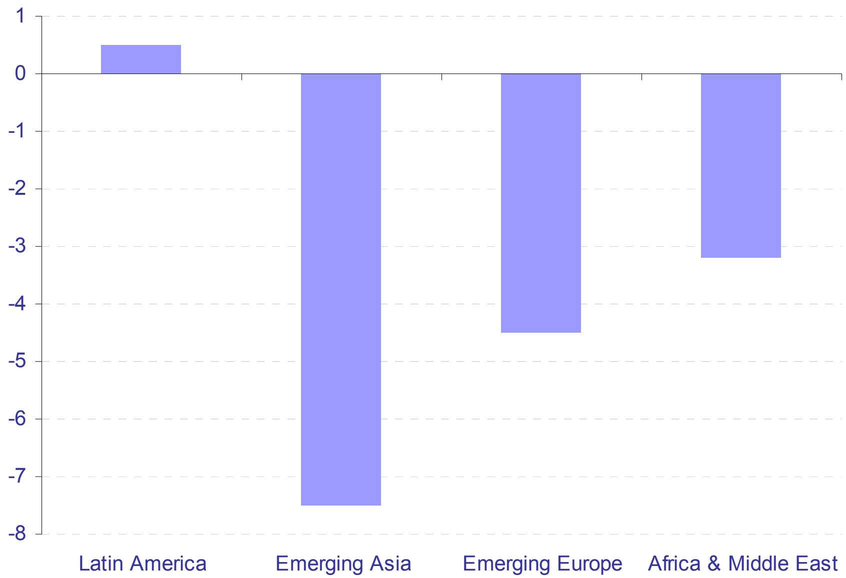
- Therefore, the recommendation to move to a Swedish model makes little sense

Section 2

Some issues are not sufficiently outlined

1 The role of foreign banking

Change in Foreign Banks' Total Outstanding Claims since Lehmann
((%, exchange rate adjusted))
Source: IMF



Foreign Banks' Lending to Emerging Markets:

Why Did Latin America Fare Better?[1]

Local subsidiaries

Credit in domestic currency

Domestic deposit base

- Spain and the United States are the dominant players (50% of foreign credit),

Better risk management

More resilient during financial crises

Less systemic risk and better resolution

1 IMF Working Paper. April 2010

Section 2

Some issues are not sufficiently outlined

2 Informal sector

What percentage change would be required in Mexico in the variables of: the informal economy, the property rights index and the legal environment to reach a Bank Credit /GDP level similar to Chile's?

- Institutional and contractual features matter more than fees.
- The report lacks specific recomendatins on this area, despite acknowledging its relevance.
- A way to explot differences among countries to reach policy recommendatios.

Comparison in Selected Variables between Mexico and Chile

	Mexico	Chile	% Differ
1. Informal economy (% GDP)	30.1%	19.8%	-34.2%
2. Physical property rights index	4.9	6.6	34.7%
3. Legal and political environment index	4.1	6.3	53.7%

Elasticity of Credit/GDP with respect to	
1. Informal economy (% GDP)	-0.12
2. Physical property rights index	0.49
3. Legal and political environment index	0.36

Bank Credit in Mexico (% of GDP)

	2007[1]	Simulation
1. Informal economy (% GDP)	19.2%	20.0%
2. Physical property rights index	19.2%	22.4%
3. Legal and political environment inde:	19.2%	22.9%

Section 2

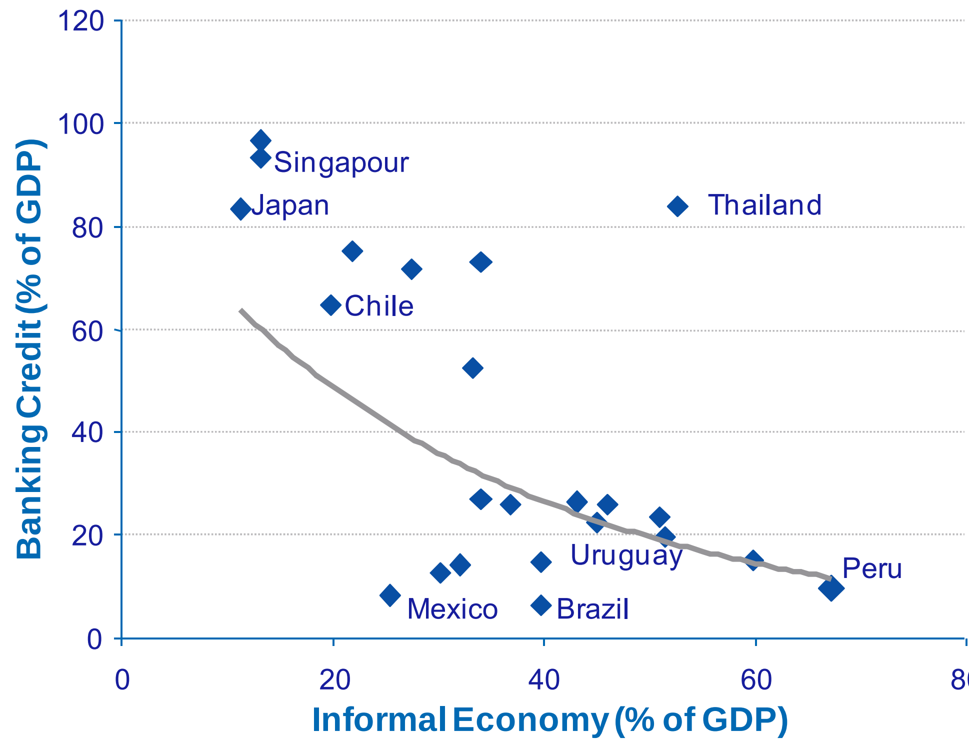
Some issues are not mentioned

1 Informal sector

- Informality makes it more **difficult to obtain information** about the credit risk of potential clients.
- Limited access to formal financial products (credit) **impairs growth prospects for small firms.**
- Absence of financial products as a mean of payment **increases transaction costs**.
- Authorities have difficulties to gather and cross information in order to **enforce tax and labor regulations**.
- Informality implies higher prices, thus being a risk for '**inclusive growth**'
- <u>Therefore, informality makes banking penetration more difficult.</u>
- Starting by the liabilities' side would be optimal in this case

Informal Economy and Banking Credit

Source: Schneider (2010), World Bank, BBVA Research "Report on Banking Penetration in Peru, Colombia, Mexico and Uruguay"



Section 2

Some issues are not mentioned

2 Interest rates caps and taxes

Estimation results of Credit/GDP model

Source: BBVA Research, 2010. "Report on Banking Penetration in Colombia"

	Elasticity
Inflation	-0,0016
Spread	-0,0406
GDP, per capita	0,00138
Growth (-1)	-9,95697
Information index	9,36897
Property register index	-1,59309
Contracts' compliance index	-4,17199
Creditor rights index	3,78737
Tasa de usura	-1,65323
Eta	1
Constant	18,45867

1. **Ceiling on interest rates** in **Colombia** have a significant effect on credit penetration. They are usually justified by banking concentration, but there is no evidence of that causing low competence levels

2. **Taxes on financial transactions** in the margin discourage the use of the financial system to perform transactions, encouraging the use of cash. Singh, Belaisch, Collyns, Masi, Krieger, Meredith and Rennhack (2005) find a negative effect on financial intermediation with this tax being implemented in Colombia and Brazil

Section 2

Some issues are not mentioned

3 Basel III

- Adjustment to new capital and liquidity regulation will have consequences, in particular in emerging economies:
  1. Less credit: The need to generate returns could lead to a lower supply of credit, reducing the capital ratio denominator and making easier to comply with liquidity regulation.
  2. Wider funding margins: Margin increases will feed through to the real economy as higher finance costs and/or lower returns on savings.

Impacts of new regulation on credit and GDP

Source: BBVA Research. ttp://www.bbvaresearch.com/ Documentos de Trabajo

	Credit		GDP	
	All countries	Emerging countries	All countries	Emerging countries
+1% CAPITAL	-0,30%	-0,53%	-0,08%	-0,13%
+1% LIQUIDITY	-0,08%	-0,13%	-0,02%	-0,02%

- A gradual implementation of new regulation could mitigate these effects

Section 2

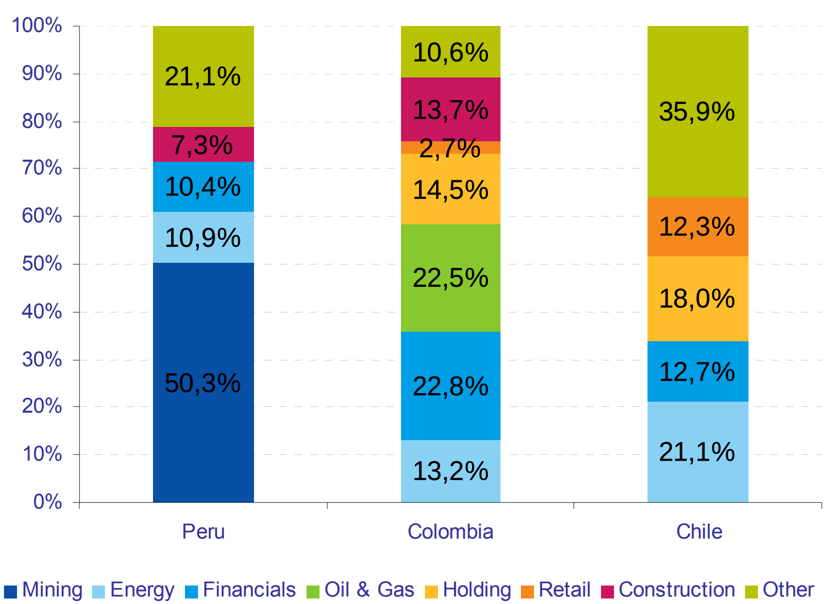
Some issues are not mentioned

4 Closer economic integration in the development of capital markets

- MILA will have more industry groups than each of its component markets, making it easier for investors to form more diversified portfolios.
- It is the second Latam Market in capitalization and the third in daily volume negotiated, very close to Mexico.

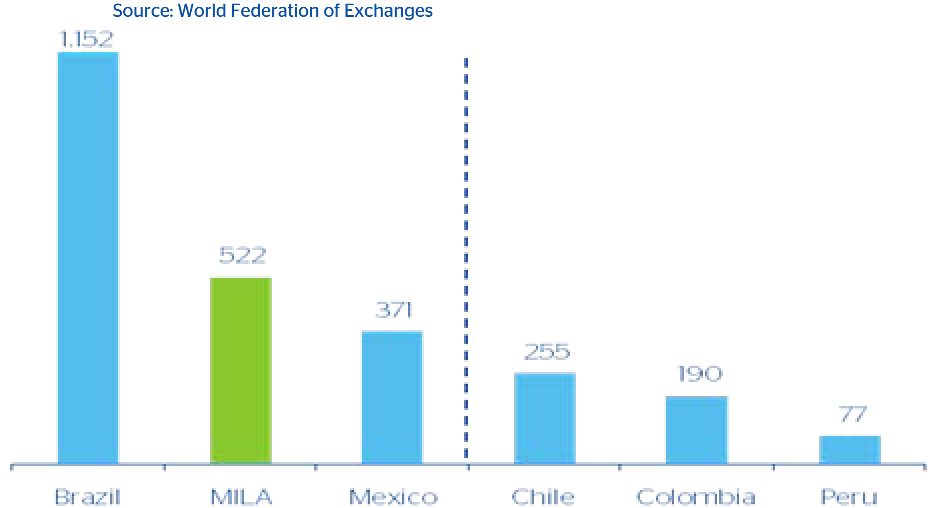
Market Composition, by Sector (%)

Source: BVL, BVCS and BBVA Research



LatAm Market Capitalization (bn USD, Sept '11)

Source: World Federation of Exchanges



Section 2

Specific recommendations can be extracted from the study of individual cases

- **Institutional reforms** are still needed. A success story could be what authorities might be starting in Mexico.:
  - Reduce information requirements (audited financial statements, or tax I.D. number)
  - Simplify documentation and risk evaluation criteria for SMEs bank loans.
  - Increase development bank (NAFIN) guarantees funds for SMEs bank loans
  - Create a unique and centralized movable assets registry (Registro Único de Garantías Mobiliarias, RUG)
  - Increase development bank (BANOBRAS) infrastructure loans in projects that involve long term bank financing
- **More information in credit bureaus** is needed to increase access to potential clients, in particular households and SMEs.
  - Households: Covered population ranges from 33% to 100% of adults in Latin America..Banks could be given indirect access to other sources, such as retail stores or utilities databases.
  - SMEs represent 95% of firms in Mexico
- **Low-cost default accounts**: For the entire population, promoted by the government and associated to the National Registry of Identity (Chilean experience). Complemented by a massive diffusion of POS and debit cards as means of payment and by the mandatory payment of salaries through banking accounts
- **Financial education** can be pursued via incentives (like the removal of fees in BBVA)

Section 3

Conclusions

- After significant advances in growth and macro stability policies, it is time for Latin America to focus more on "micro" reforms.
- Synergies with other measures, such as the improvement of the labor market, fiscal reforms, etc. could be exploited
- Regarding technical aspects, **data should be available** to conduct further analysis
- Some policy recommendations are based on **inconclusive or misleading arguments**. This could be harmful coming from the World Bank.
- Some **pending issues** could be included
  - **A more complete list of policy recommendations,** such as the removal of interest rate caps, banking taxes reduction, a decrease of the size informal sector or a gradual implementation of Basel III and new regulation.
  - More concrete **individual recommendations** based on the particular characteristics of each country: institutional reforms, more information in credit bureaus or low-cost default accounts. Differences among countries should be exploited

Appendix

Appendix

Some factors are not sufficiently outlined

1 Informal sector

Determinant Factors of Bank Credit: Results of the panel regression

	G FGLS	H FGLS
Informal economy	-0.146* (-3.91)	-0.100 (-1.54)
Physical property rights	3.756* (10.54)	
Legal and political environment		3.277* (4.92)
Bank interest rate	-0.248* (-4.13)	-0.538* (-4.40)
Inflation	-0.005 (-0.17)	-0.024 (-0.59)
Per capita GDP	0.00109* (21.66)	0.0009* (6.17)
Debtor information	3.533* (21.88)	3.809* (12.52)
Deposits over GDP		
L. Deposits over GDP	0.765* (21.66)	0.701* (19.04)
Constant	6.237* (2.31)	7.308* (2.21)
Observations	86	86
Adjusted R^2	0.602	0.650

* p < 0.05 ** p < 0.10
Note: t Statistics in parenthesis
L Indicates it is behind one period
Source: BankWatchMexico, BBVA Reserach, February 2010

Appendix

Some factors are not sufficiently outlined

1 Informal sector

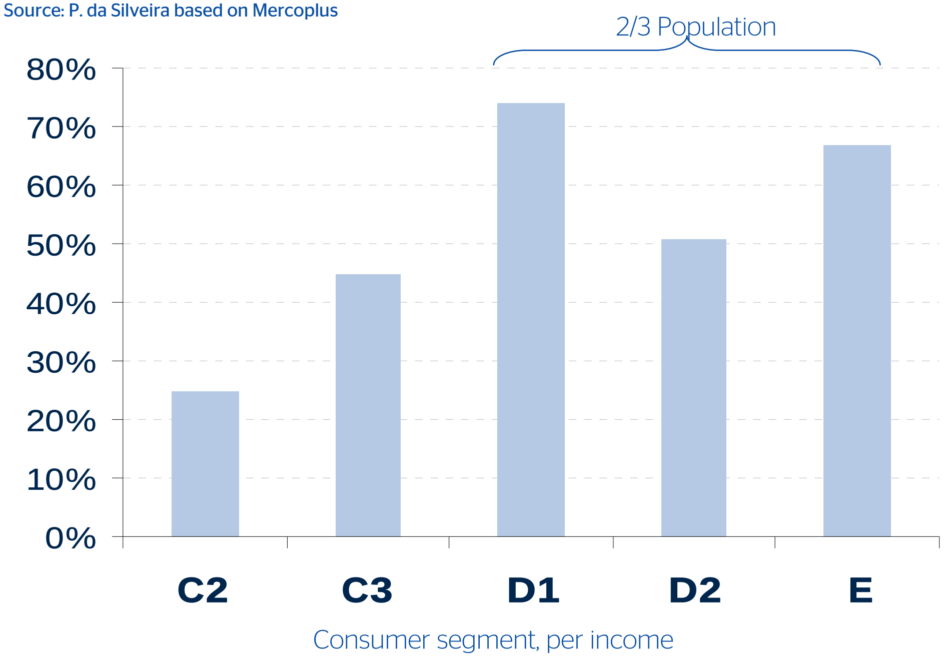
- Non-banks usually provide banking services to low-income segments of population, contributing to banking inclusion.
- However, institutions that are not affected by banking regulation and not so closely supervised could constitute a risk for the stability of the system

Some of their **disadvantages** are:

- Their portfolios are more risky, as the risk profile of their clients is worse
- They usually grant small consumer loans, which are risky
- The information available on the risk quality of their clients is not comprehensive
- They have a limited capacity to obtain long-term and solid funding, so asset-liability mismatches cannot be ruled out

Uruguay: % Answers to Survey having outstanding credit in the shadow banking

Source: P. da Silveira based on Mercoplus



Appendix

Some factors are not mentioned

2 Interest rates caps and taxes

- Ceilings on interest rates may hinder small loans because of the high administrative cost of recovery. Some borrowers are excluded from the formal market because these ceilings do not reflect their risk

Cases in South America

Colombia	Chile
The law provides the usury rate as the maximum that can be charged on credit transactions	For loans set a limit of interest is called the conventional maximum interest
Corresponds to 1.5 times the current bank rate (CBR)	This interest can not exceed 50% over the current interest governing at the time of the convention, either fixed or variable rate
The CBR is certified by the Superintendency for trade patterns, micro-credit and consumption, using information disbursement rate of the financial system	Averages are established in connection with the operations for each calendar month

Ease of access to credit1/ (2009-10 weighted average)

Source: WEF

1/ Obtaining credit for company has become [1 = most difficult, 7 = easy]

Appendix

Some factors are not mentioned

2 Interest rates caps and taxes

Estimation results of the econometric model

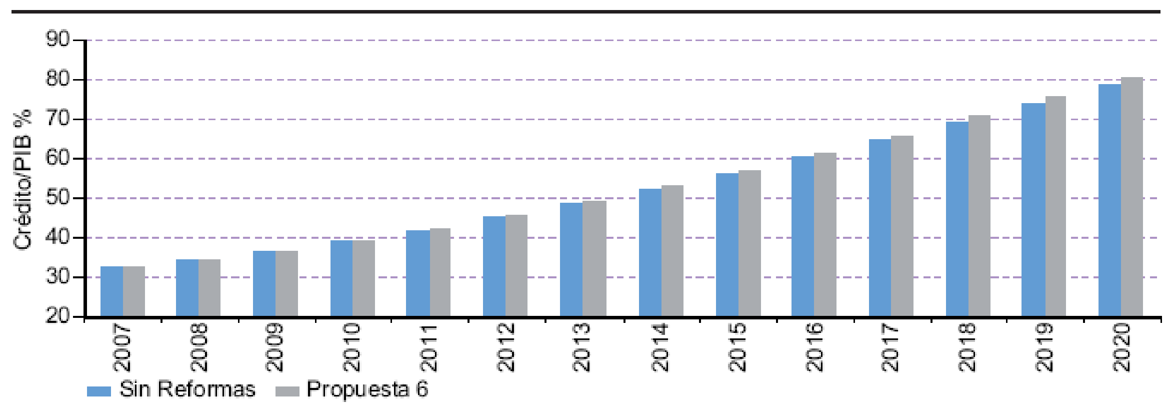
Source: BBVA Research

	Número de obs = 993
	R2 = 0.9569
	ajust = 0.9501
	55) = 1056.635
	ob > F = 0.000
	FEVD
Inflación (-1)	-0.00160
	(0.893)
Spread	-0.04060
	(0.378)
PIBpc	0.00138***
	(0.000)
Crecimiento (-1)	-9.95697
	(0.150)
Indice Información	9.36897***
	(0.000)
Ind. Registro Propiedad	-1.59309***
	(0.000)
Ind. Cumplimiento de Contratos	-4.17199***
	(0.000)
Indice de derechos legales de acreedores	3.78737***
	(0.000)
Tasa de Usura en Países en Desarrollo	-1.65323**
	(0.042)
Eta	1.00000***
	(0.000)
Constante	18.45867***
	(0.000)

- According to a BBVA study for Colombia, the removal of the interest rate ceiling would have a positive impact on financial intermediation

Impact of elimination of the usury rate in Colombia

Source: BBVA Research



The case of Nicaragua: the market shrank after parliament established ceilings on interest rates in 2011. The annual growth of the portfolio was reduced from 30% to less than 2%.

Appendix

Some factors are not mentioned

2 Interest rates caps and taxes

- Taxes on financial transactions at the margin discourage the use of the financial system to perform transactions, encouraging the use of cash
- Singh, Belaisch, Collyns, Masi, Krieger, Meredith and Rennhack (2005) find a negative effect on financial intermediation with this tax being implemented in Colombia and Brazil

Rate of tax on bank debit transactions in 2004 for some countries in Latin America

(%)

Country	Rate
Argentina	0.60
Bolivia	0.30
Brazil	0.38
Colombia	0.40
Peru [1/]	0.005
Venezuela	0.50

Source: Rojas Suarez (2006)

1/ Current rate.

Appendix

More information in credit bureaus is needed to increase access to potential clients - specially SME and families

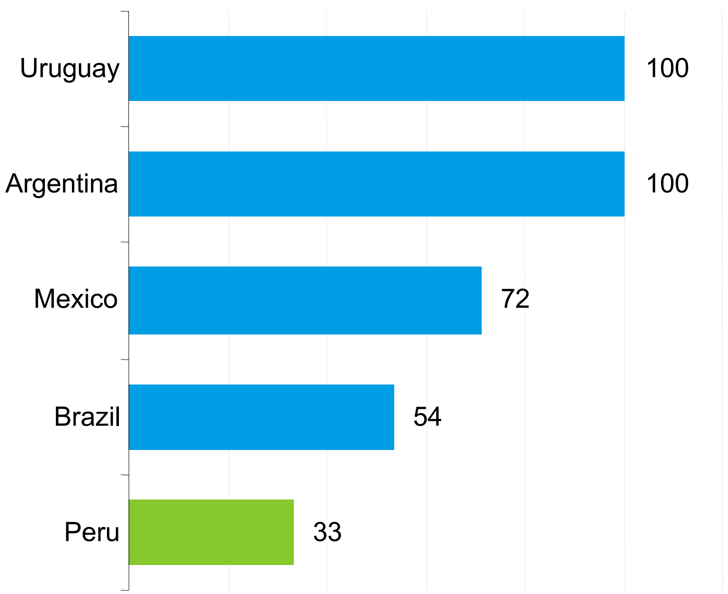
Some LAC countries are still lagging behind in access to potential banking customers information

In those countries that are lagging behind, in addition to credit bureau information, banks could be given indirect access to other sources

Credit bureaus access to information

(% of adult population)

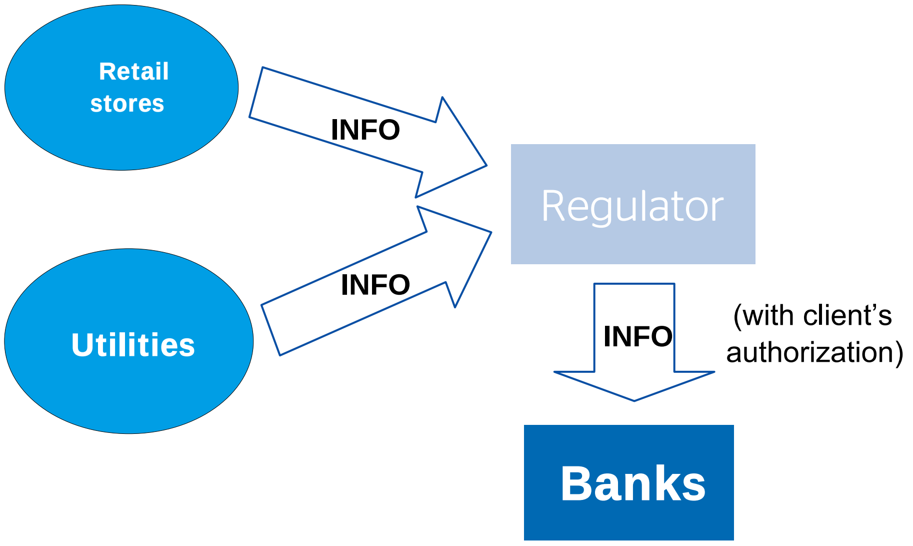
Source: Doing Business 2011 "Creando oportunidades para los emprendedores"



Proposed additional information flow

(% of adult population)

Source: BBVA Research Peru

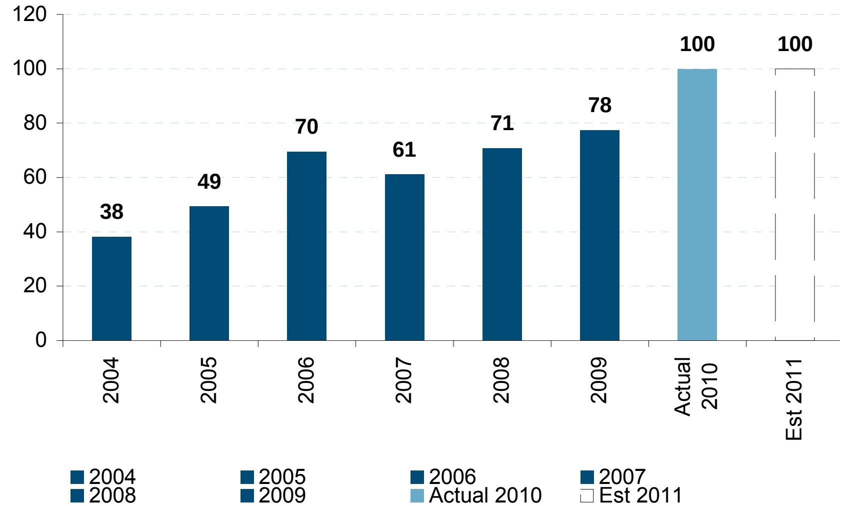


Appendix

Additional information for credit bureaus in Mexico

- In some cases, more detailed analysis is needed to guide reforms.

Private credit bureaus coverage in Mexico



Note: WB DB Indicators only consider private bureaus that have been operating five years, so until 2011 measurements will include data from Circulo de Crédito

More and better credit bureau data:

- Add data from firms' contributions to social security and housing provident funds (Infonavit, Fovissste)
- Add data about persons payments of public services (electricity, water, taxes, etc)
- Access to government databases that permit validation of credit bureaus databases.

Appendix

Automatic enrolment accounts (default accounts)

- Bank accounts could be open at birth and ratified when the client becomes adult, and incorporate incentives for its use: access to different kind of credits (e.g. housing), seminal capital under some requirements, and discount in services are necessary for a targeted group of the population.
- Behavioral economics literature recommends this as a way to break inertia (the auto exclusion hypothesis in WB report). See Utkus and Mitchell (2010), Madrian (2010), Choi et al (2010)
- Successful experience in Chile with RUT accounts could be taken as an example.

Low-cost default accounts	• For the entire population, promoted by the government and associated to the National Registry of Identity (Chilean experience).
Complemented with other measures	• Massive diffusion of POS and debit cards as means of payment. • Mandatory payment of salaries through banking accounts
Supported by the Government	• Given their social benefits, costs could be covered (at least partially) by the government.