

# New competitive strategies of foreign banks in large emerging economies: the case of Brazil\*

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## 1. Introduction

Financial relations, all over the world, have been deeply transformed over the last two decades. New products, new markets and new regulatory systems have radically altered the environment in which financial sectors operate, opening up new profit opportunities but also creating new (and sometimes very great) risks. Among the most important of these changes, we have the worldwide movement of liberalization and deregulation of the banking industry. Practically everywhere, domestic banks have lost the protection of strict regulatory barriers to entry, becoming vulnerable to strong competitive pressures both from other domestic financial (and even non financial) institutions and from foreign banks.

Until the very recent past, in most of the world, foreign banks had their range of operation severely limited by both regulatory and market factors. The activities of foreign banks were usually limited by regulations, according to some principle of reciprocity. The foreign banks themselves, on the other hand, used to concentrate their efforts on the support of companies head-quartered in their country of origin and their employees, particularly their executives, and other clients of similarly high incomes. In some cases, they operated in niches where sophisticated products were transacted. On the whole, these banks occupied a fringe position within the entire domestic banking system.

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One might say that the foreign banks' activities were merely an extension of their domestic markets, serving their traditional domestic clients abroad. The foreign markets were little more than a projection abroad of domestic markets.

All this was radically changed in the 1990s. Foreign banks that had seemed content to keep their largely marginal positions in domestic markets for so long started to implement an aggressive strategy, in open competition with locally owned banks to conquer increasing market shares in sectors traditionally reserved to those local institutions. These market shares were also targeted by other foreign banks choosing to embark decisively on the expansionary train by, in most cases, buying local banks. A large number of these foreign banks, despite being retail banks in their countries of origin, had never tried (or were never allowed) to dispute local retail markets. The novelty of the situation was not the expansion of retail banks but that these banks were finally liberated to aim at taking retail market shares from local banks.

In Latin America, the new wave of incoming foreign banks took place in a relatively short period of time. One of the first countries to suffer such an 'invasion' was Uruguay, back in the 1980s. In the 1990s, a country as large as Argentina saw its banking system become almost completely internationalized. Mexico seems to be heading the same way, since the legal restrictions against foreign participation in the local banking system were lifted. In Brazil, between 1994 and 1998, foreign-controlled banks increased their participation among the fifteen largest banks from 6.5 to 34% (Table 1).<sup>1</sup>

What should come out of this process? The optimists point to potential gains in efficiency and the reduction of intermediation costs resulting from the unhindered operation of institutions commonly assumed to be more productive than local banks. The pessimists, in contrast, point to the loss of sovereignty that foreign dominance of the local banking systems may entail. All these arguments are, however, too general in character. The expansion of foreign banks in emerging economies is still too much in its infancy for its effects to be accurately evaluated. The foreign banks are coming to the emerging

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<sup>1</sup> Total participation is actually higher than that because of minority participation of foreign banks in locally controlled national banks. The expansion of foreign banks has continued after 1998, although at a slower pace.

TABLE 1

FIFTEEN LARGEST PRIVATE BANKS BY TOTAL ASSETS  
(Balance sheets of December 31<sup>st</sup> - R\$ million)

1994 assets			Share of 15 largest	1998 assets			Share of 15 largest
Bradesco	Domestic	18124667	0.170005	Bradesco	Domestic	49375066	0.205763
Itau	Domestic	13886268	0.130249	Itau	Domestic	38926156	0.162219
Bamerindus	Domestic	12756797	0.119655	Unibanco	Domestic	27297603	0.113758
Nacional	Domestic	10934686	0.102564	Real	Foreign	16626701	0.069289
Unibanco	Domestic	10486049	0.098356	Santander*	Foreign	16528917	0.068881
Economico	Domestic	7465820	0.070027	Safra	Domestic	14710968	0.061305
Real	Domestic	7313678	0.068600	HSBC	Foreign	13839782	0.057675
BCN	Domestic	6956443	0.065249	BCN	Domestic	12176177	0.050742
Safra	Domestic	6012695	0.056397	Sudameris	Foreign	8406778	0.035034
Lloyds	Foreign	3363324	0.031547	BBA Credit.	Domestic	8252133	0.034389
Mercantil SP	Domestic	2697030	0.025297	ABN Amro	Foreign	8098128	0.033747
America do Sul	Domestic	2266921	0.021263	Bozano, Sim.	Domestic	7666356	0.031948
Citibank	Foreign	2125271	0.019934	Citibank	Foreign	6230908	0.025966
Boston	Foreign	1408161	0.013208	BilbaoVizc.	Foreign	6063382	0.025268
Garantia	Domestic	814723	0.007641	Boston	Foreign	5761260	0.024009
Total Domestic		99715777	0.935310			15840445	0.660127
Total Foreign		6896756	0.064689			81555856	0.339872

\* Including banks Santander Brasil and Santander Noroeste.

Source: Gazeta Mercantil, *Balanço Anual*, several issues.

economies, in any case, not to increase macroeconomic efficiency but to explore profit opportunities and to hold or expand their market share. How do they expect to achieve these goals? What do their strategies imply for the countries receiving them? Does it make any difference whether the receiving country is large or small? To answer the first question and to advance some hypotheses about the second and third is the ambition of this paper, taking the case of Brazil as an example. Thus, we proceed by discussing, in Section 2, the change in the role reserved to foreign banks. Although the strategic change in the nature of the foreign banks' activities must obey some more general reasons, the specific mode of penetration of these banks in a given economy may be important to shape their short- and medium-term expansion possibilities. The specificities involved in the case of Brazil are discussed in Section 2. Section 3 describes and discusses the strategies defined by the foreign banks to explore expansion opportunities

in the Brazilian economy. Section 4 then debates the expected impacts of these strategies. Finally, Section 5 summarizes the argument and concludes the paper.

## 2. The changing role of foreign banks in Brazil

The 1996 acquisition of Bamerindus, then the 4th largest private bank operating in Brazil, by HSBC was a watershed in the recent history of Brazilian banking. Banking was traditionally approached, in Brazil as in most of the rest of the world, except for the Anglo-Saxon countries, as a kind of public service. Provision of credit and payment services as well as holding the population's savings was judged something of strategic interest for the country as a whole and therefore not to be left in the hands of foreigners. Accordingly, the foreign banks operated in Brazil as they did in most parts of the world for a long time, occupying strictly limited niches of the domestic financial markets. As pointed out by Freitas (1998), since the banking and capital market reforms of 1964/66, foreign banks had had permission to operate in the country in lines of business defined according to the principle of reciprocity. Moreover, severe limits were imposed on the possibility of opening branches. Foreign banks had little choice but to concentrate on serving firms headquartered in their country of origin, and their executives. The provision of financial services to high-income groups, in particular investment fund management, was also exploited, being an activity that can dispense with a large network of branches. Capital and exchange controls, on the other hand, prevented the use of a foreign bank's most powerful tool, namely: the possibility to offer investment facilities abroad to domestic wealth holders. Foreign investors could, however, hold minority participation in domestic banks.

In the mid-1990s, on the eve of its largest transformation in recent history, the Brazilian banking system was largely dominated by two groups of institutions: on the one hand, there were public banks, a group led by federal institutions like Banco do Brasil and Caixa Economica Federal (Federal Savings Bank); on the other hand, we found a relatively numerous group of private banks dominated by a

small number of large domestic banks led by Bradesco and Itau, followed at a certain distance by Unibanco.

### 2.1. *The Real Plan and its effect on the banking sector*

It is generally acknowledged that the Brazilian banks are something of an exception in Latin America. Inflation in this country has strengthened the banks rather than destroyed them, as happened in Argentina, for instance. Despite enduring very high inflation rates for a long time, the Brazilian economy was never dollarized thanks to the development of a complex system of indexation.<sup>2</sup> Moreover, the banks invested in technology to allow them to set up a very agile payment system, minimizing the period of time during which funds remained idle, a very big plus to depositors under high inflation.<sup>3</sup> Finally, drawing on the US experience with NOW-type interest earning current accounts, depositors were offered accounts partially protected against inflation. Unlike the US accounts, however, these were supplied by the banking system themselves, avoiding the loss of deposits that plagued US banks. For all these reasons, the Brazilian banks did not suffer any significant loss of core deposits.

At the same time, with the banks able to keep their sources of funds intact, high inflation was creating new opportunities for profitable financial investment. Cash-strapped Brazilian governments not only issued large amounts of public debt continuously, but also gave many forms of incentives to private investors, including banks, to hold it in their portfolios. Thus, the banks were able not only to survive but also actually profit and grow despite persistently high inflation.<sup>4</sup>

The Real Plan of 1994 radically changed this picture.<sup>5</sup> As had occurred with other stabilization attempts in the past, inflation was drastically reduced in a very short period of time. The Real Plan was

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<sup>2</sup> See Cardim de Carvalho (1993).

<sup>3</sup> According to McKinley Global Institute (1994), Brazilian banks were efficient in the organization of a payments system adapted to high inflation.

<sup>4</sup> According to the Tanzi effect, under persistent inflation, fiscal revenues tend to lose real value because of the delay between the fact generating the tax and its effective payment while payments are made at currently rising prices, so deficits are renewed even if the budget is balanced *ex ante*.

<sup>5</sup> The Real Plan is named after the new currency that was introduced, the real.

generally perceived as robust, in particular because it did not rely on any form of price control or freeze. Rather it depended on an overvalued exchange rate in an environment of trade liberalization that used cheap imports to price out of the market any domestic producer attempting to keep inflation alive. In addition, before launching the plan, in July 1994, the federal government had adopted emergency plans to reduce or eliminate public deficits, although these plans consisted entirely of temporary measures. It was believed that the very success of the plan would be sufficient to eliminate some of the causes of the deficit and, at the same time, to create the political momentum needed to support the adoption of additional austerity initiatives.

The steep fall in inflation rates and the prospect of reaching fiscal equilibrium in the near future threatened bank profits. So-called 'treasury' operations with public securities had been responsible for a large share of the banks' assets and profits. Some banks had actually been created in the past with the sole purpose of exploiting these operations. The end of inflation was to kill off the latter, but it was also to hurt larger banks.

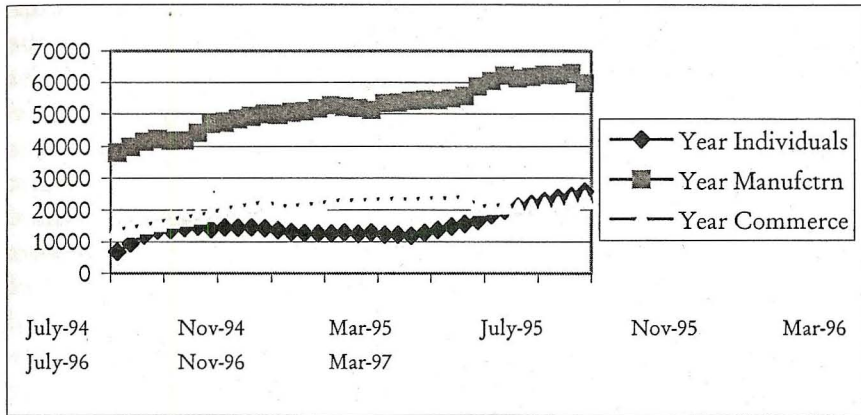
In the immediate aftermath of price stabilization there was, however, a silver line for the banks. The fall of inflation rates, by eliminating the inflation tax, led to a wide-scale redistribution of income in favor of the general population. In particular, the lower-income classes were most intensely favored by price stabilization because these groups had been left largely defenseless against high inflation in the past. The middle and high-income classes had their financial and monetary wealth defended by indexation, including their current accounts. The lower income groups, in contrast, had to hold currency or non-indexed deposits. As inflation came down, large income and wealth effects took place<sup>6</sup> and consequently these groups increased their demands for goods and services with verve. The banks soon saw an alternative to treasury operations in the supply of consumer credit to these emerging groups and of working capital credit to firms to serve these new customers. As a result, credit to the private sector grew quickly in the second semester of 1994, as shown in Figure 1.

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<sup>6</sup> A positive income effect resulted from stopping the erosion of real incomes. A wealth effect resulted from stopping the erosion of money balances.

FIGURE 1

## FINANCIAL SYSTEM LOANS



The rapid increase in aggregate demand in the second semester of 1994 was in itself sufficient to cause imbalances to emerge on the trade balance by pushing up imports. Overvalued exchange rates depressed exports and the remaining inflationary pressures pushed imports even higher. The success of the stabilization plan, under these conditions, depended crucially on the continuous maintenance of foreign capital inflows to finance current account disequilibria. The Mexican exchange crisis of late 1994 and early 1995 led to a sharp reduction of private flows of capital to the Latin American countries, forcing the central bank of Brazil to raise interest rates steeply in order to keep foreign capital coming in.<sup>7</sup> Rising interest rates, however, put an end to the incipient boom initiated by the stabilization plan. Non-performing credits increased drastically and a large-scale banking crisis became a distinct possibility by mid-1995.<sup>8</sup>

By mid-1995, the Brazilian banking sector was generally perceived to be at a crossroad. In fact, one might say, the banks were facing several crossroads at the same time. On the one hand, structural changes were evolving quite independently of the achievement of price stability itself. The public banks had been declining since the

<sup>7</sup> Measures were also taken to reduce credit supply and decelerate aggregate demand growth.

<sup>8</sup> The near-crisis in Brazilian banking and its development was discussed in detail in Cardim de Carvalho (1998).

beginning of the 1990s for quite independent reasons. Fiscal imbalances at the state level had long been financed by borrowing from state banks on the part of local governments. These banks usually appealed to the central bank to refinance these placements, making the money supply 'endogenous' in a very peculiar sense: the state banks all but created money themselves according to the local governments' whims. In the late 1980s these facilities were closed. The state banks then had to sell securities to private markets. The terms and interest rates imposed by the markets to absorb these securities led most of these banks to the brink of bankruptcy. Bailing out these banks by the central bank was eventually made conditional on the cessation of their activities and privatization. Some of them were so far advanced on the way to bankruptcy that they were simply put under the control of the central bank. The process of cleaning up and privatizing state banks has taken the whole decade and is still going on. When the Real Plan was implemented, the state banks already had a shrinking share of the market. By the end of 1994, control of two of the largest state banks in the country was taken over by the central bank.<sup>9</sup>

The second crossroad was faced by the private banks, and was the one described above. Brazil had a banking sector shaped by inflation, not only in the sense that treasury operations were an essential source of bank revenues and profits, but also because the private financial markets themselves operated under rules that reflected the impact of high inflation. Short-termism, the importance of liquidity, the paramount concern with the agility of payment systems were, among others, dominant features of private financial deals. All this had to change if inflation was going to be reduced or eliminated for good. It meant not only that the banks and other financial institutions had to learn to deal with private lenders and borrowers on a different basis, but also that innovations that had been evolving on for some time in the international financial system in the ways borrowing and lending are conducted had to be learned as quickly as possible and brought to the local markets. Banks that were incapable of catching up, because of conservatism or of structural inadequacies, would

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<sup>9</sup> Banespa, the state bank of São Paulo, was the 6th largest bank in the country and the largest of state banks in 1998. No balance sheets were published for the period between 1994 and 1998. Banerj was the state bank of Rio de Janeiro. Both were taken over by the central bank on December 31<sup>st</sup>, 1994. The shrinkage of state banks is shown in IBGE/Andima (1997).

probably be doomed to failure. The banks had to be prepared to offer credit services to different classes of customers, with specific demands, under specific risks and conditions. At the same time, financial investors expected the banks, particularly the investment banks, to be able to offer them a diversified supply of products. It was assumed with some degree of confidence that we would see reproduced in Brazil the same pattern of banking sector organization that was taking shape in the rest of the world: a bi-modal structure in which, on the one hand we see a few large universal banks, offering mainly retail products to mass markets, for which size is one of the fundamental competitive factors, and, on the other hand, a number of investment banks, supplying sophisticated investment products, for which technical expertise was the essential input.<sup>10</sup>

As these pressures for change mounted in the Brazilian economy, large banks in the developed economies were also feeling the heat of increased competition rooted in financial liberalization and deregulation. As *The Economist* put it, referring to Germany, banks were being subjected to 'hellish' competition on their home turf.<sup>11</sup> The creation of the euro area would certainly intensify competition by removing some protective barriers against foreign banks. The ever-threatening proximity of US banks, growing in their own domestic markets through mergers and acquisitions, also stimulated by deregulation, was a final factor to consider. One might say that expanding to other countries was practically imposed on European banks by competition. It was therefore no accident that they were to be the most aggressive in occupying new markets. The Brazilian banking market was very attractive to institutions searching for new markets. The potential growth of banking activities was notably strong, given the dynamism of the economy in the past, the large share of the population that was still denied access to banking services or that used them on a very small scale, and the opportunity of introducing financial innovations already being used by some of these institutions in other mar-

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<sup>10</sup> The 'prediction' that this was the probable trend to be followed by the Brazilian banking sector was first made in IBGE/Andima (1997). It has been largely confirmed by developments to this date.

<sup>11</sup> The forces pushing German banks to expand abroad are in fact present in all other developed economies: competition from money market funds for deposits, competition from foreign investment banks in capital markets and corporate finance, etc. See *The Economist*, 2 December 1995.

kets. On the other hand, although the local market was dominated by strong domestic banks, they were hardly impregnable. As shown in Table 2, even though the situation improved after price stabilization, the overall operational efficiency of Brazilian private banks was much lower than that in the developed countries. The foreign banks would also benefit from a longer experience with credit markets and financial innovations, not to speak of the advantages resulting from belonging to groups with connections in many financial centers. It is hardly surprising that when the Brazilian government decided to let foreign banks in, a veritable avalanche of purchase offers took place.

The opportunity for foreign banks finally came in consequence of the near-crisis of 1995. Even though the central bank was able to contain the banking crisis that began to unfold in mid-1995, after the failure of the *Economico* and *Nacional* banks,<sup>12</sup> the list of banks placed under its management grew rapidly. It was in this context that permission for foreign banks to operate in the domestic economy seemed to be a solution for a large number of problems at the same time. The acquisition of problem banks by foreign banks could be a quick fix to local banks' difficulties. Acquisition by foreigners would reduce the workload of the central bank, increase its revenues and bring foreign exchange to the country in the form of direct investment. At the same time, it could be a vehicle to speed up the modernization process of the Brazilian banking system, since the foreign banks were expected to bring with them the financial innovations they applied in other markets, as well as modern methods of management and cost control that could reduce the costs of financial intermediation. Finally, it was believed that creating more competition in the banking sector was good in itself even if no other immediate benefit was to be expected. Given the heavily concentrated nature of the sector in Brazil, the only hope for more competition could only come from foreign banks.<sup>13</sup>

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<sup>12</sup> See Cardim de Carvalho (1998).

<sup>13</sup> One cannot, of course, overlook the international pressures on Brazil and, in fact, on every emerging economy, to open their banking systems to foreign participation. See, for instance, Summers (1998 and 1999) and the very frequent references in IMF (e.g. 1997 and 1998) documents to the positive contribution to be given by foreign banks from advanced countries to the more primitive banking systems of the emerging countries. In fact, opening the domestic banking system to foreign banks was made a conditionality in the rescue packages of Korea, Thailand and Indonesia.

TABLE 2

## BANKING MARKET INDICATORS

	Bank credit to private sector/GDP - 1997 - %	Operating costs/ Banking assets		Net interest margin as % of banking assets	
		1990/94	1995/96	1990/94	1995/96
Taiwan	138	1.3	1.3	2.1	2.2
Indonesia	57	2.3	2.8	3.3	3.6
Korea	64	1.9	2.1	2.2	2.2
Malaysia	95	1.6	1.4	4.7	3.2
Singapore	97	0.8	0.7	2.2	2.0
Thailand	105	1.9	1.8	3.6	3.6
Argentina	18	11.0	6.3	13.1	7.2
Brazil	24	10.1	6.7	15.5	6.7
Chile	53	3.1	3.2	6.3	5.7
Mexico	14	4.0	3.0	5.4	4.4
USA	65	3.7	3.4	4.1	3.8
Japan	111	1.0	1.1	1.2	1.5
G-10 Europe	89	2.1	1.9	2.3	2.0

Source: BIS, 68th Annual Report, June 1998.

There was, however, one important difficulty. Since the passing of the 1988 Federal Constitution, the size of the foreign banking sector in Brazil had been frozen. In fact, in Brazil, oddly enough, the organization of the financial system is considered to be a constitutional matter. The writers of the 1988 constitution were not then sure, however, how the Brazilian financial system should be organized, so they left the matter for later deliberation. As a result, a regulatory vacuum was created, including the rules regulating the role of foreign capital in the banking sector. A safety valve, nevertheless, was maintained, in the form of 'transitional arrangements' that, among other things, gave the President of the Republic the power to let new foreign banks into the country by decree, on a case by case basis, if it was "in the national interest". This rather arbitrary mechanism was first used by the central bank to allow HSBC to buy Bamerindus in 1996, supported by a special emergency line of credit created by the central bank, called PROER, in the midst of the banking crisis of the preceding year.<sup>14</sup> In fact, Bamerindus was among the ten largest banks in the country, and a buyer for a bank of such a size could better be found

<sup>14</sup> The odd circumstance of having to implement strategic policies, like the one on foreign investment in the banking sector, through a 'transitional' arrangement has been criticized by many analysts. See, for instance, Freitas (1998) and Cardim de Carvalho (1999).

among foreign banks than among the domestic institutions. After the purchase of Bamerindus, and the 'discovery' of the mechanism through which the President could circumvent congressional debate on the role of foreign banks, the same process was repeated many times.

## 2.2. Foreign banks in the Brazilian banking sector

The Brazilian financial system is rather peculiar in many respects. It is relatively advanced, offering a diversified supply of products and services, through markets populated by sophisticated intermediaries. The most numerous and most important class of banking institutions are the German-universal type multiple banks (see Table 3), called "multiple" banks because they are authorized to operate in many segments of the financial market, particularly those of commercial banks and of investment banks.<sup>15</sup>

TABLE 3

BANKING SECTOR IN BRAZIL: NUMBER OF FIRMS  
(In December of indicated year)

	1994	1995	1996	1997	1998
Multiple banks	210	205	191	179	173
Commercial banks	34	35	38	36	28
Development banks	6	6	6	6	6
Investment banks	17	17	23	22	22

Source: Banco Central do Brasil (1998).

Even though there are a relatively large numbers of financial institutions in operation,<sup>16</sup> a few towering banking institutions constitute the core of the system: Banco do Brasil and Caixa Economica Federal (Federal Savings Bank), among the public banks and Bradesco and Itau among the private banks. Thus, the hard core of the banking sector is in local hands. Foreign banks have been allowed to operate in the country for a long time, under three different forms: "offices of

<sup>15</sup> For the evolution of the Brazilian banking sector, see Hermann (1998).

<sup>16</sup> Over 800 institutions in December 1998, down from a little more than a thousand in December 1994. Cf. Banco Central do Brasil (1998, Table 1).

representation" (not allowed to work as actual bank), branches and subsidiaries (Brazilian firms under foreign control).<sup>17</sup> Besides these three forms, the law also allowed minority participation in locally controlled banks. In this paper, we are interested only in branches and subsidiaries, since representative offices are not really banks and minority participation, in most cases, does not give foreign banks any real influence on the institutions that accept them.

As we have seen, the Brazilian economy lived through a long period of high inflation, from the mid-1960s to the mid-1990s. The banks adapted to this environment, mainly through two channels: 1) on the one hand, payment system technologies were adopted to make deposit circulation as agile as possible, reducing clearing delays and making overdraft accounts generally available to all but the lowest-incomes customers; 2) placing the resources they could borrow on public debt, with high returns and high liquidity, which allowed banks to pay interest on current accounts, and keeping core deposits relatively stable. Inflationary "revenues" deriving from interest on the investment of floats and on paying depositors interest rates lower than the banks earned in their purchases of public debt accounted for a large part of the banking sector earnings. According to research made by the Brazilian Central Statistical Office (IBGE), inflation revenues represented more than 40% of imputed added value of the financial sector in 1991 and 1992. As a result of the stabilization plan of 1994, these revenues were brought to zero in 1995.<sup>18</sup>

The elimination of inflation revenues could only cause great turmoil in the banking sector. This turbulence was at first disguised by the credit boom that immediately followed on the creation of the new currency, but when the central bank adopted restrictive monetary policies, in late 1994, the fragility of a large part of the banking system became impossible to conceal. In fact, while price stability eliminated an important source of profits, the Mexican crisis and ensuing restrictive domestic monetary policies raised interest rates and

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<sup>17</sup> Branches of foreign banks were not authorized to operate as multiple banks, in contrast to subsidiaries. The National Monetary Council, the chief banking regulator in Brazil, decided on December 20, 1996, to extend to branches the same privileges enjoyed by subsidiaries.

<sup>18</sup> IBGE/Andima (1997, p. 44, Table 34).

cut credit,<sup>19</sup> raising the proportion of non-performing credits. Under these conditions, it is not surprising that the banks perceived as more fragile would have their market value depressed, even though perceptions were not always accurate.<sup>20</sup> This reduction in price signaled opportunities for acquisitions and, were the legal possibility there, should attract foreign as well as local banks.

One should, in fact, expect such interest to be strong. The Brazilian banks benefited from high spreads. Operational efficiency, on the other hand, was relatively low, suggesting that more efficient and competitive banks could take market shares from them with relative ease. Moreover, if in terms of number of institutions one might describe the market as 'overbanked', in terms of provision of financial services there was (and still is) a large potential market to be explored in practically all segments of the financial system. Total credit supply as a proportion of GDP was 30% in 1994. This proportion actually declined in the following years (Table 7). Even if we disregard the exceedingly high ratios found in Asian countries, there is evidently still much space to expand the credit supply in Brazil (see Table 2).

With hindsight, one can say that the banking crisis of 1995 opened a window of opportunity for foreign banks to set foot in the country. The crisis devalued the existing banks, putting a large number of them under the control of the central bank, without compromising, it seemed, the long term possibilities for the industry. In a report dated December 1998, the central bank of Brasil identified 104 financial institutions as going through some kind of 'adjustment' between the launching of the Real Plan and that date, 34 of which were multiple banks and another 7 were commercial banks undergoing bankruptcy procedures. In the end, 34 multiple banks had to sell as-

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<sup>19</sup> In fact, the central bank implemented both kinds of measures. Raising interest rates was not enough to deflate the credit boom of late 1994, probably because of a Minsky-type interest-inelasticity of credit demand in the late phases of a boom. According to Minsky, speculative and Ponzi agents borrow at shorter maturities than their assets on the expectation that they will be able to roll over their debts. Under these conditions, rising interest rates do not reduce the demand for credit, because the latter is a demand for rolling over past debts, not to fund new projects, that could be discouraged by higher interest rates. Although there is no hard evidence that this has occurred in Brazil, it is very much consistent with available anecdotal evidence.

<sup>20</sup> Bank Nacional was receiving high marks the day before it was closed and sold to Unibanco.

sets or to have their control transferred to other institutions, local and foreign.<sup>21</sup>

When the Brazilian government decided to invite foreign banks to buy problem banks as a means of solving (or avoiding) the bank crisis, the initiative was so enthusiastically received by potential entrants that at a certain point the central bank had to remind them that for each acquisition a special authorization by the President of the Republic was necessary.<sup>22</sup> Foreign banks willing to acquire banks under central bank administration would enjoy, as an incentive, the privilege of choosing the 'good' assets, leaving non-performing credits to the central bank. When the local bank to be acquired was in healthy condition, a 'toll' would be charged by the central bank, as a 'contribution' to sanitize the banking system.

Given the circumstances in which entry of foreign banks was allowed, in the midst of a banking crisis, the only effective means of penetrating the market was through the acquisition of a domestic institution. This could be a minus when the acquired bank was known to have been bankrupt but, on the upside, the acquiring bank would get a net of branches, skilled labor and some goodwill all at once. The balance of advantages and disadvantages seemed to have been overestimated to some degree, as will be seen later, but the alternative form of growth, 'organic' growth from scratch, would certainly not be feasible given the powerful presence of domestic banks like Banco do Brasil, Bradesco, Itau, etc.

That foreign banks came to the country with the intention of holding (or acquiring) large (and growing) market shares is shown by the fact that the number of branches of foreign-controlled banks was not reduced after purchase was completed. As we see in Table 4, the number of branches of foreign banks increased monotonically between 1995 and 1998, showing a huge increase in the relative participation of foreign bank branches in the system's total: from about 2% up to 1996 to about 15% in 1998.<sup>23</sup>

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<sup>21</sup> That the number of bankrupt multiple banks and of multiple banks being sold is the same is just a coincidence.

<sup>22</sup> Banco Central do Brasil, *Comunicado*, n. 5796, September 9, 1997.

<sup>23</sup> There is a slight distortion in these data because a Brazilian-controlled bank was counted as foreign because it was owned by a holding created at the Cayman Islands. In any case, this distortion is no longer meaningful because this bank too, Meridional, was sold later to Santander Bank.

TABLE 4

## FOREIGN CONTROLLED BANKS: NUMBER OF BRANCHES

Year	Foreign bank branches	Banking system - total	Share of foreign bank branches, % of total
1988	247	16228	1.52
1993	384	17972	2.14
1994	378	18760	2.01
1995	360	17798	2.02
1996	403	16686	2.42
1997	1610	16383	9.83
1998	2395	16060	14.91

Source: Banco Central do Brasil (1998).

Table 5 shows the national origin of the foreign banks that operate in Brazil. In fact, the wave of acquisitions that took place since 1996 was led by European banks. American banks, which had been operating in the country for a long time, seemed to have taken some time to react to the new environment. In fact, they chose at first to stay put in their niches, as will be seen below, before considering expanding to face the new competition. They relied on the advantage they had of knowing the local market, on the one hand, and not having to absorb other, sometimes problematic, institutions, on the other, as was the case with the incoming European banks.

TABLE 5

NATIONAL ORIGIN OF FOREIGN BANKS  
(Position in December 31, 1998 - Number of institutions)

	Multiple banks	Commercial banks	Investment banks
United States	11	5	1
Germany	5	1	
Spain	4	1	1
France	3		
United Kingdom	3	1	
Italy	3	1	
Switzerland	2		
Japan	2		
Netherlands	2	1	
Portugal	2		
Other	9		1

Source: Banco Central do Brasil (1998).

Tables 6, 7 and 8 show the evolution of the participation of foreign banks in the local market from 1994 to 1998. Table 6 shows that the foreign banks' share of total assets held by the banking system almost doubled between 1995 and 1998. Although practically all the other groups of banks lost participation (except for CEF), the great losers of the period were the public banks owned by the states. Some of these banks were actually bought by the leading domestic banks, but this did not prevent the rise of the share of foreign banks due to the latter's acquisitions of private banks with liquidity or solvency problems.

TABLE 6

## BANKING SYSTEM: SHARE OF TOTAL ASSETS, %

	1993	1994	1995	1996	1997	1998
Banks under foreign control	8.35	7.16	8.39	9.79	12.82	14.15
Private domestic banks	40.67	41.21	39.16	39	36.76	38.15
State-owned banks	13.41	18.17	21.9	21.92	19.06	10.79
National savings bank	14.51	14.98	16.4	16.47	16.57	17.98
Bank of Brazil	22.93	18.28	13.91	12.52	14.42	18.41
Credit cooperatives	0.13	0.2	0.24	0.3	0.37	0.52

Source: Banco Central do Brasil (1998).

Table 7 shows that the supply of credit by foreign banks is still very limited, as, in fact, is the case with the whole banking system. In 1998, the total bank credit was still less than 20% of GDP. This shows – and it seems to have been an important input in the decision of many banks to set foot in the country – that competition with domestic banks can actually be avoided for a while, simply by expanding the credit market to a proportion of GDP closer to what is found in other economies.

Finally, Table 8 shows that the foreign banks have been employing very efficiently one of their main competitive weapons, namely privileged access to funds in international financial markets. Thus, while in 1998 banks under foreign control or with foreign participation controlled only one quarter of the system's total assets, they were responsible for 46% of the funds borrowed abroad by all the banks.

Despite the significant increase in the share of foreign banks in the total number of branches, total assets and net worth of the banking system as a whole, these numbers may still underestimate their actual impact. A large number of the banks being acquired were, in fact,

TABLE 7

## SUPPLY OF CREDIT: RELATIVE PARTICIPATION, % OF GDP

	1994	1995	1996	1997	1998
Banks under foreign control	1.44	1.46	2.07	2.41	2.4
Domestic private banks	9.8	8.14	7.83	7.28	6.59
State-owned banks*	5.25	6.01	5.61	2.12	1.46
Federal savings bank (CEF)	5.64	5.8	5.74	6.37	6.65
Bank of Brazil (BB)	5.51	4.09	2.54	2.26	2.48
Credit cooperatives	0.09	0.11	0.13	0.15	0.19
Total: Banking system	27.73	25.61	23.92	20.6	19.76
Total: Financial system	30.28	27.79	26.6	23.54	23.69

\* Includes State Saving Banks but excludes CEF and BB

Source: Banco Central do Brasil (1998).

TABLE 8

## BANKING SYSTEM: SHARES OF NET WORTH AND OF EXTERNAL BORROWING BY CLASS OF BANKS

	1993	1994	1995	1996	1997	1998
Share of net worth						
Domestic banks	86.89	83.46	75.73	81.53	72.5	73.01
Banks under foreign control	7.28	9.57	13.08	10.29	14.29	15.5
Banks with foreign participation	5.33	6.26	9.75	6.92	11.66	9.69
Share of external borrowing						
Domestic banks	67.73	76.09	69.14	68.23	57.99	53.7
Banks under foreign control	24.4	15.96	22.79	25.13	26.5	27.25
Banks with foreign participation	7.97	7.96	8.07	6.64	15.51	19.05

Source: Banco Central do Brasil (1998).

among the largest in the country, so the foreign banks came to control assets, net worth and access to customers in the top tier of the market, which is especially significant given the stratified nature of the Brazilian banking system referred to above. In other words, ratios calculated in terms of the banking system as a whole conceal the fact that a large part of the assets controlled domestically are in fact in the hands of a number of institutions that occupy very limited niches.

### 3. The new strategies of the foreign banks

One can hardly exaggerate the potential impact on the domestic system of the change in strategies adopted by foreign banks in Brazil before and after the 1995 banking crisis. When confined to limited niches of the market for banking services, serving a small fraction of it, foreign banks were, from a competitive point of view, harmless to the local banks. In fact, one could say they were complementary, since the foreign banks would operate mainly in foreign exchange-related markets, leaving practically the whole domestic market to be exploited by the local banks. In particular, since they were not actually competing with the local banks, one could consider the domestic market to be highly protected, as in fact has been the case in many countries until recently. Allowing the foreign banks to freely acquire domestic banks potentially changes all this. Even if the number of banks is not changed the degree of competition is likely to increase dramatically, although not necessarily at once, since there may be problems in integrating the acquiring bank with its acquisitions.

The impact foreign banks may have on the domestic market depends, of course, on how they intend to operate. Which markets are they targeting? How do they expect to consolidate and expand market shares? What kind of relationship will they try to establish with the existing banks, especially the largest ones? These are key questions to evaluate whether and how foreign banks will help to shape the domestic banking market.

The first element to consider in searching for the answers to these questions is that Brazil's is a large economy. This means that it is probably possible to accommodate a certain number of banks operating at scales sufficiently large to allow them to benefit from decreasing costs. In other words, the *internal* financial market in an economy such as this is enough to induce banks to fight for market shares in the expectation of being able to reach efficient scales of operation.<sup>24</sup> It is also a diversified market, which stimulates banks to try to benefit from scope economies. Finally, Brazil is the leading economy in an

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<sup>24</sup> There has been a long debate in the literature on whether there are significant economies of scale in banking. Studies focusing on US banks tend to show that these economies are largely irrelevant. Studies on European banks tend to show the opposite. See, for instance, Srinivasan (1992), Mester (1987) and Santos (1998).

economic zone, Mercosur, where we find at least one other important economy, that of Argentina. The possibility of enjoying scale and scope economies in Brazil may give foreign banks cost advantages with which to search for market shares in the whole regional market. Accordingly, we will find that practically all of the foreign banks operating or preparing to operate in the country are announcing aggressive plans to displace established market shares.

But if a large economy may be attractive to foreign banks because it allows them to reach efficient scales of operation the same reason works in favor of domestic banks. In some segments of the banking market, like commercial banking and other retail activities, there is a clear advantage on the side of domestic institutions, as pointed out in a study prepared by the Federal Reserve Bank of New York (1991). Moreover, as noted in the same study (p. 2), "banks and securities firms compete most successfully in international markets by building on traditional domestic market strengths".<sup>25</sup> These hypotheses seem to tally with the evidence from the Brazilian banking system. Accordingly, only a few banks planned, or at least admitted planning, to mount a direct challenge to the leading domestic banks, like Banco do Brasil, Bradesco or Itau. In fact, only three of them, namely HSBC, Bilbao-Vizcaya and Santander, acquired local banks with the manifest intention of fully operating as universal banks.<sup>26</sup> Later, Citibank also announced its own intention to extend its operations and to be a candidate to purchase Banespa, the former São Paulo State Bank taken over by the central bank, but which is still a very large bank (*Gazeta Mercantil*, 1/10/99). A large retail bank in England, in contrast, namely Lloyds, in the voice of its vice-president, acknowledged that the investment necessary to compete on equal terms with local leaders would be so high as probably not to be worthwhile (*Gazeta Mercantil*, 16/3/1999).

Although the policies announced were decidedly on the aggressive side, a segmentation of strategies is clearly visible among the for-

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<sup>25</sup> In wholesale segments, customers are usually more sensitive to price differences, something that may give some advantages to foreign banks.

<sup>26</sup> On the plans and strategies of HSBC, see *Euromoney*, September 1997 and September 1998. On Bilbao-Vizcaya's plans, see *Euromoney*, November 1996 and September 1998. For the strategies of the Santander group, see *Euromoney*, November 1996, September 1997 and November 1998.

eign banks, depending on which factor each considers to be its major strength. On the basis of policy statements announced by the incoming banks themselves, we can expect the concentration of their efforts to consolidate positions in two main segments of the financial market. The first, within reach of a limited number of larger banks, is retail banking, with special emphasis on consumer credit, credit cards, etc. The second segment is the provision of investment bank services, particularly corporate finance, and asset management.

### 3.1. *Occupation of retail markets*

To grow in the segment of direct consumer credit seems to be a particularly frequent goal among the largest foreign banks interested in retail markets. At least six financial groups (AIG, GE Capital, Lloyds, CCF, American Express Bank and Citibank) announced plans to build up a strong presence in this segment. As late as 1999, the newspapers were still pointing out that a large number of financial institutions were pushing the central bank to allow them to purchase independent local financial companies (*Gazeta Mercantil*, 20/7/99). When the sale of Bamerindus sent the signal that the central bank was willing to allow foreign banks to compete in segments that had been traditionally closed to foreign institutions, the exploitation of consumer credit became one of the main targets sought by these banks. In fact, consumer credit had long been relegated to a position of secondary importance by the local institutions. Income concentration limited the market to a relatively small share of the country's population. It also meant that cross-sale of financial products would be very limited in this segment. High inflation caused real incomes to be highly volatile, posing potentially high risks of default. Inflation also brought with it high interest rates, which also increased risks of default. Because of inflation, monetary policies frequently relied on restricting credit supply, becoming a third factor to discourage this line of business. Finally, the duration of contracts was very short because of the interest rate uncertainty created by changing inflation rates.

With the end of inflation, most of these negative factors disappeared and as a result consumer credit grew very quickly in the immediate aftermath of the stabilization plan. In fact, as we saw, it grew so much that after a few months the central bank had to impose new

limits on this activity. Persistently high unemployment then became an important factor to increase default risks.

The foreign banks, nevertheless, seem to believe that there is a potentially large market to be exploited in this segment in the medium-term future. As an official of a foreign institution put it, with the expected decline in interest rates only 'professionals' would survive in this market. They expect not only to incorporate new borrowers among the large share of the population that did not have access to these services but also to dispute the existing market with local institutions. Their optimistic expectations as to the latter are based on their expected technical superiority in dealing with credit risks, both in quantifying and in managing them. Price stability should make borrowers more sensitive to the cost of loans. More efficient institutions – those able to charge less for the loans – would have a strong competitive advantage.

In the case of a retail mass market, to compete for the consumer credit market requires, of course, access to consumers. Traditionally, the main barrier to entry in this segment was represented by the capilarity of the domestic banks, with branches spread throughout the country while foreign banks were allowed to keep only a limited number of branches. This was changed with the new policy. As a result, foreign banks willing to compete for the consumer credit market embarked on an intense wave of acquisitions of local banks, a movement that has not ended so far. Bank Bilbao-Vizcaya plans to increase the number of its branches from 222 in 1999 to about 1,000 in a three-year period (*Gazeta Mercantil*, 3/3/99). Bank of Boston, operating with a much higher income group, planned to double its branches, from 32 in January 1998 to 63 (*Gazeta Mercantil*, 24/2/99). Caixa Geral de Depositos, a Portuguese bank, and Santander also announced plans to open many new branches (*Gazeta Mercantil*, 6/8/98 and 6/2/98).

Other, more innovative, means of reaching new customers includes the creation of 'mini-branches' in stores and supermarkets, pioneered by Citibank with its agreement with the video-renting chain Blockbuster,<sup>27</sup> and use of the Internet. Although Internet banking in Brazil was actually pioneered by Banco do Brasil, and by pri-

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<sup>27</sup> Citibank announced the creation of 35 mini-branches in Blockbusters stores all over the country in which all kinds of transactions can be performed 24 hours a day. Cf. *Gazeta Mercantil*, 24/2/99.

vate banks like Bradesco, foreign banks like Boston, CCF, Lloyds and Citibank were the quickest to follow their lead (*Gazeta Mercantil*, 9/7/99).<sup>28</sup> This market is in any case still in its infancy (in fact, offering banking services in general through the internet is still in an early phase), but it will be the arena of an intense fight among banks to gain clients and reduce operational costs in the near future. At present, the market is also limited by the low share of the population that owns computers or knows how to use them in more complex ways. On the other hand, the banks are trying to develop user-friendly software that allows even computer-illiterate people to use it. As is the case of other countries, though, with the exception of the US, how far Internet banking and suchlike innovations will go is still a matter of speculation.

A line of business related to consumer credit is the management of credit cards. Price stability has made mass issuance of credit cards viable again. This is still another segment favored by foreign banks targeting retail activities.

In sum, as far as the retail markets are concerned, competition is being intensified in the consumer credit segment and ancillary activities, like credit card management. Although the first steps taken by the foreign banks seemed a little timid, this may have to do more with the need to adjust acquired and acquiring banks to each other than with other reasons. Some banks have in fact tried to downplay their disposition to engage in a competitive fight with the market leaders, like Bradesco or Itau, but actions like the purchase of Meridional by Santander and the willingness of many of them to purchase Banespa reveals a much more aggressive inclination.

### 3.2. *The wholesale markets and investment bank services*

Wholesale and investment banking seem to be the most attractive areas for foreign banks. These segments are intensive in skilled labor, research and special market connections, which are all elements about which foreign banks do seem to have advantages. Between 1997 and 1999, no fewer than fifteen institutions announced their intention to

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<sup>28</sup> While this paper was being prepared, Santander Bank completed the purchase of Meridional banking group and a number of large foreign banks were preparing to bid for Banespa on the occasion of its privatization auction.

prioritize fund and asset management, particularly in the areas of investment funds, private pensions and private banking.<sup>29</sup>

Investment banking and corporate finance are also privileged for similar reasons. At least seven banks intend to compete heavily to lead capital market operations and placement of securities while corporate finance is the declared priority of six large banks.<sup>30</sup>

Resource management is seen as a very promising area, given the relative sophistication of a large number of depositors, acquired during the inflation years as a result of trying to minimize inflationary losses on liquid funds. In Brazil, in contrast to other emerging countries, one finds even middle-income groups prepared to buy riskier but more profitable financial products instead of just holding current account deposits or even interest-earning savings deposits. In addition, repeated attempts to reform social security by the federal government under the persistent prodding of the IMF are prompting the middle income groups to join private pension schemes to prevent their incomes from collapsing after retirement. Finally, income concentration is responsible for the existence of a large pool of resources in the hands of a number of households which is a potential market for asset management and private banking.

The focus on corporate finance, on the other hand, results mainly from the advanced stage of the privatization process, which has already transferred to private hands a large number of businesses that will now have to find funds for investment in private capital markets, both domestic and international. Power generation and distribution, and telecommunications, among other sectors, will demand heavy investments and the financial institutions have to be prepared to get mandates for placement of securities or to obtain syndicated loans and provide for ancillary activities, like the contracting of derivatives to hedge the funding risks, etc.

In addition, it is expected that private firms in other sectors will also have to spend heavily to recover competitiveness after two dec-

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<sup>29</sup> Banks Espirito Santo (from Portugal), CSFB, ABN Amro, Chase, Deutsche, UBS, Merrill Lynch, Morgan Stanley Dean Witter, BNP, Mellon, Lloyds, Nations, CCF, American Express and Dresdner. Private banking could perhaps be better classified as retail banking, but it is here included with asset management because its nature is much closer to the latter.

<sup>30</sup> Corporate finance is targeted as a priority by Bank of Boston, Chase, Citibank, Lloyds, CGD and Nations. Investment banking is the goal of Espirito Santo, Chase, Bank America, Lehman Brothers, Société Generale, Deutsche and UBS.

ades of macroeconomic stagnation. The foreign banks count on their experience with financial innovations, dealing with more sophisticated segments of international capital markets like securities and derivatives and, most of all, they depend on their network of subsidiaries, branches and offices spread throughout the world. These advantages should allow foreign banks a decisive advantage over domestic banks in terms of cost of funds, including what is to be raised as regulatory capital under the rules of the Basle Accord of 1988 and its amendments.

Finally, the area of investment banking that seems to be the most attractive to foreign banks is mergers and acquisitions. Again, experience in putting these deals together, advising parties and obtaining bridge finance and permanent funding are major competitive weapons held by the foreign banks. In fact, the latter were responsible for three of the four first places in the ranking of M&A deals made in Brazil in 1998.<sup>31</sup>

Actually, foreign banks seem intent on conquering, or at least setting foot in, all segments of local financial markets, with the possible exception of the traditional business of accepting demand deposits. The latter does not appear as an attractive proposition for all but the largest foreign banks, and for many reasons. Managing demand deposits involves heavy operational costs in terms of labor and branches that can only be recovered through the charge of tariffs. In itself it is a poor instrument to allow cross selling of more profitable financial services that can actually be provided independently. Resources obtained as deposits are subject to regulatory restrictions and taxes, besides being an instrument that is frequently used by monetary authorities. In sum, supplying deposits is a low-profit line of business that becomes less and less essential to allow for the supply of other products and services as time goes by. In contrast, developing credit business to firms and consumers and participating in capital markets on a large scale are the winning propositions sought for by foreign banks.

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<sup>31</sup> The leaders, by value of the deals, were: JP Morgan (22.75%), Bradesco (20.75%), CSFB Garantia (17.48%) and Santander (12.69%). Cf. *Gazeta Mercantil*, 28/10/99.

#### 4. Expected impacts of internationalization of the banking sector

The rapid increase in the degree of internationalization of the Brazilian banking market after the Real Plan, especially in the multiple bank segment (Table 9) is still very recent (and is in fact still developing), and it is too early to search for a more definite description of the impacts of the increasing exposure of domestic banks to foreign competition. In fact, very little has changed in the last four years since the sale of Bamerindus to HSBC and the opening of the way for the wholesale internationalization of the Brazilian banking system. HSBC itself has significantly toned down its plans to challenge local market leaders voiced bombastically at the time of the purchase. From the aggressive early discourse about occupying all market niches and reducing the prices of bank services across the board, HSBC officials changed to the cautious view that price wars would damage everyone (*Gazeta Mercantil*, 15/5/97). More importantly, foreign banks, contrary to patterns verified internationally, have not been shown to be more profitable than domestic banks.<sup>32</sup>

TABLE 9

BANKING SYSTEM: PARTICIPATION IN VOTING CAPITAL  
(Number of institutions in each category)

Range	Commercial banks			Multiple banks			Investment banks		
	1988	1994	1998	1988	1994	1998	1988	1994	1998
0 to 20%	5	1	1		8	12	6	1	3
20 to 50%	4	1	1		20	13	24	7	2
50 to 80%	3				3	3	1		2
80 to 100%	4		1		17	40	3		3
Total	16	2	3	0	48	68	34	8	10

Source: Banco Central do Brasil (1998).

As we see in Table 10, treasury and interfinancial operations were actually a more important source of revenues to foreign than to domestic banks in 1997 and 1998. As low as the efficiency of domestic banks may be in supplying credit, the foreign banks seemed to be even less interested in doing it themselves. Table 11 does suggest, however, that the foreign banks may have an advantage in terms of

<sup>32</sup> Claessens *et al.* (1998) showed that while foreign banks were generally less profitable than domestic banks in the developed world, the opposite was often true in the developing countries.

cost of borrowing, although the data are still too vague and relate to too short a period to allow any safe conclusions.

Be it as it may, the very little change verified up to the present has led some market participants to think that the foreign banks have adapted to local market conditions rather than the reverse.<sup>33</sup>

It is believed in some, not always disinterested, quarters that the mere penetration of foreign banks should result in a significant increase in macroeconomic efficiency in the recipient economy. According to this view, the foreign banks would automatically bring with them better market practices, new technologies and, sometimes seen as the most important factor, they would be independent of local governments' favors and less likely to maintain incestuous connections with local businesses. Arguments like this were frequently raised to justify the pressures made on the Asian countries to open up their banking systems to foreign institutions, which ended up transformed into conditionalities for rescue by the IMF.

These concerns, if they were ever really justifiable, have less force in the case of Brazil. In fact, generally the Brazilian banking system has received much more positive evaluation from the multilateral institutions and the 'market'. The leading domestic banks were generally praised even if considered a little too conservative for their own good. The largest private banks successfully resisted the 1995 crisis and surfed the new crisis in 1997/99 with relative ease. Even some of the foreign banks setting foot in the country referred to them with the respect that is due to strong competitors, as we saw above, usually defining goals that would postpone any direct conflict with banks like Bradesco or Itau.<sup>34</sup>

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<sup>33</sup> Analysts from a well-known consultancy firm, Austin Asis, were quoted in the press as stating that foreign banks adapted to the high spreads and low risks of treasury operations. *Gazeta Mercantil*, 26/7/99.

<sup>34</sup> On the solidity of Brazilian domestic banks, see, for instance, *The Economist*, "Survey on Latin American Finance", 9/12/1995 and *Euromoney*, September 1995. The magazine warned, however, that competition should be tougher after price stabilization. Exactly two years later, in September 1997, when foreign banks were already enlarging their operations in the country, the same magazine observed that competition did become more intense and that HSBC could be a threat to Bradesco. As we noted above, however, the HSBC proved less of threat than expected.

TABLE 10

BANKING SYSTEM: STRUCTURE OF REVENUES\*  
% of total

	Credit operations		Interfinancial		Securities		Services		Revenues from other institutions		Other revenues	
	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
1994	26.6	11.9	13.7	16.7	6.9	3.9	2.6	0.7	2.3	0.4	47.9	66.5
1995	31.9	18.1	17.0	17.0	10.9	12.7	4.9	1.9	4.1	1.2	31.2	49.0
1996	29.8	26.4	15.6	23.9	13.6	17.2	7.7	3.3	5.3	1.8	28.0	27.4
1997	27.4	23.0	11.5	16.3	23.2	31.1	6.9	4.2	4.6	1.5	26.5	23.9
1998***	24.9	16.5	11.2	13.2	26.8	45.1	5.8	3.8	3.9	1.5	27.4	19.9

\* Domestic includes banks with minority participation of foreign capital; foreign includes branches and subsidiaries.

\*\* Average of first nine months.

Source: Andima, Retrospectiva 1998.

TABLE 11

BANKING SYSTEM: STRUCTURE OF COSTS\*  
% of total

	Borrowing		Loans & Obligations		Securities		Management		Other	
	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
1994	30.7	16.0	3.7	4.6	11.0	23.0	9.7	3.2	44.9	53.2
1995	35.0	13.3	6.9	3.5	5.1	25.2	15.7	4.2	37.3	53.8
1996	32.9	16.4	7.8	5.1	6.8	20.1	22.5	5.6	30.0	52.8
1997	30.6	30.9	6.3	9.7	10.8	17.5	20.7	14.6	31.6	27.2
1998**	30.1	23.8	4.4	6.7	17.1	39.6	15.1	10.2	33.1	19.7

\* Domestic includes banks with minority participation of foreign capital; foreign includes branches and subsidiaries.

\*\* Average of first nine months.

Source: Andima, Retrospectiva 1998.

Expectations remain, however, that in the longer term the increasing presence of foreign banks in Brazil will have some definite influence on the way the economy works. It is generally expected that a strong presence of foreign banks will exercise some influence in the direction of reducing the costs of intermediated funds. On the one hand, on average, local banks are less operationally efficient than foreign banks, even though this difference has been reduced drastically since consolidation of the stabilization plan (see Table 2).

A more permanent advantage in favor of foreign banks, however, is the lower cost of capital they face, either because of a higher rating, or because the backing of their mother-institution is appreciated by investors, or even because they are better known and seen as more reliable than the local institutions in the eyes of investors. This capital cost advantage, unlike the more transient operational cost advantages, may be decisive, and most banks, at least, are aware of that.<sup>35</sup>

Cost of capital advantages may even exist in local markets. In contrast with reactions in the developed countries, in crisis periods there is a manifest preference by customers for public and foreign banks. In both cases, the public believes that the controllers (the government or the foreign headquarters) will not permit their banks to go under. This preference is shown more strongly in public bank data only because the foreign banks are very reluctant to accept new depositors if their incomes do not reach a desired minimum level. This feature of the competition between local and foreign banks in the case of Brazil is the exact opposite of what one finds, for instance, in the case of the US. In the latter, depositors reveal a strong preference for domestic institutions and foreign banks can only buy funds from the former. In fact, as shown in a study by the Federal Reserve Bank of New York, in the developed countries there is a strong preference for domestic banks, especially in retail markets, although customers are more price-sensitive in some countries than in others, and national preferences are weaker in wholesale markets.

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<sup>35</sup> Peek, Rosengren and Kasirye (1998) point out that, in the case of foreign banks operating in the US, even though enjoying lower costs of capital, these banks fare worse than the domestic banks. This apparently paradoxical result is explained by the fact that foreign banks usually buy local banks in bad condition to minimize the cost of entry. This has also happened in Brazil after the 1995 near-crisis.

One result that can be expected with a high degree of confidence is the intensification of competition. In fact, as Table 12 shows, concentration among foreign banks has already decreased significantly. Competition is likely to become more intense even if the number of institutions operating in the market does not change on account of the fact that the size difference between the banks is being dramatically reduced.

TABLE 12

CONCENTRATION AMONG FOREIGN BANKS  
(Share in %)

	1988	1994	1998
Three largest banks	57.06	36.86	27.57
Ten largest banks	93.17	74.95	61.13
Twenty largest banks	99.62	92.21	83.73

Source: Banco Central do Brasil (1998).

Only a few expect that competition by foreign banks will suffice to wipe out the domestic banks, as has happened in other Latin American countries. At the other extreme, some analysts believe that nothing will happen, or in other words that the foreign banks will just adapt permanently to the existing situation, choosing not to threaten the current oligopolistic arrangements that guarantee high spreads, high tariffs, etc. It would certainly be far-fetched to expect the foreign banks to be willing to do whatever is necessary to defeat strong domestic banks like Bradesco, Itau or Unibanco. Nevertheless it is equally far fetched to expect giant banks like HSBC, Santander or ABN Amro,<sup>36</sup> to be satisfied with merely occupying the middle-sized market shares that were controlled by the banks they acquired. It is much more reasonable to expect that as soon as the transition period between the acquisition of a bank and its effective absorption by the acquiring institution is over, these banks will aggressively act to conquer larger market shares. This means introducing new products, strengthening trademarks, differentiating services, as is common in oligopolistic competition, but it will probably mean also lower spreads and tariffs. Foreign banks may be attracted by high spreads

<sup>36</sup> Citibank, which had been operating in the country for a long time, was up to now bound to respect the limits imposed in the past. Now, it also sets its eyes on a much larger market.

not only because they may see the chance of being part of a cartel but also because they see the opportunity to beat the competition if they operate at lower costs.

An important, if difficult, remaining question relates to the possible loss of sovereignty involved in allowing a large participation of foreign banks in the domestic economy. The relevance of such a concern is recognized even by analysts of the Bank for International Settlements.<sup>37</sup> The precise nature of this loss, however, is not always clearly identified. On the one hand, there is concern over the fact that decision-making powers, at least on more strategic matters, are obviously held at headquarters, as is the case with any foreign firm. In the event of a financial or external crisis, bank policies would be decided by executives enjoying the option of pulling out of the country, in contrast with the domestic banks, which are bound, to a much larger extent, to operate within the national borders.

One can easily dispose of the ingenuous counter-argument that the presence of foreign banks would reduce the probability of crises because headquarters would provide funds to its subsidiaries if necessary. It is very unlikely that bank headquarters would consider betting more money, increasing prospective losses, when a national economy is in crisis. Again, one has to remember that these banks have the choice of cutting losses and pulling out. If they don't do it, they will probably be punished by the stock markets in their own countries. The domestic banks do not have this option. The near bankruptcy of the Argentine banking system in 1995 was not repeated in the 1997 to 1999 crisis, not because banks were sold to foreigners but because the Argentine government directly negotiated with the IMF and some international banks the creation of stand-by credit lines.

Another source of concern is the possibility that the foreign banks may contribute to increase the concentration of productive activities if they use their resources to supply credit preferentially to large firms, and particularly to foreign firms. It has been documented elsewhere that large banks do discriminate against small and medium-sized firms.<sup>38</sup> On the other hand, most of the large retail banks coming to Brazil are announcing plans to expand credit to that sector. It is still too early to tell which tendency will really prevail.

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<sup>37</sup> See Honohan (1997).

<sup>38</sup> See, for instance, Dymski (1997).

On balance, thus, although the subject demands deeper examination, one cannot simply shrug off concerns about questions of sovereignty. That this point is not irrelevant is probably the reason why so many barriers to the sale of domestic banks to foreigners survive even in the European Union, despite its bylaws outlawing discrimination.

Thus, even if we take as a fact that after four years little has changed, which is not entirely indisputable, it does not mean that it will all be business as usual, the 'Brazilian' way. Worldwide experience with mergers and acquisitions shows that integration of two different financial institutions may be difficult, even if they operate in the same market. Frequently, problems in one bank are underestimated by the acquiring bank, and integration can then take even longer. The US banks, which have been in operation in the country for a longer period, seem to believe that it is actually the case that the foreign, mostly European, banks coming to Brazil are in fact going through the pains of absorbing local institutions and learning the ways of the local markets. The US banks believe that this gives them time to prepare a more organic form of expansion, benefiting from their previous basis in the country. Once the transition is over, we expect to see keener competition as the newly installed banks seek to reach efficient scales of operation, enlarging market shares and intensifying competition. In addition, there are still vague indications of possible 'overinvestment', especially in the fields of asset management. If these indications are true, one should expect even tougher competition to come.

## 5. Conclusion

Opening the domestic banking markets to foreign institutions has been an important element in the liberalization of financial markets everywhere. With the significant exceptions of the US and the UK, practically everywhere, including Western Europe and Japan, foreign banks traditionally had their activities limited to serving the transnational firms headquartered in their country of origin, the citizens of the same country and a few other segments. The presence of foreign

banks in a given economy was not a threat to the domestic banks, no matter how much more efficient the former might eventually be. Therefore, no competitive pressure was really exercised by these banks and no significant effects on the domestic markets were identifiable.

This changed dramatically in the 1990s. In many countries, although not in all, the formal barriers that kept foreign banks away or confined to small segments of the market were dismantled. In some countries, as in Western Europe, the results were not remarkable, apparently due to the survival of informal restrictions on the activities of foreign banks or the strong loyalty of clients to their national banks. In the US, foreign banks can come and go more or less freely, and their share of the domestic market has increased significantly, but they still have to rely on the secondary markets to obtain both deposits and a loan portfolio. Generally, Japanese banks seem to be more cost-efficient than domestic American banks, but less profit-efficient, so it would probably be false to say that competitive pressures from foreign banks are important to shape the domestic US banking market.<sup>39</sup> Thus, as Edey and Hviding (1995) noted, even in the OECD countries the presence of foreign banks is variable but generally small and concentrated in wholesale banking.

In the emerging economies the situation is completely different. Superior cost-efficiency by foreign banks may be overwhelming, especially in relation to the cost of capital. It is less clear how general is also the 'technical' superiority of foreign over local banks, but the former enjoy one particularly important advantage, which is that of being seen by the public as safer than the local banks. In the case of Brazil, where penetration by foreign banks on a large scale only began in the mid-1990s, the impact of foreign competition is not yet felt. Nevertheless, one may hazard a wager that it will be strong. The Brazilian banks have survived a long period of high inflation, and have learned to adapt to new situations very quickly. 'Technical' efficiency and the capacity to copy innovations or develop innovations adapted to local conditions are not likely to make the difference between domestic and foreign banks. Cost of capital advantages, on the other hand, will be a different matter. In any case, one should expect a period of turmoil, as foreign banks try their hand not only at market shares of the domestic banks but, and maybe mainly, at each other's

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<sup>39</sup> Cf. De Young and Nolle (1995).

market shares, since all of them are capable of reaching scales of operations that cannot be accommodated by the local market, even if it is enlarged as the bank managers expect. On the other hand sovereignty issues, including their extra-economic aspects, have to be carefully examined.

In sum, accommodation of potentially large foreign banks that face no regulatory limit on their range of activities any more, in an economy like Brazil's, is likely to become the major factor shaping the operation of the financial system and its efficiency to mediate resources from surplus to deficit units. As economies become more and more integrated, the profile of the financial system emerging from this competition will be an important element in the overall competitiveness of the country's firms.

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