Banking FDI in Latin America: An Economic Coup

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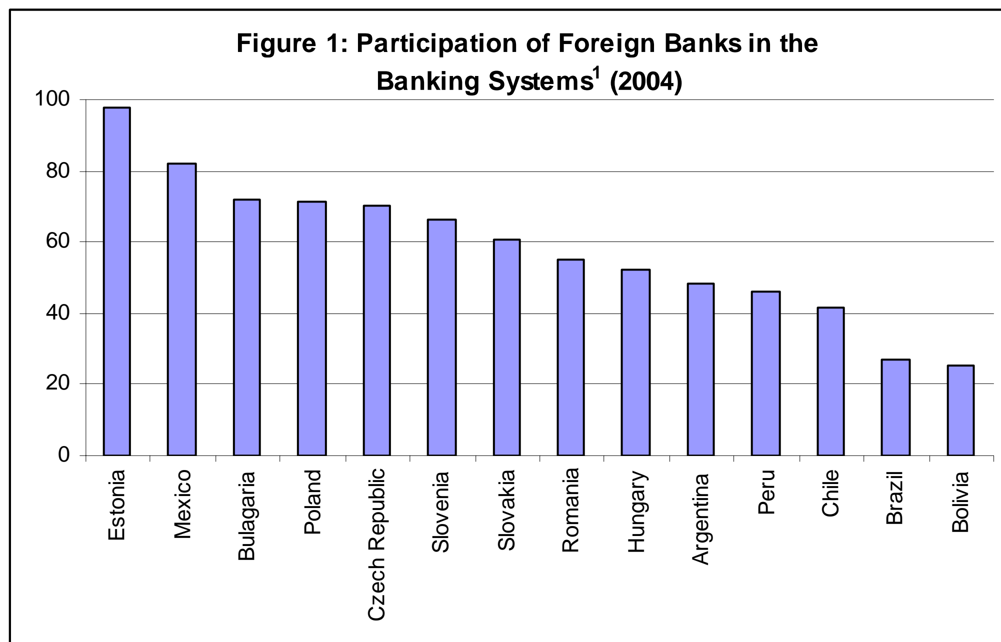
During the later half of the 1990s, foreign direct investment (FDI) into the banking industry in the emerging market (EM) economies grew at an unprecedented scale. Leading the pack were a few transition economies of Europe along with the Latin American economies which, after the Asian crisis, were joined by several of the East Asian and South East Asian miracle economies. FDI into these economies' banking systems moved in the form of large multinational banks taking over the operations of domestic banks through mergers and acquisitions, rather than in the form of de novo investments. The extent of mergers and acquisitions have been so substantial that in a few years time not only have the multinational banks purchased the controlling stakes of individual domestic banks, but in many economies foreign investors have come to hold the major share of the economy-wide banking assets.

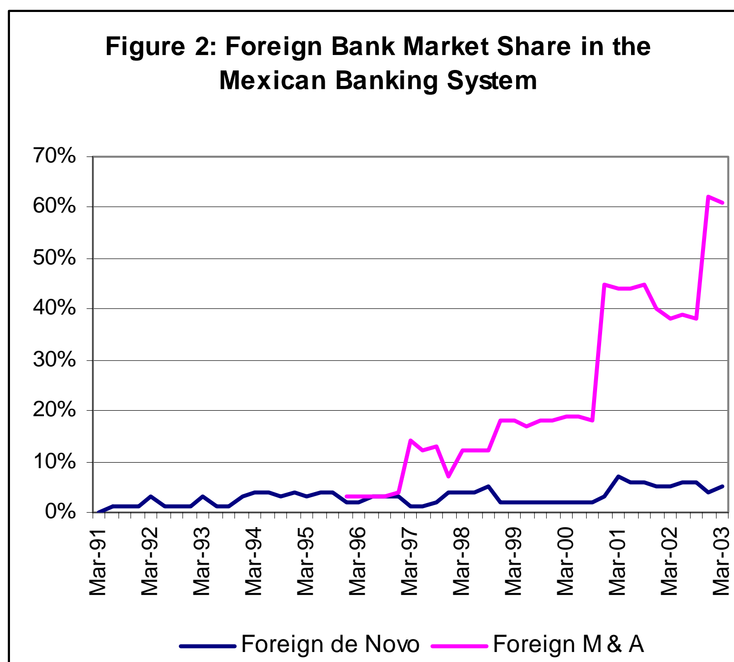


Note: [1] Participation in terms of assets in each country's banking industry. For the Czech Republic, Romania and Slovakia, participation is in terms of capital.
Source: Cárdenas, Graf and O'Dogherty 2004.

Figure 1 shows that in the year 2004 foreign control of banking assets was extremely high in many European transition economies, and a large number of Latin American economies had moderate to high (Bolivia, Brazil, Chile, Peru, Argentina) and very high (Mexico) proportions of foreign-controlled banking assets.

But more startling perhaps is the rapidity with which these economies attracted banking FDI. In Mexico in December 1996, prior to the new rules regarding foreign

ownership, only 7 per cent of total bank assets were controlled by foreign banks.[1] Roughly one half of these foreign-controlled assets were in free-standing investment banks (or foreign de novo banks) which did not engage in retail lending. These foreign de novo banks, as well as large foreign banks with no prior presence in Mexico, quickly began to purchase Mexico's largest retail banks. By March 1997, 14 per cent of bank assets in Mexico were controlled by foreign banks. By December 2002, the share of Mexican banks under foreign control increased to 66 per cent (see Figure 2). Today, 19 of Mexico's 32 banks are foreign-owned.[2] Indeed, the banks not under foreign ownership are extremely small.



Note: Foreign Bank Share is measured as percentage share of total bank assets.
Source: Haber and Kantor 2003

Foreign investment in Latin America's banking sector has its origin in the deregulation and/or privatisation of the banking industry during the early 1990s in a macro-economic environment of uncontrolled capital flows. Following financial liberalization, many Latin American banks were borrowing short in the international capital markets and converting their foreign currency borrowings into loans for

[1] In 1993, the participation of foreign investment in commercial (multiple) banking credit institutions and holding companies for financial groups was limited up to 30 per cent of the ordinary capital. From the mid-1990s, through successive amendments to the Law of Credit Institutions, the Law to Regulate Financial Groups and the Foreign Investment Law, foreign investors were allowed to participate up to 49 per cent of the ordinary capital, as well as additional capital. Further amendments were effected from January 1999 raising the limit to 100 per cent participation in both the ordinary and additional capital of commercial (multiple) banking credit institutions and holding companies for financial groups (http://www1.apecsec.org.sg/download/ieg/invst4-mex.pdf).

[2] These include the three largest banks in the system: Bancomer (owned by Banco Bilbao Vizcaya), Banamex (owned by Citibank) and Banca Serfin (owned by HSBC).

domestic investors.[3] Bank credit growth during these years was very substantial, with a significant proportion directed to property markets. Borrowing in the international capital markets was profitable for the banks as domestic interest rates were kept higher to attract foreign investors Interest rates also had to carry a risk premium for the future possibility of devaluation of the overvalued currency. With the Mexican peso crisis, the breakdown of international investor confidence and large-scale capital flight, the precarious stability of these economies collapsed. Few international lenders were willing to lend to Latin American banks and, seeing the flight of international capital, the impending run on local currencies and the possibility of bank failure, domestic depositors began to withdraw large sums of money from the banks. The governments' response of raising interest rates by tightening monetary policy only made things worse as it resulted in huge debt defaults on bank loans. Though the depositors were finally protected by the deposit insurance policy, and the government bailed out several shareholders, banks became burdened with high non-performing assets on their portfolios, together with steadily falling net interest margins and returns on assets. This period saw banks retreat sharply from the loan business. Across the continent, banks needed capital to meet the international regulatory standards, regain confidence and revive the failing banking system. Realising that it would be difficult to find strategic buyers for the banks from among local investors, governments decided to encourage foreign investment.[4] Recapitalisation of weak private banks thus became the primary target of the financial system and also the *raison d'etre* for lifting regulations on the entry of foreign investment in banking.

On the supply side, the process of restructuring the banking sector under the European economic and monetary union was underway. For European banks, expanding abroad was not only a source of earnings diversification but also, given the increasing market competition in banking in the European Union (EU), a way of strengthening their position in the European banking market. Further, while within EU countries there were some impediments to mergers and acquisitions due to political and regulatory constraints, this was not the case in countries outside the bloc, which actually offered incentives for such activity (Paula and Alves 2003). Thus the urgency for several Latin American economies to find investors for troubled banks, coupled with the fact that, after a rapid devaluation domestic assets could be bought at bargain basement prices, brought in a storm of multinational investment mainly from Spain and the US, but also from other developed countries like the UK, the Netherlands and Canada.[5]

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[3] In Mexico, foreign denominated liabilities grew rapidly, from 11 per cent of total Mexican bank liabilities in December 1991 to 14.7 per cent in December 1993, to 27 per cent in December 1994 (Mishkin 1996).

[4] Before banks could be sold to foreign investors, the government had to recapitalise banks and also selectively acquire bad debt. Between 1995 and 1998, 11 banks were intervened by the official supervisory agency in Mexico.

[5] Spain and the US dominate banking FDI in Latin America, with the two respectively holding 46 per cent and 35 per cent of the total banking FDI stock (data based on Thompson Financial and quoted in Soussa 2004).

What is noteworthy is that the Latin American authorities saw in the banking FDI not only a way to meet the capital needs of domestic banks, but also a possibility to improve the efficiency of the banking system through increased competition. Foreign banks were assumed to be more efficient than domestic banks in emerging economies, and as able to introduce best practices and new technologies into the host countries. Further, as the proponents of financial liberalisation asserted, the entry of foreign banks would raise market discipline and increase the **efficiency** of domestic banks, and thereby also financial intermediation and the supply of credit (see Fry 1988). This was not all. There was another enticement for the Latin American authorities: the logic of foreign banks **stabilising the macro-economy** in conditions of domestic economic shock had a strong appeal. Peek and Rosengreen (2000) in a widely quoted paper provide the theoretical explanation as to why foreign banks are less sensitive to domestic shocks than domestic banks. Since the portfolios of foreign banks are better diversified and global banks have better access to international capital markets, the impact of a domestic shock that could seriously affect domestic banks can be easily absorbed by foreign banks. Also, foreign banks have more ready access to foreign currency during banking crises because the lender of last resort for a foreign bank is the central bank in the bank's home country rather than that of the host country. Finally, the presence of well-capitalised foreign banks mitigates the extent to which the funds of worried domestic savers and investors flee the country when a shock is anticipated. In other words, a foreign bank is a safe heaven for depositors who might otherwise choose to remove their funds from the country in a `flight to quality'.

Downslide in Efficiency and Intermediation

While the theoretical fallacies implied in the `efficiency' argument are beyond contestation today, the Latin American experience of foreign bank presence over the past several years also reflects the lack of empirical support that an association of foreign ownership/investment with efficiency suffers. Banking FDI into the major Latin American countries since the mid-1990s was accompanied by a process of consolidation of banking such that the number of banks in these economies declined by an average of 30 per cent over a period of barely six or seven years (see Table 1) The rising concentration of banking in Latin America has led to concerns about competition in banking. Orthodox economists, who would otherwise support mergers on the grounds of efficiency, stress the need to balance improvements in efficiency without foregoing the competitive structure. This is easier said than done. Latin America is painfully realising that once the economy is exposed to the juggernaut of transnational capital, the process becomes irreversible due to the involvement of extremely powerful financial interests that do not brook any argument in favour of regulation. Thus, billionaire banking empires assert that competition is inherent to the market system, and the effects on markets may stem from both the actual entry of new competitors as well as the likelihood of an increase in new entries to the industry in pursuit of high profits (i.e., market contestability).

Table 1 : Decline in the Number of Banks

	1996	2002	Change	%Change
Argentina	117	80	-37	-32%
Brazil	253	177	-76	-30%
Chile	31	25	-6	-18%
Colombia	39	27	-12	-31%
Costa Rica	30	21	-9	-29%
Mexico	40	32	-9	-21%
Peru	22	15	-7	-32%
El Salvador	18	13	-5	-28%

Source: Levy-Yevati and Micco 2003.

Quite predictably, IMF studies (such as Gelos and Roldós 2002) uniformly defend the argument that consolidation and competition are not antithetical and that cross-border mergers have brought in efficiency gains to the host countries. A few relatively independent studies which review these experiences from the host country perspective, however, refute any such improvement. Paula and Alves (2003) find no clear evidence that foreign banks in Brazil have been more efficient than domestic ones either in terms of operational cost or profitability. In fact, the net interest margins of foreign banks have proved larger than those of domestic private banks. Consolidation has not brought about the anticipated decline in net interest margin through cost reduction or product diversification and expansion. In a study of six Latin American banking systems, Wong (2004) finds no efficiency improvement in the way banks fulfilled their intermediation role over the years 1995-2000. Taking intermediation as the key function of banking, he calculates the efficiency of each bank in converting inputs (measured as operating costs, labour costs, interest expenses and total deposits) into outputs (total loans, interest and non-interest incomes). Except for Chile, where concentration of banking assets has accompanied gains in efficiency of intermediation, in all other countries the situation has worsened with consolidation. Finally, a study of bank-level balance-sheets of eight Latin American countries by Levy-Yevati and Micco (2003) finds that, due to higher leverage ratios and more variable returns, the foreign-owned banks were much more risky than national banks,. They were able to reap oligopolistic rents while choosing a riskier profile, whereas national banks were seen as imperfect substitutes of foreign branches or subsidiaries because of actual differences in their menu of products, the value of the brand name and the perception of an implicit insurance provided by the foreign bank's parents.

Probably, the worst effect of the domination of FDI in banking is felt in the way it affects the debt-intermediation and risk-bearing functions of banking institutions. Foreign banks usually focus on a select range of activities, such as foreign currency loans, acceptance and guarantees relating to international trade and syndicated loans, for a select circle of clients — multinational corporations, large domestic corporations and high net-worth individuals. Retail banking services such as small

checking and savings account, mortgages or small business loans are hardly emphasised by foreign banks. It is therefore natural to expect that loan ratios for foreign banks would be lower than the domestic banks. However, some recent evidence shows that there are only marginal differences in the portfolios of foreign and domestic banks (Goldberg et al. 2000). There seems to be a convergence in the asset structure across bank ownership, which if true, considerably weakens the criticism that the foreign banks' behaviour independent of domestic regulatory oversight is determined solely by economic motives. The truth, however, is that the entry of multinational banks has set in motion processes that force domestic banks to adjust their portfolios in line with these banks. Weller (2000) and Weller and Scher (1999) show that in the face of increased competition from multinational banks, domestic banks reduce their loan exposure. This is very clearly the case with the European transition economies that the authors study in detail. The marked slowdown in credit to the private sector in Latin American economies in recent years can also be understood in this context (see Table 2). Foreign banks `cherry pick' the best customers (low cost, low risk), leaving domestic banks with borrowers of lesser quality. As a result, both the costs and credit risks at domestic banks increase. On the other hand, in order to remain competitive, domestic banks need more capital to invest in new technology — both in machines and in training. The need for capital, coupled with the loss of prized customers, creates a tendency towards asset switching — away from traditional lending into fee-based income, investments in government securities and loans based on standardised balance-sheets — which also serves to shore up the risk-weighted capital ratios among the domestic banks, particularly as regulatory standards become more stringent after economic crises. Banks that resist this change are burdened with more risky loans (without the buffer of cross-subsidy as high net-worth customers shift to foreign banks) and high non-performing assets, which in the medium term make them ideal candidates for takeover and further consolidation by multinational banks. Dymski (2004: 21) notes the consequences of these strategic adaptations in the credit markets: 'Banks operating differently than the elite multinational banks must adapt or loose customers and profits; but in adapting they sacrifice some of the unique characteristics that have either made them well-suited engines of industrial growth or that make them candidates for engineering such growth transitions.'

Table 2: Credit Slowdown in Historical Context

	Argentina	Bolivia	Colombia	Mexico	Peru
Deposit Money Banks					
Average credit/GDP 1960-2000	14.5	16	13.1	10.2	10.5
Most recent credit boom					
Relative	1979-82	1981-92	None	1992-95	1981-86
Absolute	1961	1992-95	None	1992-95	None
Deviation from trend — recent years					
1997	0.4	-0.44	1.89	-1.54	2.95
1998	1.94	3.68	3.65	-0.94	3.75
1999	0.47	0.29	-0.4	-2.6	1.49
2000	-1.82	-6.33	-1.63	-3.19	-2.31

Source: Barajas and Steiner 2001

Table 3 presents the share in GDP of net credit extended to the public and private sectors by commercial banks and other financial and banking institutions. Domestic credit to the private sector as a percentage of GDP is lower on average in 2003 for the Latin American economies as compared to 1995, when domestic banking was opened to foreign investment. The most marked and consistent decline in private sector credit is observed in Mexico, which has the highest penetration of foreign banks. Except for Chile, there has been little improvement in private sector credit share in GDP for the other economies in the region and the slight uptrend during 1998 and 1999 has been reversed in recent years. On the other hand, public sector share in total domestic credit has expanded in every economy. Banks reluctant to take on intermediation risk are looking at sovereign debt as an easy investment avenue. Sovereign debt is attractive not only because of the low risk involved, but also because many of these economies offer extremely high returns on government securities. No doubt, this has heightened the attractiveness of acquiring bank assets by foreign investors. Finally, it is clear from the experience of the Latin American economies that not only has financial deregulation and liberalisation failed in its promise to allocate greater amounts of lendable resources to the private sector, by creating a distorted structure of risk-adjusted returns it has actually given rise to the crowding-out phenomenon (lending to public sector crowding out private sector) where earlier there was none.

Table 3: Domestic Credit as Share of GDP for the Latin American Economies

		1995	1996	1997	1998	1999	2000	2001	2002	2003 *
Argentina	Domestic Credit, *of which*	23.4	24.6	25.6	28.6	32.2	32.8	32.9	41.5	34.4
	Public Sector	3.7	5.4	5.5	5.9	7.2	8.5	9.9	24.8	23.0
	Private Sector	19.7	19.2	20.1	22.7	25.0	24.2	23.0	16.7	11.5
Bolivia	Domestic Credit, *of which*	49.5	54.1	60.1	65.6	65.1	61.3	58.6	55.1	52.6
	Public Sector	1.3	1.1	1.9	1.7	1.1	2.7	2.9	3.7	4.5
	Private Sector	48.2	53.1	58.2	63.9	64.0	58.6	55.7	51.3	48.1
Peru	Domestic Credit, *of which*	13.0	16.1	20.3	25.4	27.7	27.1	26.4	25.0	22.3
	Public Sector	-1.0	-1.9	-1.1	-0.5	-0.3	0.9	1.3	1.6	1.3
	Private Sector	14.0	18.0	21.4	25.9	28.0	26.2	25.1	23.4	21.0
Venezuela	Domestic Credit, *of which*	14.2	9.7	9.8	11.9	11.1	11.0	12.3	11.4	9.9
	Public Sector	4.9	2.8	1.4	1.1	1.4	2.1	2.4	2.8	2.9
	Private Sector	9.4	6.9	8.4	10.7	9.6	8.9	9.8	8.7	7.1
Mexico	Domestic Credit, *of which*	39.8	26.6	36.8	39.8	37.2	37.0	37.9	37.6	38.6
	Public Sector	9.0	6.7	15.0	16.6	17.1	19.1	20.4	20.1	21.1
	Private Sector	30.8	19.9	21.8	23.3	20.0	17.8	17.5	17.4	17.5
Colombia	Domestic Credit, *of which*	18.3	19.5	21.1	24.8	26.9	23.9	25.8	27.7	28.3
	Public Sector	2.8	3.0	3.6	4.1	5.7	5.8	7.3	8.4	9.1
	Private Sector	15.4	16.5	17.5	20.7	21.2	18.1	18.5	19.2	19.2
Brazil	Domestic Credit, *of which*	39.8	40.3	41.1	42.6	47.3	43.7	44.4	46.4	46.4
	Public Sector	4.8	7.8	10.5	9.4	12.1	10.9	11.0	13.9	13.5
	Private Sector	35.0	32.4	30.7	33.3	35.2	32.8	33.4	32.6	32.8
Chile	Domestic Credit, *of which*	61.8	62.5	65.5	66.3	69.3	68.6	71.3	73.1	75.8
	Public Sector	1.3	1.4	2.4	2.4	2.7	2.7	3.3	4.1	4.0
	Private Sector	60.5	61.1	63.2	63.9	66.6	65.9	67.9	69.0	71.7

Note: * Preliminary figures. Domestic credit refers to net credit extended to the public and private sectors by commercial banks and other financial and banking institutions.
Source: Economic Survey of Latin America and the Caribbean, 2003-2004, ECLAC.

Cross-border Mergers and Instability
The Argentine crisis of 2001-2 has blown away the illusion of macro-economic stability associated with banking FDI. While the Argentine experience during the 1990s was in many ways similar to that of other Latin American economies, an

additional complication for Argentina was the currency board system, under which a strict one-to-one parity was set between the Argentine peso and the US dollar, and the government and Central Bank were prohibited by law from printing pesos unless they were fully backed by dollars held as foreign reserves. This ruled out the use of exchange rate as a handle of adjustment, a needlessly risky policy in an environment of liberalised capital flows. No doubt, this made the Argentine authorities even more eager to invite banking FDI as foreign banks with a more diversified line of credit, it was assumed, would be able to provide the international reserve currency if there was a sudden run on Argentine peso. Thus, after the Mexican peso crisis, Argentina encouraged foreign bank penetration to a much greater extent than Brazil: among the top 10 banks in Argentina 7 were foreign, 2 were public banks and one was a domestic private bank. On the other hand, in Brazil in the same year (2000), of the top 10 banks, 4 were foreign, 4 were domestic private and 2 were federal. (Paula and Alves, 2003) In 2001, when it became clear that the present exchange rate parity was unsustainable and the peso would lose its value against dollar, the multinational banks, instead of maintaining their regular banking business, clandestinely moved their assets overseas, thereby contributing to capital flight and abetting the crisis further. By the time the government finally devalued peso and announced a freeze on bank accounts and exchange controls, $30 billion of mostly peso deposits had been changed to dollars and moved overseas in a period of two to three months. Among those accused of this plunder were the country's principal foreign banks — HSBC, Citibank and BBVA.[6]

Further, seeing the depressed condition of the Argentine economy, the multinational banks started selling their stakes in other Latin American countries, giving rise to concerns that contagion of the crisis in one country may work through the investment decisions of these banks. In 2002, smitten by the losses in Argentina, the Spanish giant BBVA sold the equity of its Brazilian subsidiary, which reduced its exposure in Brazil by approximately 50 per cent. And the leading Satander Central Hispano sold its Peruvian subsidiary and 25 per cent of its Mexican subsidiary’s shares.

In Bolivia, a different story unfolded, which showed the perils of giving up the space of idiosyncratic adjustments to foreigners. A tightening of credit policies initiated by the banking subsidiary of Spanish Santander Central Hispano, and quickly followed by other foreign subsidiaries, worsened an already sluggish economy. Santander’s Bolivian subsidiary Banco Santa Cruz embarked in a restructuring of its balance sheet, with a dramatic reduction of credit since 1999. Between December 1999 and December 2002 the credit portfolio of foreign banks declined by 62 percent, while the credit of the domestic private banking sector contracted by 9 percent. (see Table 4) It was a clear case where strategic decisions of the parent bank had serious implications for emerging market economies. It proved that the decisions taken by these banks could impinge wider economic damage on host country economies, especially if foreign bank ownership is highly concentrated.

[6] See Small 2002.

Table 4: Bolivia Total Credit of Private Banks (million $s)

	Dec-96	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02	Change Dec 99/ Dec 02 (%)
Domestic-owned banks								
Banco Nacional de Bolivia	363	410	474	481	433	400	406	-16%
Banco de la Union S.A.	n.a	n.a	n.a	n.a	383	272	238	
Banco Mercantil	283	331	424	437	415	380	358	-18%
Banco Ganadero	42	83	140	162	159	142	127	-21%
Banco BISA	341	408	456	537	555	475	406	-24%
Banco Economico	148	216	268	262	231	191	173	-34%
Banco Solidario	47	62	71	78	72	74	75	-3%
SUM	**1225**	**1510**	**1834**	**1956**	**2248**	**1933**	**1784**	**-9%**
Foreign-owned banks								
Banco Santa Cruz [1]	617	707	947	871	515	332	238	-73%
Banco de Credito de Bolivia [2]	194	272	456	485	478	362	273	-44%
Banco de la Nacion Argentina	20	31	32	25	22	17	10	-59%
Citibank N.A	41	39	227	200	155	116	86	-57%
Banco do Brasil	4	8	10	12	14	12	6	-52%
SUM	**876**	**1057**	**1672**	**1593**	**1181**	**840**	**613**	**-62%**
ALL BANKS	**2101**	**2567**	**3506**	**3548**	**3429**	**2773**	**2397**	**-32%**

Note: [1] Banco Central Hispano (BCH, Spain) acquired 90 per cent of the bank in 1998. After the merger of Banco Santander and BCH in Spain, the share increased to 96 per cent in October 2001.

[2] Acquired by Banco de Credito del Peru in November 1993.

Source: Cárdenas, Graf and O'Dogherty 2004.

In Sum

Over the 1990s many Latin American economies opened their domestic financial sector ,including banking, to foreign direct investment to an unprecedented extent. Whereas FDI entered these strategic sectors of the economies with what was touted as a missionary agenda of strengthening the capital base of ailing and failing domestic banks and infusing international best practices and technology, the experience during the short time of foreign bank presence in Latin America has vindicated every apprehension on its role. The Latin American experience has shown that the extensive domination by foreign banks gave rise to conditions of: (a) stalled overall growth in credit with domestic banks also reducing loan exposure; (b) far greater financial instability during episodes of shock to the domestic economy; and (c) uncertainty and slow economic growth due to foreign banks acting as conduits for transmission of contagion and strategic decisions from parent banks onto developing

markets. These consequences are but an expression of the loss of economic sovereignty that comes hand in hand with excessive reliance on foreign investment.

Despite the dismal experience of Latin American economies staring us in the face, EM economies continue to believe in the virtues of foreign investment in banking and therefore liberalise the financial sector and encourage foreign investment in the sector. Among the latest to toe this line are some of the major Asian economies — South Korea, Japan, India — which until the 1990s had highly protected and segmented banking regimes with a strong emphasis on social and development banking. The question before us now is: Do we turn a blind eye to history and allow Asia to go the Latin American way?

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