Latin American Banking After the Acquisition Wave: What Next ?

by André Cappon

The recent wave of acquisitions has radically changed the Latin American banking landscape. Through a series of dramatic moves by global players such as Banco Santander, BBV and HKSB, the share of foreign ownership in the banking systems of Latin American countries has soared to over 20% on average (and close to 40% in some cases such as Peru and Venezuela). Most of these acquisitions have been made by non-US institutions.

The foreign acquirers bought Latin American bank franchises at high premiums to book value. What is their strategy ? How can they earn back the acquisition premium ? And what does it all mean for U.S. banks which by and large have missed out on this acquisition wave ?

In the last few years, Latin America has achieved political stability, elected democratic governments and introduced free market oriented economic reforms. Inflation is mostly under control, economies are growing again and so is the demand for financial services.
Seen from the outside, Latin financial services seem attractive. The argument for investing in Latin American bank franchises focuses on several factors.

- Emerging middle class: as the economies of Latin America grow, a new middle class is expected to grow rapidly and demand more retail financial services.
- "Underbanked" economies: only 5-20 % of the population has a bank relationship, while population per branch ranges from 8000 to 15000 vs. 2000-4000 in Europe or the U.S.
- "Leveraged growth" of financial services: bank deposits and assets growing much faster than GNP: e.g. deposits growing at 30% per annum while the economy grows at 5% per annum.
- High margins: net interest margins in Latin America are around 5-6% of assets (vs. 2-3% in Europe or the U.S.), fee income is as high as 3-4% of assets
- Relatively inefficient banks: Latin American banks have relatively high cost structures, with a non-interest expense/ assets ratio as high as 7-8% vs. 3 % in the US or Europe.

The high premiums paid by the recent acquirers suggest very bullish views of Latin American banking. Having paid, say, two or three times book value for a bank generating an ROE of 15%, acquirers must be confident of doubling or tripling profits rapidly if they only intend just to maintain the ROE performance and shareholder value.

This will be a major challenge, for several reasons.

The *emerging middle class* phenomenon is, so far, more superficial than commonly assumed. By and large, Latin American populations remain mostly poor. Only the top 10% or so of the typical Latin American population has a household income comparable to the median household income of developed economies. *Mass market* median salaries in Latin America currently are in the range of a few hundred dollars per month, while prices are not significantly different from the US or Europe. The middle class has in fact shrunk during the lost decade of the 80s. The privatization wave of the 90s, while healthy in the long run, has eliminated many public sector jobs, which supported middle class households in these economies. There is definitely a new middle class emerging today, but it is not clear that there are enough of them, so far, to compensate for the lost decade…
To put things in perspective, assume that Latin American economies, starting from a GNP per capita of around $5,000 today, were to sustain steady growth of 5% per annum. Under this scenario, it will take *15 years* for GNP per capita to reach $10,000, the level of the poorer Southern European countries such as Portugal or Greece today…In other words, for the foreseeable future, Latin America will have relatively low income per capita on average and the high income inequalities typical of emerging markets.
More accurately, Latin America has an *aspiring* middle class.

The *underbanking phenomenon*, when adjusted for income levels, is a lot less dramatic than it seems initially. Latin America's low branch density (branches per capita) relative to developed economies reflects quite accurately the lower income levels per capita. The low penetration of DDAs reflects the fact that bank fees are quite high, a lot of the population may not have the minimum amount necessary to maintain a traditional banking relationship or may simply prefer dealing in cash, in the informal economy.

The *leveraged growth* of financial assets observed in Latin American economies is in fact the result of two superimposed trends. The first trend is "natural growth": as economies develop, financial services do experience real secular growth. The second trend is simply "remonetization": years of inflation had withered financial assets in Latin America, as people preferred to hold wealth in physical form (real estate, cars e.g.), in offshore accounts or in US dollars under the mattress. As the economies stabilized, a good part of the growth of financial assets is simply recovery. In other words, the observed growth rates of 30-50% per annum in financial assets cannot last very long.

The *high margins* observed in Latin American commercial and consumer banking reflect two factors. On the one hand, relative to developed economies, Latin American economies undoubtedly present a higher risk profile. On the other, the high margins reflect the need to cover the costs of a relatively inefficient banking system and sometimes also reflect cozy cartels. The new foreign owners of Latin American banks may in fact compete hard for market share and thereby reduce somewhat these margins in the medium term.

Improving efficiency and management in the Latin American banks they acquired will definitely be the top priority for the new foreign acquirers. In other words, while there will definitely be revenue growth, it will be probably slower than expected or riskier than anticipated. A good part of the profit growth will have to come from expense reduction, higher productivity, introduction of technology and tighter, sharper management techniques.

If the acquirers are to earn back the premiums, they will need concerted efforts, clear strategies and imagination. Several suggestions follow, both on the revenue side and the cost side.

Revenue growth opportunities will probably be mostly driven by retail demand for consumer finance and mortgages. As inflation subsided in Latin America, it has become possible for "aspiring middle class" households to borrow (at high rates !!!) in order to acquire consumer goods, automobiles and homes, for which there is enormous pent-up demand. On the wholesale side of banking, revenue growth opportunities will be limited, since the risk-adjusted profit margins have been squeezed in Latin America as much as everywhere else…

Average deposit levels per household will probably remain fairly small relative to developed economies, since incomes are relatively low. On the investment side, the pension fund administration companies known as "Administradoras de Fondos de Pensiones" or AFPs will likely be the main vehicle for channeling savings. The combination of the above factors suggests a great future in Latin America for originating consumer assets, securitizing them and placing them with the AFPs, who will crave high-yield investments, as government bond yields decline. Several Latin American countries, notably Argentina and Brazil are beginning to create mortgage-backed securities markets along US lines.

On the cost side, the bulk of a bank's costs are in the branch network. It is well known that branches are expensive, "generalist" distribution channels, especially in Latin America, where there are still many bureaucratic paper-intensive transactions in banking. To serve efficiently the banking needs of the mass market in a relatively low-income economy will require innovative, imaginative non-branch solutions. Such solutions are beginning to emerge.

- The Chilean consumer finance companies (such as CrediChile, a subsidiary of Banco de Chile) are an enlightening example of innovative distribution. Most of them are subsidiaries of banks and the distinguish themselves from the parent by offering a low-cost, mass-market package of retail banking services. The package typically includes an ATM card tied to a savings account (often with direct payroll deposit) and a consumer loan or line of credit. Customers are not allowed to use high cost traditional bank branches and become used to transacting primarily on the ATM. They visit consumer finance "stores", when they wish to borrow. The bank makes its money on the consumer finance products and considers the other services as a loss leader.

- Another example is the Brazilian PABs ("Posto de Antendimento Bancario" or banking service points). These are minimum service branches, typically located on the premises of a large employer, such as an automobile assembly plant. They will usually have an ATM and may have a skeleton staff, which may be augmented at peak times, such as lunch hours. The PABs constitute a low-cost solution (savings on rent, staff) coupled with a highly effective distribution channel, thanks to the semi-captive nature of the customer base and the opportunity of offering direct payroll deposit and low-risk consumer finance since the customers are by definition employed…

- Distribution through specialized salesforces is another interesting examples. Rather than leave distribution in the hands of generalist, fixed location branch personnel, which guarantees a lot of idle time and underutilization, innovator institutions in Latin America are introducing specialized salesforces. Such salesforces focus on consumer finance, credit cards, mortgages, mutual funds, AFP accounts etc. By dealing in narrow product area and by training their salespeople intensively, the salesforces can achieve high productivity. Their compensation is typically minimum wage plus a bonus which is in effect a production-related commission: in other words the cost of the salesforces is almost entirely variable.

Innovations such as those listed above are being adopted in Latin America by both local and foreign-owned banks. The foreign owned bank networks throughout the region have an additional, very significant opportunity for cost reduction: *rationalizing operations at the regional level in order to achieve scale economies.*

Latin America has some natural advantages in this regard: fairly homogeneous culture, commonality of language - Spanish or Portuguese (and "Portunhol"!!!), and institutions favoring regional integration such as Mercosul, the common market of the Southern Cone. In view of these advantages, the foreign bank acquirers will look for a number of classic regional integration opportunities. Examples are:

- Credit card operations. There are significant economies of scale in processing credit cards - typically a doubling of scale brings about a 20% reductions in unit costs. Similarly, customer service centers are characterized by significant scale economies. The obvious implication for banks that cover the region is to set up regional credit card centers in the most favorable locales based on labor quality and costs as well as telecommunications costs.

- Treasury and capital markets operations. The foreign acquirers can achieve some scale economies by regionalizing certain treasury and capital markets functions where they can find the best talent and the best infrastructure in terms of systems and telecommunications. It is quite reasonable to have a regional Latin American securitization unit, or derivatives unit, while maintaining local presence for selected trading and sales activities.

- E-banking, e-brokerage and call centers can similarly be set up at the regional level, taking advantage of the language homogeneity. Electronic delivery of banking services has a great future in Latin America, primarily because the large cities of the region (e.g. Sao Paulo, Buenos Aires, Rio, Santiago, Caracas, Mexico City) are highly congested and insecure, due to street crime. The middle and upper-middle class population in Latin America is already fairly well "wired" with cell phones and rapidly moving to the Internet. New access technologies, e.g. access to the Web via cell phones will be adopted very quickly in Latin America and will no doubt become preferred methods to deliver retail financial services.

Many of the rationalization opportunities cited above will also occur through a process of intra-market bank consolidation, similar to the one that has been going on for the last 10-15 years in the United States and Europe. Intra-market consolidation in Latin America is beginning to happen. The pressure for intra-market consolidation will be somewhat mitigated by the growth opportunities.

To sum up, the recent foreign bank acquirers in Latin America will have to work hard and demonstrate imagination at the regional level in order to earn back the premiums they paid.

What about the US banks, post the recent acquisition wave? Until the 1980s, US banks were very important in Latin America, much more so than the Europeans. The LDC debt crisis, followed by the credit troubles at home in the early 1990s as well as the consolidation of US banking drove most US banks to withdraw from many international activities, especially from Latin America.

A handful of US banks, notably Citibank, Bank of Boston and JP Morgan, maintained and strengthened their Latin American presence. This strategy has served them well, since Latin American operations turned out to be quite profitable albeit volatile, over the long haul. These banks, especially Citibank and Bank of Boston have very strong positions in Latin America and have been there for about a century. In many ways they have become an integral part of the local banking scene. Their consumer franchises are very strong, although they tend to be focused on the small upscale segment of the population (historically, those customers who could afford bank service), which they serve locally through relatively small branch networks (due to historical restrictions on branching by foreigners) and internationally through private banking. The key strategic issue for these banks is whether to broaden their customer base and go "downmarket" and whether to do so through branches (which would require acquisitions) or through non-branch channels. Most likely they will be cautious and opportunistic acquirers, since they have seen many ups and owns in the local market (which makes them reluctant to acquire at high prices). They will probably lead the market in terms of innovation, both in terms of product and in terms of non-branch distribution methods.

The other US banks, notably the superregionals, have become excessively domestic. A time will come, probably very soon, when they will start to look across the US borders and the Latin American market will beckon. They will have to work hard to reestablish their presence in Latin America. Undoubtedly some will acquire, probably at a high premium. Some will look into strategic alliances with local banks. Others may go for non-bank acquisitions, in businesses such as consumer finance, securitization or securitization-related services such as mortgage insurance or financial guarantee insurance.

US banks have not made aggressive investments in Latin America in the last decade or so. Some of this reflects a "once burned, twice shy" mentality. In some ways, they have given up to newcomers a marketplace in which they had a natural advantage.
To reestablish their position, they will have to try harder and show more determination and strategic imagination. They should hurry.

Andre Cappon is President of The CBM Group, Inc. a management consulting firm specialized in financial services. The CBM Group has an active emerging markets practice and has broad experience in Latin America.
The author gratefully acknowledges the assistance of Ms. Marina Alcalde, who was responsible for much of the research on which this article is based.