SYMPOSIUM ON BUILDING THE FINANCIAL SYSTEM OF THE 21ST CENTURY: AN AGENDA FOR LATIN AMERICA AND THE UNITED STATES

November 12-14, 2014
Harvard Law School, Cambridge, MA

WEDNESDAY, NOVEMBER 12

6:30-7:25 p.m. **COCKTAIL RECEPTION** Sheraton Commander Hotel
The George Washington Ballroom, 16 Garden Street, Cambridge, MA 02138

7:25-7:30 p.m. **GREETING AND OPENING ADDRESS**

- Hal S. Scott, Nomura Professor of International Financial Systems, Harvard Law School

7:30-8:00 p.m. **KEYNOTE ADDRESS**

- Susan Baker, Director, Office of International Banking and Securities Markets, U.S. Department of Treasury

8:00-10:00 p.m. **DINNER**

THURSDAY, NOVEMBER 13

8:00-8:30 a.m. **BREAKFAST BUFFET** Wasserstein Hall, 1st Floor

8:30-8:35 a.m. **WELCOME REMARKS** Wasserstein Hall, Rm 1023

- Martha Minow, Morgan and Helen Chu Dean and Professor of Law, Harvard Law School

FUNDAÇÃO GETULIO VARGAS DIREITO GV ESCOLA DE DIREITO DE SÃO PAULO

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Universidad de Chile Centro de Gobierno Corporativo y Mercado de Capitales

8:35-9:30 a.m. **KEYNOTE PANEL SESSION** Wasserstein Hall, Rm 1023

Panelists will introduce and discuss issues relevant to the topic. Each panelist will make a 5-7 minute presentation before all of the participants are broken into small, working groups.

Improving Capital Markets in Latin America and the U.S.

- Juan Andres Camus, Chairman, Bolsa de Comercio de Santiago
- Juan Pablo Córdoba, President, Bolsa de Valores de Colombia
- William Brodsky, Executive Chairman of the Board, Chicago Board Options Exchange
- Alexandre L. Ibrahim, Vice President and Regional Head, Intercontinental Exchange, NYSE
- Roberto Belchior, Chief Legal Officer, BM&FBOVESPA (Moderator)

9:35-10:35 a.m. **SMALL GROUP BREAKOUT SESSIONS** Wasserstein Hall

Participants are divided into working groups for facilitated discussions with the views raised by the panelists serving as a foundation for the discussions. A facilitator encourages conversations which occur under Chatham House Rules, and a rapporteur will record the major themes (sans attribution) for use during the sessions on the final day.

Group	Room	Facilitators	Reporters
1	3007	David Gruppo	William Grimes
2	3008	Dieter Linneberg	Richard Mattione
3	3011	Diego Serrano Redonnet	Patricia Sampaio
4	3012	Thomas Heather	Jose Agusto Martins

10:35-11:00 a.m. **REFRESHMENT BREAK** Wasserstein Hall,1st Floor

11:00-11:30 p.m. **PANEL SESSION** Wasserstein Hall, Rm 1023

Panelists will introduce and discuss issues relevant to the topic. Each panelist will make a 5-7 minute presentation before all of the participants are broken into small, working groups.

Extraterritorial Impact on Latin America of U.S. and European Regulations

- David Gruppo, Head of Latin America Corporate and Investment Banking, Bank of Tokyo Mitsubishi UFJ, a member of MUFG
- Thomas S. Heather, Lawyer, Ritch, Mueller, Heather y Nicolau, S.C.

11:30-1:00 p.m. **SMALL GROUP BREAKOUT SESSIONS** Wasserstein Hall

Participants are divided into working groups for facilitated discussions with the views raised by the panelists serving as a foundation for the discussions. A facilitator encourages conversations which occur under Chatham House Rules, and a rapporteur will record the major themes (sans attribution) for use during the sessions on the final day.

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1	3007	Alberto Kiraly	William Grimes
2	3008	Sergio Suchodolski	Richard Mattione
3	3011	Mike Lubrano	Viviane Muller Prado
4	3012	Andre Jánszky	Jose Agusto Martins

1:00-2:30 p.m. **LUNCH AND KEYNOTE ADDRESS** Wasserstein, Milstein East B

- Lawrence Summers, President Emeritus, Charles W. Eliot University Professor, Harvard University

2:45-4:30 p.m. **KEYNOTE PLENARY SESSION** Wasserstein, Milstein East C

U.S. Monetary Policy and its Impact on Latin America

- Manuel R. Agosin, Dean, School of Economics and Business, Universidad de Chile (Moderator)
- Sebastian Claro E., Board Member, Banco Central de Chile
- Manuel Ramos-Francia, Deputy Governor, Bank of Mexico
- Jeremy Stein, Moise Y. Safra Professor of Economics, Harvard University, Former Governor of the Board of Governors of the Federal Reserve Bank

4:30-7:00 p.m. **FREE TIME**

4:30-7:00 p.m. **REPORTERS MEETING** Wasserstein Hall, Rm 5052

7:30-8:00 p.m. **EVENING RECEPTION** Sheraton Commander Hotel

Mount Vernon Ballroom, 16 Garden Street, Cambridge, MA 02138

8:00-8:30 p.m. **KEYNOTE ADDRESS**

- Stephen Scherr, Chief Strategy Officer and Head of Latin America, Goldman, Sachs & Co

8:30-10:30 p.m. **DINNER& KEYNOTE ADDRESS**

- Gabriel Amado de Moura, Chief Investment Officer, Itau Unibanco

FRIDAY, NOVEMBER 14

8:00-8:30 a.m. **BREAKFAST BUFFET** Pound Hall

8:30-9:30 a.m. **PRESENTATION & DISCUSSION** Pound Hall, Rm 102

Pension Fund Diversification of Latin American Assets

- Scott FitzGerald, Executive Vice President, State Street Corporation (Moderator)
- Carlos Ramírez Fuentes, Chairman of the National Commission System Retirement Savings
- Álvaro Clarke, President, Corporate Governance and Government Markets Center, Universidad de Chile

9:30-10:15 a.m. **KEYNOTE PRESENTATION** Pound Hall, Rm 102

- Jaime González Aguadé, Chairman of the Board, Comisión Nacional Bancaria y de Valores

10:15-10:45 a.m. **REFRESHMENT BREAK** Pound Hall

10:45-11:45 a.m. **PRESENTATION & DISCUSSION** Pound Hall, Rm 102

Co-chairs will moderate a plenary discussion that uses a synthesis of the small group sessions from the previous day as the basis for session.

Improving Capital Markets in Latin America and the U.S.

- Kathleen C. Barclay, President, AmCham, Chile
- Tamara Lothian, Senior Visiting Scholar & Lecturer in Law, Columbia University, Research Fellow and Visiting Professor of Law, Fundacao Getulio Vargas, Rio de Janeiro

11:45-12:45 p.m. **PRESENTATION & DISCUSSION** Pound Hall, Rm 102

Co-chairs will moderate a plenary discussion that uses a synthesis of the small group sessions from the previous day as the basis for session.

Extraterritorial Impact on Latin America of U.S. and European Regulations

- David Bunce, KPMG Senior Partner of KPMG in South America
- Samuel Libnic, General Counsel for Latin America & Mexico, Citi

12:45pm **CLOSING & REFRESHMENTS** Pound Hall

HARVARD LAW SCHOOL
PROGRAM ON INTERNATIONAL FINANCIAL SYSTEMS

2014 Symposium on Building the Financial System of the Twenty-First Century: An Agenda for Latin America and the United States

FINAL REPORT

Cambridge, Massachusetts, November 12-14, 2014

The Fifth Latin America-U.S. Symposium on Building the Financial System of the Twenty-First Century was held at the Harvard Law School from November 12-14, 2014. Sessions addressed how to improve capital markets in Latin America and the U.S., extraterritorial impact on Latin America of U.S. and European financial regulation, U.S. monetary policy and its impact on Latin America, and pension fund diversification of Latin American assets. Despite the relatively healthy growth of the U.S. economy, there were some worries about the softness of global growth and about the potential effects of the U.S. "taper" on Latin American economies. Participants also expressed considerable concern about the potential negative effects on Latin American financial systems of regulatory reform in the U.S., EU, and the G20. Nonetheless, participants saw many opportunities for Latin American financial markets due to growing middle classes, good economic governance in many countries, infrastructure needs, and the potential for regional cooperation.

Session 1: Improving Capital Markets in Latin America and the U.S.

Session 1 considered the potential for improvement of capital markets in Latin America and the U.S. Participants noted the growth potential of Latin American markets, as well as concerns about fragmentation and obstacles to expansion. Discussion addressed regulation and enforcement, market structure, and regional cooperation. There was also considerable discussion of the effects of U.S. capital markets on Latin American financial systems and intermediation

Growth Potential of Latin American Capital Markets

Participants expressed optimism about the growth potential of Latin American capital markets. On the supply side, they saw considerable room for expansion of the investor base, as middle classes grew across the region. Meanwhile, they also observed substantial and increasing demand for funds—for infrastructure, for corporate investment, for housing, and for household consumption. Many participants also spoke enthusiastically of what they saw as supportive conditions in a number of Latin American economies, in the form of relative macroeconomic stability and strong institutions of economic governance. The development of strong institutions, including central banks and financial regulators and supervisors, was seen as particularly important to laying the foundation for sustainable growth of Latin American capital markets. Participants noted the successes in this regard of Brazil, Mexico, Chile, Colombia, and others, which they contrasted with more disappointing developments in Argentina and elsewhere.

At the same time, participants pointed to a variety of obstacles to the development of regional capital markets. They noted that most Latin American markets continued to suffer from low liquidity, limited issuer bases, and lack of domestic institutional investors. Participants considered a number of reasons for underperformance. Fragmentation of markets along national borders was seen as contributing to these problems, particularly for smaller economies. A number of participants also noted that Latin American financial systems remained bank-based. Moreover, governments were seen as having an outsized role in many countries—not only in terms of regulation and fiscal policies, but also as direct actors in capital markets in the form of state-owned financial institutions, other firms, and pension funds.

Participants agreed that a key factor in the continued development of Latin American capital markets would be macroeconomic stability. They noted that the most successful capital markets were those located in economies that had made a clear commitment to keeping inflation under control and somewhat constraining fiscal deficits and debt. In contrast, memories of serious inflationary and currency episodes in other economies were seen as making potential investors skittish. While macroeconomic stability was not seen as a sufficient condition, it appeared to be a necessary one.

Regulation and Enforcement

Participants agreed that the quality of financial regulation and enforcement in Latin American economies varied significantly. While Brazil, Mexico, and the members of the Mercado Integrado Latinoamericano (MILA; i.e., Chile, Colombia, and Peru, with Mexico scheduled to join the following month) were seen as having developed high quality regulation and consistent enforcement regimes, other jurisdictions had been less successful and their capital markets remained undeveloped. Even among the better-developed markets, a number of participants suggested that improvements were needed in transparency, disclosure, and corporate governance. They felt that the prevalence of controlling shareholders (in some cases, the state) in many companies made disclosure and corporate governance all the more important to ensure fairness and efficient allocation of capital. Another aspect of regulation that was seen as limiting the development of many Latin American capital markets was capital controls, which remained an important factor in the region, with the exception of a few economies such as Chile and Mexico.

A general concern raised by many participants was the inefficiency of court systems in many of the Latin American countries. Courts could take years to enforce contracts or to complete enforcement actions in some countries, with inconsistent results. Recognizing the difficulty of wholesale court reform, a number of participants argued that a better model would be more extensive reliance on self-regulation and arbitration as an alternative. There was considerable enthusiasm for the Novo Mercado model, based on private enforcement of voluntary corporate governance standards.

Participants also discussed other assorted challenges with regard to regulation and enforcement. For both Latin America and the U.S., participants stressed the importance of cost-benefit analysis, to ensure that the direct and indirect costs of compliance with regulations would not exceed the benefits in terms of financial stability, fairness, and efficiency. Many participants argued that Latin American capital markets still suffered from excessively conservative regulations on entry and conduct, which had negligible benefits on financial stability but tended to drive transactions away from the regulated markets, contributing to the problems of fragmentation and lack of liquidity. Many participants also agreed that enforcement of rules was at least as important as the regulations themselves. They called for Latin American (as well as U.S.) authorities to upgrade the administrative capacity of regulators and supervisors in order improve the efficiency and consistency of enforcement. Several argued that political will was even more important than administrative capacity; this sort of political will was seen as varying considerably across jurisdictions.

Market Structure

In addition to government policies, legal infrastructure, and administrative capacity, which were seen as important elements in defining the rules of the game, participants also saw market structure as being of crucial importance in the development of capital markets. They focused on three aspects of market structure—diversity, concentration, and state ownership—that varied across Latin American economies.

Participants noted that Latin American economies had concentrated financial sectors, on a variety of measures. Formal finance centered on banks in most countries, leaving capital markets relatively undeveloped. A number of participants argued that an additional effect of overreliance on bank finance was large company bias in the economy more broadly. Large companies were seen as having good access to bank loans and therefore as being less attracted to market-based financing. Meanwhile, the absence of a significant corporate bond market meant that SMEs, which had more limited access to bank loans, also could not raise funds at reasonable cost through ABS or by issuing corporate bonds. Some participants saw the prevalence of controlling shareholders—whether state or family—as adding to the reluctance of many firms to try to access capital markets. They argued that controlling shareholders were in many cases reluctant to fully open their books or to expose themselves legally to the demands of minority shareholders. In order to expand offerings in equity and bond markets, participants agreed, it would be essential to improve SME access. They made several suggestions as to how to do so. Asset-backed securitization was seen as one way to improve market-based borrowing for SMEs. For equity markets, costs of listing and quality of information were identified as two key roadblocks; one way that participants suggested to address these issues was the development of different stock exchange sections for start-ups and SMEs.

Capital markets (other than Brazil's) tended to focus on equities and government bonds, with limited access to other financial products such as corporate bonds, asset-backed securities, and derivatives. There was some disagreement as to whether the development of local derivatives markets would be appropriate to all Latin American financial markets. Some participants offered evidence that an expansion of derivative products, such as index futures and options, would contribute to liquidity and trading volume of conventional equities and bonds. They argued that, in the absence of such products, investors would shift their transactions to other jurisdictions, such as the U.S. Other participants expressed concern about the potential for derivatives markets to drive volatility and to attract hot money from abroad, raising the likelihood of a financial or currency crisis. They argued that the potential costs were high and benefits uncertain, and emphasized the importance of gradual introduction of unfamiliar new products.

Concentration was also seen as a significant challenge to Latin American capital markets. A key issue was the investor base. Despite the growth of pension funds and asset management in the region, participants agreed that the institutional investor base remained limited to a relatively small number of large players. The prevalence of public sector pension funds tended to exacerbate the issue of concentration, especially given their buy-and-hold preferences. The growth of the asset management and retail investor base were limited by the persistence of economic inequality and the delayed growth of middle classes with investable assets. Concentration of wealth among a relatively small number of high net worth families was seen as reducing the opportunities for market liquidity.

Concentration was seen as important with regard to issuance as well. Participants noted that many sectors were dominated by a small number of domestic firms—including, in many cases, state-owned enterprises—which restricted the number of potential issuers of equities and bonds, given the bias of capital markets toward large firms. Large company bias was seen to persist largely as a result of imperfect information, as well as an assumption in a number of countries that larger companies were more likely to receive rescue financing from banks or the government if they were to get into trouble. And concentration in origination and distribution was seen as leading to high commissions, which further discouraged investors and issuers.

Finally, many participants expressed unease at the large role of state entities in the Latin American financial sector. Such entities included not only regulators, but also banks, institutional investors, and state-owned enterprises. With state entities as central players on the buy side, they questioned whether private investors could trust the integrity of markets. With regard to issuance, many participants expressed concern about crowding out due to the large stock of government bonds in many countries. Given the high yields on "risk-free" government bonds in countries like Brazil, they saw little incentive for investors to purchase riskier corporate bonds. Moreover, the prevalence of SOEs as issuers of corporate bonds threatened to further crowd out opportunities for private sector firms, since investors would expect that SOEs would be bailed out if they got into trouble.

Overall, there was some debate as to whether the U.S. model of market-based finance was necessarily appropriate for the middle-income economies of Latin America. Some participants argued strongly that having a variety of channels of financial intermediation (banks, capital markets, private equity, venture capital, etc.) was an important element in the relative resilience of the U.S. financial system in the financial crisis. This line of argumentation supported vigorous efforts by Latin American governments, exchanges, and market players to expand capital markets. Others disagreed, on the basis that few Latin American markets could readily develop the kind of information density and market liquidity that supported U.S. financial resilience. They argued that Latin American countries might do better to focus on strong regulation and supervision of banks, corporate governance, and disclosure and transparency of financial information.

Expanding the Domestic Investor Base

Many participants agreed that the regulatory, legal, and technical infrastructure in the leading Latin American capital markets was strong. There, they argued that the most pressing need of Latin American capital markets was expansion of the investor and issuer bases.

Much of the discussion of expanding investor and issuer bases focused on how countries could mobilize domestic players. (Regional and U.S.-focused strategies are discussed below.) This was particularly true for larger economies such as Brazil and Mexico, but participants also felt that expanding domestic market participation would be an important anchor for capital markets in smaller economies such as Chile, Colombia, and Peru.

A major concern was how to expand the number of institutional investors and improve their quality. A number of participants were optimistic about the prospect of doing so they pointed in particular to the growing number of pension funds, which were accumulating significant funds and needed to generate good returns. Some participants raised questions about the quality of pension fund investment, however. They noted that governance—and therefore accountability to beneficiaries—was weak in many cases. There were also questions about the level of skill among domestic institutional investors, especially as numbers increased quickly and markets became more sophisticated. Benchmarking was raised as a concern by some participants as well, who worried that it created incentives for herd behavior, which would reduce the benefits of a broader investor base. Similar concerns were raised for other institutional investors, such as asset management companies.

Perhaps a larger challenge would be the development of a large base of retail investors. Despite the emergence of a growing middle class, the history of income inequality in many Latin American economies meant that middle classes remained small relative to domestic populations and their savings remained limited. Moreover, while many potential Latin American investors had had experiences of high inflation, few had much knowledge or experience in capital markets. Thus, participants felt that it would be necessary to develop an investment culture, in which the growing middle classes could understand the benefits (and risks) of investing in capital markets, rather than parking their savings in banks. To do so, many participants agreed, it would be necessary to provide high-quality investment vehicles (such as mutual funds or exchange-traded funds) as well as investor education. They saw these tasks as the responsibility of asset management companies. It was also seen as important to ensure that asset managers and brokerages were held to high standards of conduct, so as to maintain trust in the overall financial system.

Expanding the Regional Investor Base

While much of the discussion of expanding the investor and issuer bases focused on domestic players, there was also considerable discussion about the potential of expansion of the regional investor and issuer bases. In this regard, a number of participants expressed excitement about MILA, which they saw as an ambitious and important initiative.

The potential benefits of MILA were evident. By allowing investors in any member country to purchase securities in other member country markets, it could help to address the problems of market fragmentation, low liquidity, and insufficient diversification of issuers and investors. With the planned addition of Mexico to the current Andean members, total valuation of MILA equities would exceed the size of Brazil's BM&F Bovespa.

Still, participants acknowledged that the success of such a regional strategy was not guaranteed, as member countries would have to work through a number of challenges. Despite the benefits in expanding the pool of investable funds, some participants wondered if MILA offered a large enough pool of savings to maintain viable exchanges in each of the member countries. There were also questions about the obstacle of home-country bias, and how much the common platform would actually increase liquidity.

Moreover, policy differences among members could make it more difficult to manage a common platform or could facilitate regulatory arbitrage. For example, some MILA members maintained capital controls, so regulators would need to monitor cross-border investing on the common platform to prevent circumvention. Similarly, MILA members' tax policies varied considerably, raising the likelihood that the system might be used for tax avoidance. Participants also cited other regulatory differences, including privacy laws that could potentially restrict exchange of information among regulators.

Nonetheless, participants strongly supported the effort, which they hoped would bear fruit. Indeed, a number of participants expressed hope that MILA could continue to grow by including more exchanges from the region and by acting as a regional role model for other Latin American exchanges to aspire to join. To some participants, the obvious match would be Brazil. If BM&F Bovespa were to join the group, MILA would approach the status of a truly regional Latin American capital market. Others were skeptical that Brazil should join. They noted that Brazil would gain less than the existing MILA economies from the expansion of liquidity given its existing domestic investor base and the high level of participation of U.S. and European financial institutions and investors in its markets, and that its infrastructure and functions in many ways outstripped those of the MILA economies. Moreover, the complications in terms of tax policy, capital controls, and regulatory cooperation would be significant. They suggested that Brazil would be better off focusing on improving the attractiveness of its markets to domestic and international investors than on working through a gradual process of coordination with regional partners.

Role of U.S. Capital Markets

Finally, there was considerable discussion of the role of the U.S. in the development of regional financial markets, in particular the role of the 144A market. For issuers in countries with limited investor bases, the ability to list in the U.S. remained extremely attractive, as it offered access to the world's largest and most diverse investor base, as well as deep and liquid markets. With U.S. markets booming and a growing U.S. investor appetite for riskier assets, Latin American issuers would have good reason to want to access the U.S. capital markets. Moreover, the ease of offering under 144A made it the international default for many Latin American issuers; at the same time, being listed in the U.S. was seen by many participants as offering a patina of credibility and responsibility that would benefit issuers.

Still, questions remained. A major one was what would be the effect of a U.S. offering on domestic market liquidity. Some participants presented evidence that higher trading volume in the U.S. would actually increase liquidity at home—in other words, that an international offering was a complement rather than a substitute for domestic investors. Not all participants were convinced, however. They worried that a currency, financial, or political crisis could lead to a flight to quality in which trading shifted to the U.S. Moreover, the opportunities for regulatory and tax arbitrage might create pressure on Latin American exchanges to adopt U.S. rules. Finally, for smaller exchanges, any international offering strategy could contribute to consolidation, which in turn would likely threaten their viability.

Session 2: Extraterritorial Impact on Latin America of U.S. and European Regulations

Session 2 considered the question of how extraterritoriality of some U.S. and European regulations was affecting Latin American financial institutions. Participants agreed that these effects were profound. Discussions also addressed the impact of post-crisis global standards as well. Much of the discussion focused on negative impacts of extraterritoriality and global standards, although participants also highlighted a number of potentially positive impacts.

Defining "Extraterritoriality"

Participants adopted a broad approach to the concept of "extraterritoriality" in Session 2. Indeed, much of the discussion focused on global standards rather than simply on extraterritorial enforcement of U.S. or EU laws. There was some discussion of whether it was appropriate to apply global standards in Latin America—after all, the G20 agreement only applied to G20 members (i.e., only Brazil and Mexico in Latin America). In principle, other countries applied them voluntarily, but even they felt compelled to apply global standards.

There was also considerable discussion of extraterritoriality in the narrower sense—i.e., the extraterritorial enforcement of U.S. and European laws by the national authorities of those countries. Participants addressed two kinds of extraterritoriality: U.S. and EU extraterritoriality based on their own interpretations of global standards (effectively acting as self-appointed enforcers of global standards), and extraterritorial enforcement of national (idiosyncratic) rules. The latter focused primarily on the U.S., including the Volcker Rule, Foreign Corrupt Practices Act (FCPA), Foreign Account Tax Compliance Act (FATCA), and anti-money laundering (AML) rules.

U.S. and European enforcement of global standards was seen as a significant problem by many participants. While some felt that it was inevitable that international enforcement of global standards would require leadership by the most important global markets and regulators, there was widespread dissatisfaction about the way in which U.S. and EU policymakers and regulators interpreted those global standards. Participants noted that global standards, even including Basel III, left considerable discretion for national authorities to apply them to domestic conditions. However, extraterritorial enforcement meant that U.S. or EU interpretation were being forced on Latin American economies that did business with U.S. and EU financial institutions and markets, even where the specifics of regulation did not evidently make sense for the local economy. As some saw it, the U.S. was seeking to act as global legislator, cop, and judge. Moreover, it was noted that in some cases, U.S. and EU interpretations of global standards contradicted each other, making extraterritoriality even more problematic.

Impact of Global Standards

One of the major international responses to the global financial crisis was the G20's mandate for regulatory reform. This mandate led to more extensive global standards for regulation of financial institutions and activities, including Basel III, macroprudential regulation, designation and regulation of systemically important financial institutions (SIFIs), central clearing of derivatives, etc. The goals of the new global standards were twofold: to improve the stability of the global financial system and to ensure greater uniformity of financial regulation around the world.

Participants agreed that there were clear benefits to uniform regulatory principles. Global standards would reduce the possibility of cross-border regulatory arbitrage as well as the risk of new crises arising from under-regulated markets. However, participants also noted that the new global standards had been created to address the features of the U.S. and European financial systems that had led to the global financial crisis. They questioned whether the new global standards were appropriate for Latin American economies, with very different market structures and histories. They noted that Latin American financial systems were bank-based, less complex that those of the U.S. or leading EU countries, with fewer types of financial institutions and products, higher concentration, and higher levels of state involvement. Moreover, few Latin American financial institutions operated on a global basis, while regional economies remained dependent on foreign-currency financing. Thus, they felt that many of the post-crisis reforms were not relevant to the needs of the region's economies.

These participants worried also about the costs of the new global standards. In addition to the direct costs of regulatory implementation, they argued that global standards were having a negative effect on overall economic growth, without necessarily reducing the financial risks to which Latin American economies were exposed. One example was banking regulation. With many Latin American economies adopting Basel III standards even for non-internationally-active banks (and with foreign banks in Latin America subject to Basel III from their home regulators), capital requirements for banks were rising across the region. Many participants expressed concern that higher capital requirements would raise the cost of capital. Perhaps even more important, they worried that the new rules would change the profile of bank lending away from SMEs and households and toward sovereigns and large companies. Given the dominance of banks in regional financial systems, they argued that risk capital would become increasingly rare, pushing credit-constrained SMEs and households either to postpone investment or to obtain funds through shadow banks or curb markets. These effects were seen as likely to be exacerbated if U.S. or European banks were to decide to eliminate their operations in some Latin American crises as part of a response to G-SIB regulation.

Meanwhile, many participants expressed skepticism that the new global standards would actually eliminate risk. They noted that risks in any financial system were likely to migrate to less regulated areas; moreover, they pointed out that financial crises often arose in the most regulated areas, as seen in the 2008 crisis (which was mainly about bad loans of banks) as well as in the U.S. savings and loan crisis, among others. Moreover, some raised the possibility that the very global standards that were meant to reduce risk and contagion in developed country financial systems might actually increase risk for Latin American economies. They worried that, in the event of a problem in home markets, U.S. and European financial institutions (especially, but not only, banks) might be forced to move funds from their Latin American operations or investments, leading to potential currency crises. At the least, many participants saw some of the global standards as having a procyclical bias that would not be healthy for Latin America.

Many participants expressed even greater dissatisfaction with the other type of extraterritoriality—i.e., extraterritorial enforcement of U.S. or EU (particularly U.S.) rules that had nothing to do with global standards. Global standards, they argued, at least had some global buy-in as a result of the G20 process, whereas laws like the Dodd-Frank Act contained a variety of provisions that had nothing to do with global agreements but still had global implications. There was particular concern about the Volcker Rule and OTC clearing rules. Opinions were more mixed on FCPA, FATCA, AML, and bank corporate governance rules. Although many participants were unhappy about the costs imposed on Latin American financial institutions or local branches and subsidiaries of U.S. financial institutions by the latter rules, others suggested that some of these rules were beneficial but would not have made it through domestic political processes.

Even for the U.S. and Europe, a number of participants expressed skepticism as to whether the new global standards addressed the real needs of the economy and financial system. They argued that new requirements for bank capital, central clearing, and SIFI regulation were raising costs of capital, lowering returns, and reducing availability of risk capital, while possibly only shifting risk, not reducing or eliminating it. Moreover, the fights between the U.S. and EU over derivatives clearing, alternative measurements for bank capital and liquidity, and the Volcker Rule were seen to fragment global markets.

Impact of U.S. and EU Extraterritoriality on Latin America

Participants discussed at length the effects of U.S. and EU extraterritoriality on Latin American economies. Many of the effects were seen as negative. Participants worried that extraterritoriality would raise costs of capital, reduce availability of risk capital, retard the development of local capital markets, and possibly increase the risk of financial and currency crises.

One area of concern was about the impact of extraterritoriality on cross-border financial transactions. Many participants worried about market fragmentation, particularly in derivatives and banking. Clashing U.S. and EU interpretations of how to implement the G20 principle that OTC derivatives must in general be centrally cleared created two sets of problems for Latin American markets. First, until the U.S. and EU resolved their disagreements about how these rules should be formulated, transatlantic derivatives trade would be stifled, reducing liquidity in some key products. Second, unless U.S. regulators recognized local regulatory regimes as equivalent, trading of cross-border derivatives with U.S. actors would move to the U.S., leading to an evaporation of liquidity and severe damage to clearinghouses in local markets. While some participants were cautiously optimistic about the sustainability of Brazil's derivative markets, they were more pessimistic about that of smaller Latin American markets that were less developed, even Mexico. However, they observed that even Brazil had been pressured to accept U.S. rules on credit derivatives in order to gain recognition as an equivalent regime, even though the market did not exist yet—thus preventing Brazilian regulators from setting rules based on local needs and conditions.

In banking, the growing trend toward ring-fencing and the requirements of consolidated capital for SIFIs was seen as likely to lead to at least a partial retreat from some Latin American economies. Know-your-customer rules under FCPA, FATCA, and AML would also exacerbate costs of doing business in smaller economies, which might also contribute to decisions by some banks to withdraw. This was seen as a potentially very large problem, given the importance of foreign banks in many of the Latin American economies. Not only would this reduce access to foreign capital, but it would increase concentration of domestic banking systems and thus likely raise costs of financial services. Some participants added that foreign (e.g., European or Japanese) financial institutions might well choose to leave the U.S. as well, since their U.S. branches and subsidiaries would make their global operations subject to costly U.S. regulations.

The Volcker Rule also loomed large in discussion of extraterritorial effects on Latin American finance, and not only in terms of the costs and restrictions for banks themselves. A number of participants argued that there was no good alternative to banks for market-making (which could be limited by the scope of the prohibition on proprietary trading) in Latin America, given that U.S. banks or international banks with U.S. subsidiaries were enjoined from proprietary trading, even in their Latin American operations. Given the low liquidity of many Latin American securities, it might be particularly difficult to distinguish market-making from proprietary trading, leading such banks to withdraw from the market-making function.

Participants pointed out that the impact of extraterritoriality would vary considerably by market. For example, large banks in Mexico were mostly foreign-owned. Thus, Mexico would be quite vulnerable to the retreat of U.S. or EU banks. Similarly, outside of Brazil, most Latin American OTC derivatives were cleared in the U.S., making those markets subject to U.S. derivatives regulation.

Some participants also saw negative effects of U.S. extraterritoriality on the U.S. itself. Foreign financial institutions with branches or subsidiaries in the U.S. might choose to leave the U.S., given the costs associated with compliance, legal sanctions and fines, and the need to restructure business globally to comply with the Volcker Rule. Moreover, a number of participants stated that the U.S. determination to impose its FATCA, FCPA, and AML laws on foreign counterparties of U.S. financial institutions was already leading some foreign financial institutions to choose not to do business with U.S. financial institutions, in order to avoid compliance costs and possible legal sanctions and fines.

Overall, EU and especially U.S. extraterritoriality were seen as deeply problematic for Latin American financial systems and for the Latin America-U.S. financial relationship. However, some participants pointed to two positive effects. They argued that some of the extraterritorial U.S. rules addressed real problems that local governments may lack the political will or technical expertise to tackle. These included AML and FCPA, which many participants recognized as serious problems for Latin American economies. Some participants also saw positive benefits from the extraterritorial extension of rules on corporate governance and resolution regimes. These participants argued that U.S. extraterritoriality improved the credibility and quality of enforcement efforts in Latin America, which they saw as particularly important with regard to money laundering and corruption.

Future of Extraterritoriality and Global Standards

Participants agreed that the global financial crisis had sparked a vigorous response, as seen in both global standards and a variety of new regulations in countries around the world. While Latin American economies had long been subject to some aspects of U.S. financial regulation, the U.S. post-crisis response, including Dodd-Frank and FATCA, raised the imposition of external standards to a new level.

Many participants saw extraterritoriality and global standards as a very serious challenge to the development of Latin American financial markets, so there was considerable discussion of whether there was any prospect of resistance. Some participants predicted that many countries in the region would nominally accept the imposition of external standards, but not enforce them. Others felt that the strategy of enforcement in name only would be a mistake, as it would not contribute to rule of law and transparency in the financial system. Instead, they argued that it would be essential to make the case for more flexibility in adapting global standards to local conditions in the context of the G20. A number of participants suggested that the Latin American G20 members, Brazil and Mexico, might well be able to find common cause with other economies that were finding Basel and other global standards to be unsuitable for their financial systems, citing China, South Africa, India, Japan, and perhaps others as potential allies in reopening the global regulatory response. (Some even argued that European nations could become allies in this effort, given their apparent dissatisfaction with Basel III.) Non-G20 members, meanwhile, could make their voices heard in the FSB regional consultative groups.

If global standard-setting were to be reopened, participants argued that standards should be revised to pay attention to the needs of emerging market economies. Also, observing the legal wrangles between the U.S. and EU over financial regulation, as well as some aspects of Latin America-U.S. issues over extraterritoriality, many participants called for a principles-based approach to determining regulatory equivalence.

While many participants were pessimistic about a significant rollback of global standards, others argued that the time was approaching when the pendulum was likely to swing back from what they saw as the current punitive regulatory regime to a more business-friendly, or at least neutral regime. The crux of the disagreement was whether policymakers and regulators were thinking about the costs of regulation. Many participants argued that the costs of the current regulatory regime were very high, not only in direct terms such as compliance costs, but more importantly in the overall economic costs. They saw overregulation as raising lending costs, constraining growth of credit, skewing credit provision away from SMEs and rapidly growing firms, and creating uncertainty that reduced incentives for investment. All of these were seen as creating a drag on economic growth. Meanwhile, they felt that new regulations had the effect of shifting risk to unregulated financial institutions (e.g., Basel III) or concentrating risk (e.g., in clearinghouses), raising the likelihood of a new and costly financial crisis. For these participants, measuring and communicating the costs of regulation to policymakers was an essential element in any effort to promote a rethinking of the post-crisis regulatory response.

Finally, many participants were skeptical about prospects for a reduction in what they saw as arbitrary U.S. extraterritoriality. They noted that the Volcker Rule had become established law and that banks with operations in the U.S. were already eliminating their proprietary trading and, in many cases, their market-making activities as well. Moreover, there was little hope that the U.S. political system would take into account the concerns of Latin American or other foreign governments in revising financial laws. Some, however, expressed hope that Republicans in the newly elected Congress might try to reopen debate on legislation such as the Volcker Rule for their own domestic reasons, which might provide relief to securities markets in Brazil and elsewhere in the form of a return to market-making by banks.

Session 3: U.S. Monetary Policy and its Impact on Latin America

In Session 3, participants discussed the impact of U.S. monetary policy on Latin America. There was a general agreement that U.S. monetary policy makers would continue the "taper" and move towards normalization of interest rates at some point in 2015. However, opinions were mixed as to how a gradual tightening of U.S. monetary policy would affect Latin America, due to uncertainty about the channels through which effects would move as well as about how individual Latin American central banks and governments would respond to changing conditions.

U.S. Monetary Policy

Most participants agreed that U.S. monetary policy was likely to continue moving away from the extraordinary measures of recent years. With government bond purchases under quantitative easing having ended recently, they expected that the Fed would begin to slowly raise short-term interest rates by mid-2015.

Despite the general agreement about when interest rate normalization might begin, participants expressed considerable uncertainty—and in some cases, disagreement—about underlying economic conditions and the further course of monetary policy. One important set of questions in this regard arose from the debate over whether the developed countries had entered a period of "secular stagnation." Proponents of the secular stagnation hypothesis argued that long-term interest rates were on a continuing downward trend, due to the slow growth (in some countries, shrinking) of the labor force, higher savings to accommodate longer lifespans, and lower returns on capital. The secular trend had been exacerbated in and after the global financial crisis by household and corporate deleveraging.

The secular stagnation hypothesis had several implications for monetary policymakers. First, it raised questions about potential growth. A number of participants argued that U.S. potential growth had declined considerably, and that the output gap was actually smaller than policymakers believed. Thus, while many participants believed that labor markets remained slightly soft, proponents of the secular stagnation hypothesis believed that there was very little slack in the system. If so, inflation might start rising beyond the target range sooner than expected, which would force the Fed to consider tightening monetary policy even if the economy still appeared fragile and growth weak. Second, it was not clear what "normalization" of interest rates would mean, given the declining natural rate of interest. Increasingly, the Fed and other developed country central banks might be working close to the zero bound on an ongoing basis. Third, the deleveraging of the private sector would necessitate assertive fiscal policy to prevent the reemergence of recession. This would be politically difficult in many countries, however, leaving monetary policy as the primary macroeconomic policy tool. Unfortunately, monetary policy would be unable to address the problem of aggregate demand.

There were also questions raised about how the Fed would reduce its balance sheet. Some participants asked whether it would be selling off government bonds, and if so what effect that would have on financial markets. Most expected that bonds would in fact be held until maturity, and that any monetary policy operations would be done via reverse repos or interest rates on excess reserves rather than outright sales.

With regard to effects on financial markets, participants agreed that there would be an increase in volatility, as the Fed relinquished its role as purchaser of last resort. Most participants appeared to believe that this would be manageable, but they acknowledged that there was considerable uncertainty as to how markets would react.

Effects on Latin America

Given the "taper tantrum" of 2013, participants agreed that it was important not to be complacent about the effects of U.S. monetary policy tightening on emerging markets. Although this effect could be attenuated for some economies by the continued easing in Japan and the EU, Latin American countries' dependence on the dollar meant that they would need to be prepared for potentially tough choices in the months ahead.

There was considerable debate as to what sort of volatility Latin American economies might face. Participants considered a number of different scenarios, with outcomes depending both on channels of transmission and local conditions.

One point on which participants agreed was that the effects of U.S. monetary tightening were unlikely to be uniform across Latin America. Rather, they would depend on current economic conditions (including domestic inflation and deficits, as well as trade profile) and the responses (and expected responses) of the macroeconomic authorities in each country. Economically fragile Argentina, for example, was expected to have a rougher time than Chile. The effects on commodity-dependent economies like Brazil were likely to depend as much on demand for resources by the developed economies and China. With economic stagnation in Japan and the EU and slowing growth in China, many believed that the U.S. would not be growing rapidly enough to pick up the slack, suggesting that Brazil would need to tighten fiscal and monetary policy to prepare itself for the possibility of sharp exchange rate depreciation.

Another difference among Latin American countries that several participants identified as important was the credibility of the macroeconomic authorities. Countries like Chile and Mexico, whose central banks had been consistent in managing monetary policy, were seen as far less vulnerable to attack than those countries whose fiscal and monetary policies had been more erratic or less disciplined. Chile in particular stood out as a country in which interest rates had not tracked the Federal Funds rate, but rather followed the Taylor Rule; it was suggested that this would give the central bank great credibility. There was a general anticipation that countries would face real depreciation of their currencies, but also that there would be considerable variation in how they dealt with it, reflecting differing degrees of "fear of floating." Participants suggested that some countries might impose or strengthen capital controls to prevent excessive depreciation; some participants argued that capital controls should be avoided in order to demonstrate macroeconomic authorities' long-term commitment to openness and responsible monetary policy. Instead, central banks should focus on anchoring low-inflation expectations. Prior preparation was also seen as important, as in the case of Mexico, which had built up significant reserves, qualified for the IMF Flexible Credit Line, and hedged oil revenues to protect the fiscal position.

There was also discussion of the channels through which U.S. monetary policy changes might affect Latin American economies, including gross capital flows, net capital flows, interest differentials, and exchange rates. Participants noted that, unlike traditional Mundell-Fleming models, portfolio balancing models actually led to considerable uncertainty about the effects due to questions about the holdings and preferences of investors. One point that was noted by several participants was that emerging market debt, including in Latin America, was increasingly denominated in local currencies. Since foreign investors were shown to be more likely to hold dollar-denominated assets, this suggested that a larger portion of most Latin American countries' debt was held locally, and thus less likely to exit. This was reassuring to a number of participants. However, foreign investors had also expanded their holdings of local-currency securities, which raised some concerns.

However, it was also noted that the preferences and risk appetites of investors would make a big difference in patterns of cross-border financial flows. Observing that most cross-border flows could now be attributed to global asset management companies instead of banks, some participants raised concerns about the risk of sudden reversals. Investors could choose to withdraw at any time, leading to the possibility of runs and loss of liquidity if sentiment were to shift sufficiently. The likelihood of runs would be exacerbated by the prevalence of benchmarking. With open capital markets, central bankers would need to be sensitive to slow build-up of capital inflows that could be subject to rapid reversals.

The big unanswered question was about risk premiums. It was noted that most variance in asset prices does not derive from fundamentals but from "discount rate variation," or investor sentiment. Low interest rates were seen to have encouraged risk-taking as they chased yields. Small shifts in interest differentials could lead to a much larger shift in risk premiums, but the magnitude and effect would be unpredictable. Thus, policies in both the U.S. and Latin American countries would need to be attentive to actual changes. This reinforced the argument that those countries that had been building credibility over many years would be in a better position to weather whatever happened.

Session 4: Pension Fund Diversification of Latin American Assets

Session 4 discussed pension funds' investments in Latin American assets. Participants noted that the landscape of pension fund investing was changing rapidly in Latin America. Both regional and global pension funds were increasing their investments, with significant implications for capital market development and liquidity. Participants discussed the goals of regional and global pension funds, their role as leading institutional investors in the region, and the general implications of the growth of pension fund investment in the region.

Growth of Pension Fund Investment in Latin America

Participants observed that Latin American pension funds had been growing rapidly as a result of the growth of the middle class throughout the region, and now totaled around $700 billion in assets. As the major institutional investor base in most Latin American countries, they had become an important element in capital market development.

Participants noted a number of important characteristics of Latin American pension funds. They tended to be highly concentrated and publicly controlled. Outside of Brazil, many were defined contribution, as exemplified by the Chilean system. The prevalence of defined contribution systems had contributed significantly to domestic savings in the region—for example; the Chilean system was based on mandatory savings of 10% of income and had grown to around 60% of GDP. For the most part, pension fund assets had been concentrated on local assets, especially government bonds. Given the high interest rates in many Latin American countries, many participants saw this as a symbiotic relationship, in which pension funds earned good, safe returns, and governments were able to fund their borrowing needs from a stable source.

Pension funds were traditionally highly regulated. In recent years, however, pension funds in most Latin American countries had been gradually loosening restrictions on diversification, in particular allowing more investment in international assets. International diversification was seen as particularly important for pension funds based in smaller economies, such as that of Chile and the other MILA members. Because of the limited investment options within the region, many Latin American pension funds had turned outside the region for a significant portion of their international portfolios; by investing in the U.S. and Europe, they also were able to better diversify across industries. In terms of domestic and regional diversification, participants noted that there was very little infrastructure investment, despite the considerable demand for infrastructure. This appeared to be due partly to the already-high returns on regular government bonds, which reduced the need to reach for yield. Also, there was a lack of confidence in the expected performance of infrastructure bonds.

Expanding Opportunities for Pension Funds in Latin America

In terms of investable assets, participants identified three major needs for pension funds to expand their investments in Latin America: more investment options, more liquidity, and better market infrastructure. Participants saw considerable potential for expansion of investment options, particularly for corporate and infrastructure bonds, as well as equities. As noted in Session 1, a variety of factors tended to limit the diversity of issuers, including the prevalence of controlling shareholders and low liquidity. Low liquidity was seen as both a cause and (partly) an effect of the small pool of issuers. However, with the growing interest of international investors from both Latin America and beyond, participants expressed hope that more companies would benefit from issuing equities and bonds. Limited liquidity was also seen to be a result of the typical buy-and-hold strategies of regional pension funds, many of which had been highly regulated until relatively recently. A number of participants predicted that the growing interest of global pension funds in Latin America and gradual liberalization of restrictions on the holding of international assets by local pension funds would improve liquidity, and create a virtuous cycle to expand regional markets' institutional investor bases.

In order to continue to expand opportunities for pension fund investment in Latin America, participants pointed to the importance of high-quality regulatory and market infrastructure. To encourage cross-border investment, it would be important not only to lower formal barriers and create common platforms, as in MILA, but also to move toward greater harmonization of regulation (especially including accounting and disclosure) and tax policy.

Looking at the pension funds themselves, a number of participants commented on the complexity facing managers. This was seen as a particular challenge for regional pension funds, which had traditionally been limited to simple investment strategies. While they were now benefiting from increased diversity of instruments, this also increased the complexity and risk that they faced. Pension funds therefore faced the challenge of improving their sophistication and capabilities rapidly. Even if they contracted out more complicated asset management tasks, funds would need to develop and implement better monitoring programs of outside managers.

The nature of pension funds was seen to increase the importance of effective governance, as current workers were entrusting their (compulsory) savings over a period of decades in order to guarantee income in retirement. The public, and in many cases mandatory, nature of regional pension funds would only increase the expectations of accountability to beneficiaries. Even for U.S.- and EU-based pension funds, the imperative of improving governance, compliance, internal management, and data security loomed large.

It was noted that the politics of Latin American pension funds could be challenging. Even in Chile, perhaps the best-established defined-contribution fund in the region, it took decades of political debates to develop its current regulatory investment framework for pension funds. It was argued that the key was shifting decision making to pension fund boards appointed by various stakeholder institutions as a means of reducing ongoing political interference. This was particularly important as pension funds increased their international exposure. Improved transparency was also an essential element. The point about reducing political interference was brought home to many participants by recent actions by the Argentine government to take advantage of (or "pillage" as some put it) public pension funds to cover fiscal gaps.

Finally, a major challenge that participants identified for many Latin American pension systems was that savers' expectations were very high in many countries, but it was not clear that payouts would be adequate to retirees' needs. The example of Mexico was discussed in this regard. The Mexican system was relatively new and the political process of its establishment had led to low contribution rates and many restrictions on asset management. The problems of adequacy would be compounded by longer lifespans. Some participants expressed deep concern that, when retirees started collecting pensions in the next 15-20 years, they would be angry at how little they were collecting, which could lead to severe political consequences. Meanwhile, the need to generate higher returns could lead over time to more investment in risky assets, which could lose money for the funds. In order to address the political problem in advance, participants called for much better communication about the goals and performance of pension funds and financial education. In addition, the problem of providing retirement income for Latin American workers was seen to go considerably beyond the performance of pension funds. For example, coverage remained a challenge, as many workers remained outside the formal employment system and thus outside the pension systems. This too was seen as likely to create political challenges for the future.

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