5. Latin America: The high density of assets strengthens banks' solvency

Latin America's financial systems have demonstrated their strength in the past few years, maintaining high levels of profitability (ROE >10%), clean balance sheets with well-contained NPL ratios (<3% in most countries) and regulatory capital ratios comfortably in excess of the required minimums. Additionally, an analysis of other indicators of solvency, such as asset density or leverage ratios leads to the conclusion that these systems are well capitalised.

Latin American banks have a high density of RWAs to total assets - as high as 80% in Argentina, Chile, Colombia and Peru. In the case of Mexico the ratio was 66% as at December 2016. This is the combined result of several factors:

(i) **Heavy average weight of the loan portfolio in balance sheet totals**, representing 74% of total assets in Colombia, 71% in Chile and 66% in Peru. Argentina and Mexico, with greater exposure to public debt securities, financial investments and other liquid assets, had ratios of 50% and 48% respectively.

(ii) **Limited weight of the mortgage lending portfolio**, which with the exception of Chile (27%) accounts for less than 20% of the total portfolio in these countries. This differs from what we see in countries with higher per capita incomes and a more developed banking sector, where mortgage lending can account for as much as 50% of the total portfolio. In general terms mortgage lending is less risky, and for that reason its weighting for the calculation of RWAs is usually less than that of the other portfolios (Basel II establishes 35% for mortgage loans, as against 75% for consumer lending and 100% for businesses as a general rule).

(iii) **Limited or practically non-existent use of advanced models for calculating regulatory capital**. As at June 2017 only two Mexican banks (BBVA Bancomer and Santander México) used internal models to calculated risk-weighted assets. In the remaining countries, the banks continue to use standard models to calculate RWAs.

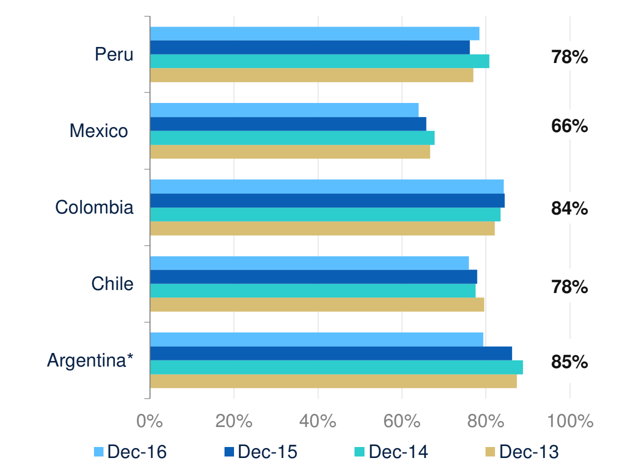
(iv) **Risk weightings under the standard model higher than those envisaged by Basel II.** With the exception of Argentina and Mexico, the countries have not adopted Basel III, but a comparison of national regulations leads to the conclusion that in general these countries adopt stricter risk weightings than those established by Basel.
We should highlight that one aspect that should reduce the density of RWAs in Colombia and Chile is the absence of requirements for operational risk - and in the case of Chile there is no requirement for market risk either. Nonetheless, the factors mentioned previously more than offset this effect. Once the requirements for these risks and others envisaged in Basel III have been adopted, *ceteris paribus* the density of RWAs will be even higher.

Leverage ratios in excess of 10% in nearly all countries

The high density of RWAs entails high minimum regulatory capital requirements, which translates into high leverage ratios (Figure 2). In all the countries analysed, accounting capital represents more than 10% of total assets in the balance sheet, with the exception of Chile which, with 8%, nevertheless maintains a very high ratio. In the countries that have yet to adopt Basel III, as is the case of Chile, Colombia and Peru, the quality and quantity of their banks' capital is frequently questioned. Although the Basel III framework is more demanding, (in that it requires deductions for intangible assets and better quality capital, among other things) the reality shows that the high density of assets leads to very high leverage ratios. This reflects a high degree of capitalisation for banks in general, which enables them to face the approach to more demanding international standards with relative equanimity.

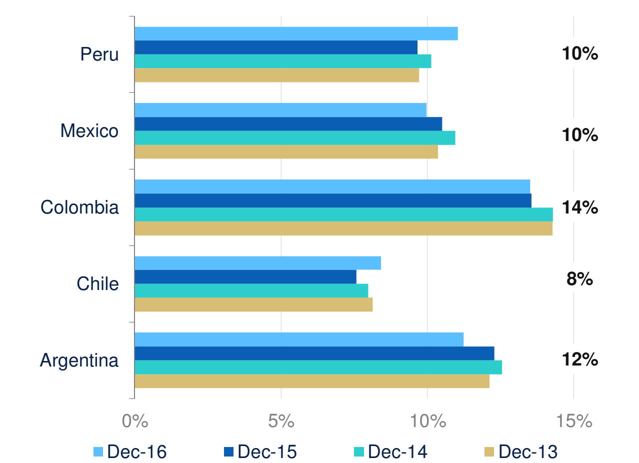
Therefore the introduction of the leverage ratio in Basel III, obliging banks with a low density of RWAs to improve their capital, will not be a problem for the financial systems of Latin America, where the high density of RWAs allows the introduction of a leverage indicator in the future to be fulfilled comfortably[7]. Thus it is not surprising that the differences among leverage ratios and regulatory capital are much smaller than for example in Europe, where many banks have Tier 1 capital ratios of double the leverage ratio.

Figure 7 Asset density (RWAs/Total assets)



Source: Central banks of Argentina (BCRA), Chile (SBIF), Colombia (SFC), Mexico (Banxico) and Peru (SBS)

Figure 8 Leverage ratio (Equity/Total assets)



Source: Central banks of Argentina (BCRA), Chile (SBIF), Colombia (SFC), Mexico (Banxico) and Peru (SBS)

7 At present only Argentina and Mexico have to comply with a minimum leverage ratio defined in Basel III as 3%.

LEGAL NOTICE

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