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Expansion Strategies of European Banks to Brazil and their Impacts on the Brazilian Banking Sector

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Abstract:

The paper aims at analyzing the main determinants of the recent wave of European banks to Brazil as well as the expansion strategies of the major European banks in Latin America, including Brazil. The hypothesis of the paper is that the European banks wave can be understood only if we consider both external and internal determinants. External determinants are concerning to the process of banking consolidation in the European financial system under EMU, that has stimulated somehow some banks to expand abroad. Internal determinants are related mainly to the gradual flexibility of the legal restrictions concerning to the presence of foreign banks in Brazilian banking sector, the price stabilization since 1994, the growth potential of Brazilian banking market, etc. The article also evaluates the impacts of the recent entry of European banks in the retail banking market in Brazil. In this particular concern, it shows that foreign entry has affected the national banking market forcing domestic banks to operate more efficiently and also to expand their activities, organically or by acquisitions/mergers. Domestic private banks are still hegemonic in comparison to foreign banks, although relative share of foreign banks has increased a great deal last years.

Key-words: multinational bank, European banks, Brazilian banking sector

Resumo:

Este paper objetiva analisar os principais determinantes da recente onda de bancos europeus para o Brazil, assim como as estratégias de expansão dos maiores bancos europeus na América Latina, incluindo Brasil. A hipótese básica do paper é que a onda de bancos europeus só pode ser entendida ser for considerados tanto os determinantes externos quanto os internos. Determinantes externos referem-se ao processo de consolidação bancária no sistema financeiro europeu no contexto da União Monetária Européia (UME), que tem de alguma

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forma estimulado alguns bancos a se expandirem para o exterior. Determinantes internos, por sua vez, estão relacionados principalmente à gradual flexibilidade nas restrições legais referentes à presença de bancos estrangeiros no setor bancário brasileiro, ao processo de estabilização de preços a partir de 1994, ao potencial de crescimento do mercado bancário brasileiro, etc. O paper também avalia os impactos da recente entrada de bancos europeus no mercado varejista bancário no Brasil. Neste particular, ele mostra que a entrada de bancos estrangeiros tem afetado o mercado bancário nacional, forçando os bancos domésticos a operar de forma mais eficiente e também expandir suas atividades, organicamente ou por fusões e aquisições. Bancos privados nacionais são ainda hegemônicos, embora a participação de bancos estrangeiros tenha crescido substancialmente nos últimos anos.

Palavras-chaves: banco multinacional, bancos europeus e setor bancário brasileiro

1. Introduction

The principal aim of this paper is to analyse the main determinants and impacts of the recent wave of European banks entering Brazil. The main hypothesis of the paper is that European banks wave can be understood only if one considers both external and internal determinants. External determinants concern the process of banking consolidation in the European financial system under EMU that has stimulated some banks to expand abroad. Expanding abroad is not only a source of diversification of earnings for these banks, but also a way to strengthen their position in the European banking market under the pressure of economic and monetary union. Internal determinants are mainly related to the gradual flexibilization of the legal restrictions with respect to the presence of foreign banks in the Brazilian banking sector in the context of the 1995-banking crisis.

The article also evaluates the impacts of the recent entry of European banks into the retail banking market in Brazil. In this particular concern, it shows that foreign entry has affected the national banking sector in Brazil forcing domestic banks to operate more efficiently and also to expand their activities, organically or by mergers and acquisitions. Domestic private banks are still hegemonic compared to foreign banks, although the relative share of foreign banks has increased a great deal in the last few years. They have responded to the more competitive environment by seeking to become more efficient and participating aggressively in the recent acquisitions and mergers wave, particularly in the privatisation of state-controlled banks.

The paper is divided in five sections, besides this introduction. Section 2 examines the process of consolidation in the European banking industry under EMU, with emphasis on the recent process of European banking consolidation. Section 3 analyses the determinants of the expansion strategies of the multinational banks. Section 4 examines the determinants of the expansion of European banks in Brazil, as well as the expansion strategy of the four major European banks in Latin America – BSCH, BBVA, HSBC and ABN-Amro. Section 5 focuses its analysis on the reaction of the three big domestic private banks – Bradesco, Itau and Unibanco to recent entry of foreign banks into the Brazilian banking market. A final section summarises the arguments and concludes.

2. Consolidation in the European banking industry

The Single Market Programme and European Monetary Union (EMU) may be seen as reducing the efficiency barriers to cross-border consolidation within the European Union (EU) and within the subset of nations participating in monetary union, respectively. Indeed, these policies can reduce or eliminate differences in currency, regulatory/supervisory structures, and explicit rules against foreign competitors from other EU nations, which should make it easier and less costly for financial institutions to operate across international borders within the EU (Berger et al, 2000a, p.9). The Single Market Act[1] created, in theory, the same opportunities for merger activity and bank concentration that occurred recently in the United States.

In particular, the new currency – euro - may play an important role in the EMU area by reinforcing the factors that have been driving the consolidation process in the banking sector. The adoption of a single currency is likely to increase banking competition further by reducing entry barriers, lowering currency risk (reducing the currency conversion costs of institutions operating in multiple countries), and reducing costs to consumers of purchasing services from foreign institutions. Since it lifted the economic barriers to cross-border supply of financial services within the single currency area, it has the potential to expand the scope for growth and diversification for the banks of the bloc. Thus, the adoption of the euro can reinforce the incentive to create institutions capable of competing effectively on a pan-European scale for corporate banking business. Its influence has strengthened the trend towards larger institutions that would be able to reap the full benefits of greater economies of scale brought by both increases in the scale of production and by technological progress (BIS, 2000, p. 134).

As an overall view of the banking consolidation[2] in the EU over the last decade, we stress below some features of this process (Belaisch et al, 2001, and Molyneux, 2000):

- There has been an overall fall in the quantity of credit institutions in most EU Members: all countries, apart from Portugal, have experienced a decline in the number of banks since the late 1980s. This decline in most countries can be attributed to M&As, but other forms of market exit – such as liquidation – may also have contributed to the decline.
- A common trend cannot be identified in terms of number of branches, but in many of the largest banking markets (Germany, Italy and Spain) branches network increased during the 1990s. On the other hand, the number of employees declined from 1995 to 1999, particularly in Finland and UK.
- Market concentration increased in most of European countries and in the smaller countries banking systems the five-firm assets ratio typically exceeded 50% whether measured by total assets, total loans, and total deposits. Consequently, the degree of concentration at the top is particularly striking in the smaller euro countries[3], where now just a handful of banks dominate the banking sector[4].
- Although individual euro area countries' banking systems are becoming more concentrated in consequence of mergers of large institutions, the

[1] The Single European Act was implemented in February 1992 creating a single economic marketplace stretching across the EU. The Second Banking Co-ordination Directive, implemented in 1993-94, liberalized the trade of financial services across EU border and introduced banking licence valid throughout the EU.

[2] Consolidation means a merger or an acquisition, whether within a sector or across sector, a process that in general reduces the number of institutions and increases the degree of concentration.

[3] The exceptions are Ireland, Austria and Luxembourg.

[4] According to data from Belaisch et al (2001, p.16), top five banks have the following market share (in percent of total assets in banking sector) in 1998: 69.5% in Spain; 51.5% in Austria; 89.7% in Belgium; 69.3% in Ireland; and, 63.3% in Netherlands.

concentration remains in domestic hands. Foreign bank shares within domestic markets are low within the four largest euro area economies[5]. They are only significant in Belgium, Ireland and Luxembourg where the market share of subsidiaries of foreign credit institutions as a percentage of the total assets in the end of 1997 was 36.3%, 53.6% and 94.6%, respectively.

- Consolidation has accelerated recently at the top of the banking sector, since more than half of the 30 largest euro area banks are the result of recent mergers and the average size of the top five has doubled since 1995. As a result, the average size of top 30 euro area banking groups jumped from US$ 114,9 billion in 1990 to US$ 321,0 billion in 1999 (Belaisch et al, 2001, p. 15). Thus, M&As are changing sharply the structure of the European banking sector.
- There was a decline in net interest margins – the difference between banks revenues from lending and the remuneration of banks deposits - in virtually every European banking system, possibly as a result of the increasing competitive pressures on banking sector. De-regulation of the financial services industry in euro area over the last 15 years has considerably increased competition in banking sector and reduced the role of traditional intermediation activities as the principal source of income for banks. Indeed, between 1992 and 1998, net interest margin in euro area (average) has declined from 2.0 to 1.5% of banks' assets (Idem, 2001, p.22).
- Consequently, banks have increasingly focused on non-interest income sources of earnings, replacing likely interest earnings on most banks' income statements. In UK, Austria, Finland, France and Sweden above or approaching 40% of banking system gross income was derived from non-interest income sources in 1996, while in Germany and Norway between 20-25% of gross income came from sources of non-interest income, since these countries have a more powerful tradition of banks advancing credit to industry and customers (Molyneux, 2000, p.6).
- In the majority of European countries the overall tendency in bank efficiency has been downwards, with the exception of Denmark, Finland, Sweden, Switzerland and United Kingdom. In other words, operating costs remain high in European Economic Area.
- The profitability of the banking sector in EU countries presents a mixed picture although in the majority of countries returns have improved, in spite of the decline in bank efficiency. The development of non-interest income activities may have had a positive effect on bank's performance, although profitability remains generally lower than in the United States.

Therefore, the banking consolidation's tendency has resulted in the increase of concentration levels in the European Economic Area. As a result of intensified competition, the pace of financial consolidation in Europe has recently accelerated,

[5] Foreign bank shares within domestic markets (total assets criteria) were in the end-1997, 4.3% in Germany, 9.8% in France, 6.8% in Italy, and 11.7% in Spain (Idem, 2001, p.17),

probably in anticipation of the introduction of the new currency. The driving forces of the process of consolidation in the EU include, among others, information technology, desintermediation and the integration of international capital markets, where the creation of a single currency plays an essential role.

As it can be seen in the Table 1, financial mergers and acquisitions (M&As) have not been restricted to banking industry lines, but often cross banking lines. In particular, banks have purchased insurance companies, presumably due to the popularity of bancassurance and the absence of legal barriers. However, banking institutions have expanded more actively into other sectors of financial industry than did other financial institutions into the banking business[6]. *It also can be seen that mergers and acquisitions remain to a greater extent confined within national borders*, contrasting with the small volume of businesses involving two euro countries. Therefore, there has been expressive domestic consolidation for banking institutions as well as expressive M&A activity involving securities and insurance firms in EU countries, but little intra-EU consolidation. Current cross-border activity mostly has taken the form of strategic alliances, often reinforced by the acquisition of minority, non-controlling stakes, as illustrated by the alliance between BSCH and Royal Bank of Scotland. Thus, consolidation in the European Economic Area, especially at the retail level, has predominantly prevailed within a national context rather than across borders.

TABLE 1

Merger and acquisition activity in the euro area financial industry, 1998-2000 (1) – US$ million

	Same country	Other euro country	Other non-euro country	Total	As a percentage (2)
Banks - banks					
1998	8445	147	13787	22379	13.0
1999	41242	9465	7495	58202	34.2
2000 (3)	4528	0	11654	16182	62.0
Banks - non-bank financial					
1998	28604	646	897	31147	37.9
1999	20816	800	4130	25746	56.4
2000 (3)	4768	1631	653	7052	39.1
Non-bank financial - non-bank financial					
1998	7299	7974	1201	16474	13.8
1999	15508	378	21888	37774	40.7
2000 (3)	5071	9	454	5534	18.8

Source: BIS (2000, p. 134).

(1) Either acquirer or target company is resident in the euro area

(2) Of mergers and acquisitions in all countries.

(3) 1 January to 10 April.

Indeed, it seems that there are some impediments to mergers and acquisitions within the European Union, and incentives for such activity outside the

[6] As European Central Bank (2000, p.14) states, "this may be due to the barriers to entry, historically, being higher in banking than in insurance. It may also be due to the fact that in many Member States the banking industry is far more developed and larger than the insurance industry".

region. One of these incentives is the absence of a single regulatory agency in the EU. This has limited the benefits of expanding areas of activity across borders and, at the same time, has prevented European banks from engaging in the diversification of earnings and reduction of regulatory capital, practised in the US. Although the Single Market Act and the various European commission banking and financial directives should have created some uniformity, difficulties have arisen and hampered cross border operations. There are multiple supervisory agencies within countries and no co-ordinating agency or single bank regulatory agency for the entire euro area[7] (Kregel, 2001). A different but not incompatible explanation for the fact that cross-border expansion has been rare and that consolidation has been primarily observed within national borders is that some individual European governments have very often refused the entry of other EU banks. According to Belaisch et al (2001, p. 12), “some commentators have interpreted the governments’ guidance as an apparent desire to limit foreign ownership of some influential institutions and to create a few ‘national champions’ in each country to compete in the European and global marketplace”.

Going back to Table 1, one can observe that, in terms of value, M&As embracing others non-euro countries increased a great deal in the last few years. Since valuations of emerging countries are much cheaper than European banks’ valuations, one should consider that these magnitudes are even more relevant. Therefore, there is some evidence of the increasing importance of the acquisitions outside euro borders in the strategy of some European banking groups. Particularly important has been the geographic expansion into emerging markets like Latin America and Southeast Asia and, to a lesser extent, Central and Eastern Europe. To some degree, expansion has occurred into the emerging countries with which EU banks have had historical connections, as seems to be the case of Spanish, Italian and Portuguese banks in Latin America. For those banks that are expanding overseas to increase abroad is not only a source of diversification of earnings but also a means to prepare themselves for the competition environment in the euro area.

3. Expansion strategies of multinational banks

The pace of cross-border consolidation of financial institutions has increased over the last few years, and has recently reached the retail banking market. For the purpose of this section, the relevant question is: *Why do banks headquartered in particular countries set up branches or subsidiaries in foreign countries?*

The literature of the 1970s and 1980s (Grubel, 1977; Aliber, 1984), generally speaking, built a theory of international banking heavily based on the theory of direct foreign investment in manufacturing, advanced by Kindleberger, Vernon and others. According to this explanation, multinational banks must have some comparative advantages. The basic idea is that multinational banking grows in parallel with direct foreign investment as banks try to meet the demand for banking

[7] Indeed, as Belaisch et al (2001, p. 56) states, “the current banking supervisory structure in the euro area is organized along national lines and, as a result of the introduction of the euro, the geographic domain of monetary policy no longer coincides with that of prudential supervision”.

services of these firms overseas. This bank behaviour of moving abroad is seen as a defensive attitude necessary to assure the continued business with the domestic parents of foreign subsidiaries so that the existing flow of information resulting from the bank-client relationship would not be pre-empted by a competitor bank. Secondarily, multinational service banks also do some business with local and wealthy individuals by offering them specialised services and information required for trade and capital market dealings with their native countries.

The explanation for the motives why a bank expands abroad can be interpreted in price-theoretic terms: "The continuous commercial contacts between the bank and manufacturing firm permit the bank to have access to information about the firm's financial conditions at such a low cost and high speed that it is in a better position than any other competitor to evaluate and respond to the firm's demand for loans". So, "the ability to draw on the information and personal contacts between the bank's and manufacturing firm's parents in a [foreign country] at very low marginal cost represents the main source of comparative advantage that the bank's foreign branch has in dealing with the firm's subsidiary abroad in competition with the local banks" (Grubel, 1977, pp. 352-3). From this point of view, we can conclude that internalisation of information is considered the principal advantage of a multinational bank.

Historically, as stressed by Focarelli and Pozzolo (2000, p.1, italics added), "the pattern of bank international shareholdings followed that of the economic integration between countries: banks extended their activities abroad in order to provide services to their home-country clients in international transactions; afterwards, with a growing understanding of the foreign market (in particular of regulatory and institutional aspects) and a developed network of relationships with local financial institutions, some banks were induced to increase the range of their operations and provide services to the local population too. Although this account is likely to be accurate in general (…) *today the actual pattern of bank international shareholdings depends on a wider range of factors than just the overall degree of economic integration between countries*". In particular, Grubel's theory of internalisation cannot be applied in retail banking market, since the majority of customers of foreign banks in this case have no previous connection with the bank in its native country.

The recent wave of banking internationalisation, therefore, is characterised not only by financial institutions following their existing relationships, but also (and increasingly) by global banks seeking to widen their activities in the financial markets of the host-country mainly through the acquisition of majority, controlling stakes, or acquisition of minority, non-controlling stakes. Thus, the present strategy of global, universal banks is aimed at diversifying their activities into some domestic markets through a network of branches and greater integration in the local market, while in the past banks strategies were geared mainly to serving their home-country (corporate) customers, and also to giving some support to domestic firms to access the international financial market. Such a new strategy has been, to a larger extent, stimulated by the gradual flexibility or even in some cases by the abolition of the legal restrictions with respect to the presence of multinational banks in local markets, both in developed and developing countries (Freitas, 1999).

There are few recent works that tries to establish a pattern of expansion for the recent wave of banking internationalisation[8]. One of the most common explanations is related to the effects of the increase in banking competition caused by financial deregulation. As margins and fees tighten in domestic financial services area, financial firms seek to expand overseas to generate higher returns. Thus, with banks' net interest margins under downward pressure due to the increase of the banking competition, and as the big financial institutions are in general based in mature economies, that is with low potential for growth, some banks are seeking to diversify geographically their activities for markets with potential for growth and/or with greater net interest margins. Generally speaking, banking internationalisation results from the tendency towards an increase in the minimum scale necessary for a bank to remain competitive in order to enhance its ability to generate profits. Another explanation is that there are potential risk-reduction gains from diversification of income from multiple products, client groups and geographies in multi-activity financial services organisations, and these gains increase with the number of activities undertaken.

Overall, the empirical evidence in the literature (Deminguc-Kunt and Huizinga, 1998; Claessens et al, 1998) shows that foreign financial institutions are *less* efficient than domestic institutions in developed countries. To analyse this statement, Berger et al (2000b) examined two hypotheses:

(a) *home field advantage hypothesis*, under which domestic institutions are generally more efficient than institutions from foreign nations; the advantage is in part due to organizational diseconomies to operating (for instance, turf battles between staff in different nations) or monitoring an institution from a distance (it can be difficult to evaluate the behaviour and effort of managers in a distant market), or as consequence of other barriers, including differences in language, culture, currency, regulatory/supervisory structures or explicit or implicit barriers against foreign institutions;

(b) *global advantage hypothesis*, under which some efficiently managed foreign institutions are able to overcome the cross-border disadvantages and operate more efficiently than the domestic institutions in other nations, as they have higher efficiency when operating in other nations by spreading their superior managerial skills or best-practice policies and procedures over more resources, lowering costs, or can obtain diversification of risks that allows them to undertake higher expected return investments.

Testing these hypotheses in five countries (France, Germany, Spain, UK, and the US) during the 1990s, Berger et al (2000b) show evidence in favour of *a limited form of global advantage hypothesis* in which only efficient institutions in one or a limited number of nations with specific favourable market or regulatory/supervisory conditions in their home countries can operate more efficiently than domestic institutions in other nations. A statistical study made by Focarelli and Pozzolo (2000) shows in the same connection that banks with cross-border shareholdings are larger and have headquarters in countries with a more developed and efficient market. *Banks operating in countries where banking sector*

[8] There are some few exceptions, such as Berger et al (2000b), and Focarelli & Pozzolo (2000).

is larger and more profitable should be able to export a superior skill and are therefore more likely to expand their activities abroad. In particular, local market opportunities - that combines higher expected rate of economic growth, the more stable economic conditions and the bank's inefficiency in the destination country - are the main determinants of the bank's decision to expand abroad. Banks prefer to invest in countries where expected profits are larger, owing to higher expected economic growth and the prospect of reducing local banks' inefficiency.

4. Expansion strategy of the European banks in Latin America and Brazil

4.1. Determinants of the European bank's expansion strategies in Latin America and Brazil

From the former section one can extract, that both from a historical-empirical and a theoretical-analytical point of view there are strong reasons to believe that the process of consolidation in banking industry is an international phenomenon, as a result of financial deregulation and technological changes. The new phase of banking internationalisation is a consequence of this process, with financial institutions seeking to diversify their activities, in terms of products and services, and/or geographically, and increase their minimum scale of operations to remain competitive and to enhance their ability to generate profits.

Indeed, banking consolidation has recently accelerated in banking industry in emerging market economies, changing a traditionally highly protected industry. In this connection, Hawkins and Mihaljek (2001, p. 3) states that "global market and technology developments, macroeconomic pressures and banking crises in the 1990s have forced the banking industry and the regulators to change the old way of doing business, and to deregulate the banking industry at the national level and open up financial markets to foreign competition. (…) These changes have significantly increased competitive pressures on banks in the emerging economies and have led to deep changes in the structure of the banking industry".

Latin America – including Brazil received one of the biggest influxes of foreign direct investment (FDI) in the banking sector during the 1990s. However, one cannot understand the wave of bank FDI isolated from the general movement of FDI to Latin America during the nineties. Indeed, the Latin America and Caribbean region received record levels of FDI in the nineties, with inflows totalling US$ 76,7 billion only in 1998, an amount that corresponded to around 41% of total FDI flows to developing countries. On the other hand, 42% of these inflows were concentrated in a single country, Brazil - the biggest country of the region and since 1996 the leading Latin American FDI recipient and the second-largest destination for FDI among developing countries (ECLAC, 2000, p.35-6)[9].

Some of the main determinants of the expansion of European banks in Latin America can be summarised as follows:

[9] During the nineties, as a result of the implementation of policies that aimed at stabilising the economy (the Real Plan), the wide-ranging liberalisation process which has opened up previously restricted activities to foreign investors, the regional integration policies and extensive privatisations, net FDI inflows to Brazil grew from less than US$ 2 billion in the period 1990-1994 to over US$ 30 billion in the last two years of the decade (ECLAC, 2001, p.25).

- *The process of restructuring of the banking sector under European economic and monetary union*. For some European banks expanding abroad is not only a source of earnings diversification, but also a way of strengthening their position in European banking market considering the increasing market competition in banking in the European Economic Area. The European bank's strategy for Latin America may be interpreted as a response to this more competitive environment, in which several factors were eroding income from traditional banking business. Further, due to political and regulatory constraints, there are some impediments to M&As within EU countries, but incentives to such activity outside the bloc. The preference for Latin America, and to a lesser degree Central and Eastern Europe, is partially because during the second-half of nineties Southeast Asia was in crisis, and Indian and Chinese financial system have been closed to foreign banks, leaving Argentina, Brazil and Mexico as the main big emerging markets open to FDI in bank sector.
- *In particular, the dynamics of the internationalisation of the Spanish banks* since they have been the main protagonists in the recent wave of foreign banks entering Latin America. These banks pursued growth strategies based on M&As in their natural market before they launched their international growth strategy[10]. So, they already were 'mature' banks when they decided to expand overseas. Indeed, with the implementation of EMU and the perspective of introduction of the euro, the larger Spanish banks – in particular, Banco Bilbao Vizcaya (BBV), Banco Santander and Banco Central Hispanico (BCH) had to look beyond their natural borders in search of global markets, in order to maintain their competitive position and to defend themselves from the threat of hostile bids by either local and foreign competitors. At the initial stages of this process there was a proliferation of alliances and co-operation agreements with other financial institutions, chiefly within the European Union, while the second phase has involved a fast-paced, aggressive expansion strategy aimed at the main Latin American markets (ECLAC, 2000, p.159)[11].
- *The deregulation process in Latin America, in the broader context of economic and political reforms, since early 1990s,* made room for the entry of foreign companies into key economic sectors, such as banking, telecommunications and utilities. Bank privatisation programmes in general formed part of longer-term public sector reforms, which also involved privatisation of major public enterprises with the aim of consolidating the public finances and cutting borrowing requirements (Hawkins and Mihaljek, 2001, p. 13).

[10] The expansion of Spanish banks to Latin America must also be seen in a broader context in which, after a period of structural changes in the Spanish economy driven partly by the process of privatisation of state-firms, the major Spanish service firms (transport, telecommunications, energy and financial services) decided to expand abroad.

[11] For an analysis of the expansion strategy of Spanish banks to Latin America, ECLAC (2000, Ch 3), Sebastian & Hernansanz (2000), Calderon & Casilda (2000), and Guillen & Tschoegl (2000).

- *The growth potential of banking market in Latin America is much bigger that in Europe's mature banking market*. The size of the financial system in terms of the ratio of M3 to GDP is only 28% in Latin America, while in the euro area it is 77% and in the US 71% (Sebastian and Hernansanz, 2000, p.18).
- *The Latin American banking sector offers much better prospects for increasing returns to financial institutions*, since the intermediation margins with which banks operate in these countries are considerably higher than in the developed world. While the domestic banks' average margin on assets (net interest income over total assets) in Latin America was 5.76% for the period 1988-95 (in Brazil it was 6.6% and Argentina 9.9%), in OECD's countries it was 2.80% for the same period (Claessens et al, 1998, p.26).
- *The potential gains in efficiency are high in Latin America*, since the degree of banking efficiency is in general lower than that in developed countries. The domestic banks' ratio of operating costs to assets in Latin America was on average 5.5% in 1992-1997, while it was 1.7% in G3's countries (US, Japan and Germany), 1.6% in East Asia and 4.1% in Central Europe, in the same period (Hawkins and Mihaljek, 2001, p.6)[12].

In the case of Brazil, internal determinants of the recent penetration of foreign banks are related mainly to the more stable economic conditions, with price stabilisation since 1994 which changed the long-term business landscape in Brazil, the higher expected rates of economic growth, and the growth potential of the banking market. Besides, since the early 1990s, the Brazilian economy has been undergoing a wide-ranging liberalisation process, which has opened up previously restricted activities to foreign investors. In this context, the recent entry of foreign banks is related to the gradual flexibility of the legal restrictions concerning the presence of foreign banks in the Brazilian banking sector. Article 52 of the Transitory Dispositions Act of the Constitution of 1988 prohibits, until regulated by complementary law, the installation of new agencies for foreign financial institutions and the increase of shares in the capital of financial institutions based in the country. However, the Constitution of 1988 kept open the possibility of foreign institutions having access to the domestic market, since article 52 also established that such restrictions did not apply to the authorisations resulting from international agreements, reciprocity, or decisions made in the Brazilian government's interest.

A particularly important change occurred in 1995, when a banking crisis resulted from the tightening monetary policy and rising interest rates in response to the effects of the Mexican crisis of 1994-95. According to Carvalho (2000, p. 148), "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 larger number of them under the control of the central bank, without compromising, it seemed, long-term possibilities for the industry. In a report dated December 1998, the

[12] The high operating cost (as well as high interest rate spreads) of domestic banks in Latin America are in large part the legacy of the high-inflation period of the 1980s and the early 1990s, when inflationary revenues generated easy profits for the banks and, consequently, there was little pressure to cut costs.

central bank of Brazil identified 104 financial institutions as going through some kind of 'adjustment' between the launching of the Real Plan and that date".

In this context, the Brazilian government allowed the entry of some foreign to acquire some problematic banks – such as Economico-Excel and Bamerindus - and also to strength the national banking sector. The Legislative Intent ('Exposicao de Motivos') no. 311, from 23/8/95, allowed the President to authorise on a case-by-case basis the entrance of foreign banks into Brazil. In that occasion, Brazilian government announced that foreign banks would not be allowed to open new branches or acquire smaller banks unless they purchased one of the troubled banks. The norms establishes that the entrance of foreign banks interest the country, and emphasises the following favourable aspects: (i) improvement in operational efficiency of the banking sector with positive effects on bank intermediation; (ii) increase in banking competition would cause a reduction in the spreads and banking fees, with positive impacts on the loans rate of interest; (iii) diversify and improve supply of financial services with lowest costs; (iv) introduction of new management technologies and innovations in products and services.

Thus, as a result of the greater flexibility in the regulatory framework concerning the entry of foreign banks, the Brazilian government permitted the entrance of a great number of foreign banks, going in the direction of the international tendency of expanding financial conglomerates that are looking for new markets for their businesses. The changes in the regulatory framework concerning foreign banks, the programme of privatisation of state-owned banks, the price stabilisation since 1994, the growing potential of Brazilian retail banking market, the development – still infant – of pension funds and securities market in Brazil, the increasing integration of the Brazilian economy into commercial and financial flows, taken together, have attracted foreign capital to the Brazilian banking sector.

4.2. Recent European banks wave in Brazil

The recent wave of mergers and acquisitions (M&As) in banking sector in Brazil involved, first, mainly the purchase of failing banks by prosperous ones, as typically are the cases of acquisition of Nacional by Unibanco, Economico by Excel, and Bamerindus by HSBC. Furthermore, and increasingly, bank take-overs embraced a strong bidder and sometimes a weak, but not yet insolvent, target, such as the acquisition of BCN by Bradesco and Noroeste by Santander.

The recent wave of mergers and acquisitions (M&As) in the banking sector in Brazil involved, first, the purchase of failing banks by prosperous ones, typified by the acquisition of Nacional by Unibanco, Economico by Excel, and Bamerindus by HSBC. Furthermore, and increasingly, bank take-overs embraced a strong bidder and sometimes a weak, but not yet insolvent, target, such as the acquisition of BCN by Bradesco, Noroeste by Santander, and Real by ABN-Amro.

Table 2 lists M&As in the Brazilian banking sector during the period 1995-2000. The table shows that:

a) Foreign banks dominated acquisitions, with the obvious predominance of European banks. Unlike in neighbouring Argentina, where foreign bank acquisitions included two of the largest three private banks, foreign acquisitions in Brazil mainly involved medium-sized banks. This partly reflects the fact that market capitalisation of the very largest banks has proven prohibitive.

b) The principal foreign acquisitions, in terms of size, were the purchase of Bamerindus by HSBC, that was paradigmatic since it embraced for the first time a big domestic retail bank, Excel-Economico by BBVA, America do Sul by Sudameris, Banco Noroeste by Santander, Banco Real by ABN-Amro, and Banespa by BSCH. The last case was the biggest acquisition of recent years in Brazil, since it involved the purchase of a bank with assets worth around US$ 15 billion. It allowed that Banco Santander do Brasil jumped the ranking of banks to become the third largest private bank in Brazil and the fifth major bank in the global ranking, including state-owned banks. Banespa's acquisition was a sort of 'turning point' in the history of BSCH in Brazil, since prior to the Banespa acquisition in November 2000, Santander do Brasil's relatively modest investments in Meridional and the prestigious investment bank Bozano, Simonsen left the group still locked out of the market elite at number 7 in the banking industry[13].

c) The big American banks already established in Brazil - Citibank and Bank Boston –, have not participated of the wave of M&As in Brazil, and opted to grow organically in the Brazilian banking market, where they traditionally have focused their activities on a smaller and more selective clientele[14]. The recent strategy of these banks in Brazil has been to increase their customer base, including segments of the middle class and medium-sized firms. BankBoston sought to perform in a more selected segment of the retail market, with monthly income over R$ 4,000.00, while Citibank sought to augment its customer base including low segments of the middle class, with monthly income over R$ 1,000.00, as well as firms with annual revenues over R$ 5 million. The timid presence of American banks in the recent wave of M&As in Brazil can be partly explained by the fact that they obtained good profitability with the offer of new products in their own domestic market (United States), where could expand geographically within the country due to the deregulation of the financial system.

[13] The Grupo Financeiro Meridional, that included Banco Meridional and Bozano, Simonsen, was bought by BSCH for close to US$ 1 billion, while Banespa was bought for US$ 3.7 billion, a sum five times higher than its book value.

[14] BankBoston and mainly Citibank's recent acquisitions of local banks or branches in Latin America suggest that banks' strategies may be changing.

TABLE 2
Main M&As in the Brazilian banking sector - 1995-2000

Year	Acquirer	Origin of acquirer	Institution acquired
	BSCH	Spain	Banespa
2000	Itau	Brazil	Banestado
	Bradesco	Brazil	Boavista
	Unibanco	Brazil	Bandeirantes/Credibanco
	BSCH	Spain	Meridional/Bozano Simonsen
1999	Bradesco	Brazil	Banco do Estado da Bahia (Baneb)
	Bradesco/BCN	Brazil	Pontual
1998	ABN-Amro	Netherlands	Banco Real
	ABN-Amro	Netherlands	Banco do Estado de Pernambuco
	Itau	Brazil	Bemge
	Unibanco	Brazil	Dibens
	Sudameris (Intesa/Credit Agricole)	Italy/France/Brazil	America do Sul
	Chase Manhattan	United States	Patrimonio
	Bradesco	Brazil	Pontual
	GE Capital	United States	Banco Mappin
	CSFB	Switzerland	Banco Garantia
	BBVA	Spain	Excel-Economico
	Caixa Geral de Depositos	Portugal	Bandeirantes
1997	Santander	Spain	Banco Noroeste
	Banco Interatlantico	Portugal/France	Boavista
	Santander	Spain	Banco Geral de Comércio
	Itaú	Brazil	Banerj
	Bradesco	Brazil	BCN/Credireal
	HSBC	United Kingdom	Bamerindus
	Bozano Simonsen	Brazil	Meridional do Brasil
	Swiss Bank Corporation	Switzerland	Omega
	Robert Fleming	United Kingdom	Graphus
	NationsBank	United States	Liberal
	American Express	United States	SRL
	Banco de Crédito Nacional (BCN)	Brazil	Credireal
	Mellon Bank	United States	Brascan
	Llyods	United Kingdom	Multiplic/Losango
	Unibanco	Brazil	Fininvest (50%)
	Icatu	Brazil	Fininvest (50%)
	HSBC	United Kingdom	Bamerindus
1996	Banco de Credito Nacional	Brazil	Itamarati
	Cindam	Brazil	Fonte
	Banque Nacional de Paris	France	Banco Comercial de Sao Paulo
	BBA Creditanstalt	Austria	Financiadora Mappin
	Itaú	Brazil	Banco Frances e Brasileiro
	Itamarati	Brazil	Crefisul
	Excel	Brazil	Economico
	Sudameris Brasil	Italy/France/Brazil	Financeiro&Industrial de Investimento
1995	Unibanco	Brazil	Nacional
	Pontual	Brazil	Digibanco

Source: Own elaboration with information from Chase Manhattan (2000) and Central Bank of Brazil.

d) The three major domestic private banks – Bradesco, Itau and Unibanco – have reacted to the penetration of foreign banks, participating actively in the process of mergers and acquisitions, with some important purchases, such as Nacional by Unibanco, BCN/Credireal by Bradesco, Banerj by Itau and Bandeirantes by Unibanco. Particularly important has been the participation of Itaú in the purchase of state banks, such as Banestado (Parana), Banerj (Rio) and Bemge (Minas Gerais). In the case of Unibanco and Itau – both smaller than Bradesco, the largest private bank - their behaviour took partly the form of a defensive reaction, since they tried to maintain their market share and leadership in the banking market, using acquisitions/mergers in order to avoid take-overs.

The growing presence of foreign banks in Brazil is confirmed by the available data. In terms of market share, banks controlled by foreign financial groups have raised their stake from 7.2% in 1994 and 12.8% in 1997 to 27.4% in 2000 of the total of the assets in the banking sector in just six years, while the participation of all other segments[15], specially state-owned banks, declines (Table 3). The increase of foreign banks in Brazil occurred, to a greater extent, on domestic private banks and, to a lesser extent, on state and federal-owned banks[16]. Although there is a declining trend in the relative share in the segment of the public banks (both state and federal ones), including the two 'giants', Caixa Economica Federal and Banco do Brasil, their relative share is still highest with 36.6% of total assets by end-2000, followed step-by-step by domestic private banks (35.2%). On the other hand, the major domestic private banks in Brazil have increased their market share in the banking sector via M&As of state and private-banks and, to some extent, by organic growth. Consequently, the market share in the banking sector (total of assets of both public and private banks) of the top 4 domestic private banks – Bradesco, Itau, Unibanco and Safra - increased from 23.7% in 1999 to 27.6% in 2000, a significant increase of 3.9 percentage points in their market share in just one year, according to data from Central Bank of Brazil.

Figure 1 shows that among the twelve biggest private banks in Brazil, seven banks are foreign owned, including five top European banks – HSBC, ABN-Amro, Santander (BSCH), Sudameris, and BBV Banco (BBVA) – and two American banks – Citibank and BankBoston, respectively from the groups Citicorp and FleetBoston. The top 12 private bank concentrate around 40% of total banking assets (including federal and state-owned banks) and 78.3% of the total of assets of the private banking sector by end-2000. In December 2000, the five big domestic private banks together (Bradesco, Itau, Unibanco, Safra and BBA) had 45.2% of private banks' total assets, while the seven big foreign banks had 33.1%. Therefore, domestic private banks still dominate the private banking sector in Brazil, although foreign banks have now an important presence in the Brazilian market. Santander, in particular, after the purchase of Banespa, in November

[15] With the exception of the credit co-operatives, which market share is negligible.

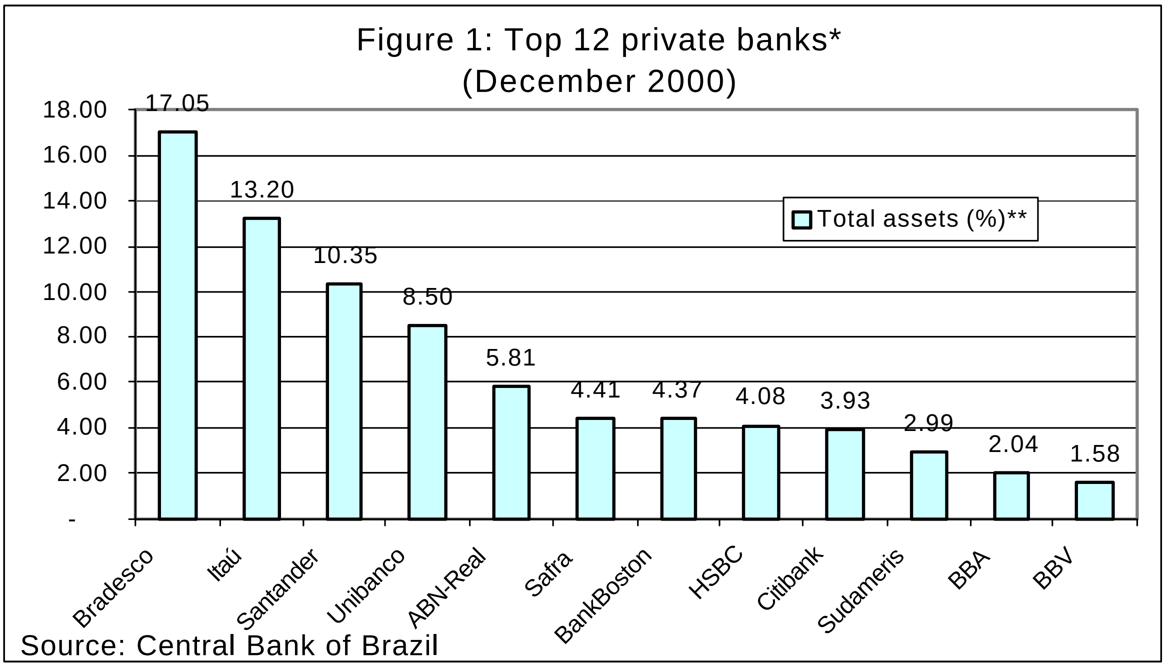
[16] We are considering in this section 'state banks' as banks whose main owners are the government of Brazilian states, and 'federal banks', the banks whose main owner is the federal government.

2000, became the biggest foreign bank in Brazil and the third largest private bank, after Bradesco and Banco Itau.

TABLE 3
Market share of the banking sector in Brazil (total assets), 1993-1999 (%)

Institution	1993	1994	1995	1996	1997	1998	1999	2000
Banks with foreign control	8.35	7.16	8.39	9.79	12.82	18.38	23.19	27.4
Domestic private banks	40.67	41.21	39.16	39	36.76	35.29	33.11	35.2
Public banks (+Caixa estadual)*	13.41	18.17	21.9	21.92	19.06	11.37	10.23	5.6
Caixa Economica Federal	14.51	14.98	16.4	16.47	16.57	17.02	17.06	15.4
Banco do Brasil	22.93	18.28	13.91	12.52	14.42	17.44	15.7	15.6
Credit cooperatives	0.13	0.2	0.24	0.3	0.37	0.5	0.7	0.8
Banking sector	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Brazil
(*) Excluding the two big federal banks: Caixa Economica Federal and Banco do Brasil.



(*) Data include all the banks of each financial conglomerate.
(**) Total assets include only private banks.

4.3. Expansion strategies of the major European banks

As we have seen in section 3, Grubel's theory of internalisation does not apply to the recent wave of multinational banks expansion to retail banking market in emerging countries. Indeed, this is the case of the European banks – BSCH, BBVA, HSBC and ABN-Amro – that expanded to Brazil during the nineties buying local banks, since most of their customers are Brazilian ones, that is, they do not have any previous connection with parents firms from the same country of the banking group

According to Focarelli and Pozzolo (2000), banks operating in countries where the banking sector is larger and more profitable should be able to export a superior skill and are therefore more likely to expand their activities abroad. Indeed, all the biggest European banks in Latin America – BSCH, BBVA, HSBC and ABN-Amro – recently increased their market share in their domestic markets via mergers and acquisitions, attaining top (or important) positions in these markets[17]. Expanding abroad is not only a source of earnings diversification for these banks, but also a way to strengthen their position in the European banking market under the competitive pressure of economic and monetary union.

There are some common and some distinct features in the strategies of the biggest European banks in Latin America. One obvious common feature is that all of the top 4 are big universal banks that choose to invest abroad as a strategy to expand their activities. In 1997, overseas income represented more than 35.0% of the total revenues of these banks (Nellis et al, 2000, p.57), and this relative share increased in the case of the Spanish banks, because of their recent acquisitions in Latin America.

[17] To mention only the more recent and important M&As involving these banks, HSBC bought Midland in 1992, lifting the group's total assets from £ 86 billion in 1991 to over £ 170 billion in 1992, creating one of the largest financial organisations of its kind in the world; ABN mergered with AMRO in 1991 and got the leadership in banking market in Netherlands; Santander mergered with Banco Central Hispanico (a former merger between Banco Central and Hispanico) in 1999, becoming the largest Spanish financial group; afterwards, BBV (a former merger between Bilbao and Vizcaya) mergered with Argentaria, forming the second largest Spanish financial group. Consequently, the Spanish banking sector became one of the most highly concentrated in Europe, forming a sort of duopoly, with the market share of the two major institutions growing from 33% in 1987 to 50% in 1996 (ECLAC, 2000, p.158), and increasing even more after the recent mergers.

TABLE 4

Biggest foreign banks in Latin America by assets (Sept. 2000) – USD million

Bank	Origin	Argentina	Brazil	Mexico	Chile	Colombia	Venezuela	TOTAL	%
BSCH*	Spain	26,130	28,682	20,100	30,200	1,376	2,556	109,044	33.99
Citibank**	USA	10,429	8,798	42,590	6,350	1,137	686	69,990	21.81
BBVA	Spain	9,174	5,004	37,300	4,900	2,811	3,700	62,889	19.60
BankBoston	USA	11,350	9,315	358	6,800	108		27,931	8.71
HSBC	UK	5,016	9,126	15,202				29,344	9.15
ABN-Amro	Netherlands	2,801	15,581	154	2,900	110	95	21,641	6.75
TOTAL		64,900	76,506	115,704	51,150	5,542	7,037	320,839	100.00

Source: Own elaboration with data from Sebastian and Hernansanz(2000, p.37); Banco Santander(Banespa-Brazil); and Gazeta Mecantil(Banacci-Mexico)

Notes: (*) Including Banespa, with data from November 2000

(**) Including Banacci, with data from December 2000

All these financial groups are seeking to expand their activities in Europe, as is the case of HSBC in France[18], and ABN-Amro in Italy. They are also present in other Latin American countries, but this presence is uneven, as one can see in Table 4. The total assets of the 20 largest foreign banks in the region is highly concentrated in just three banks - BSCH, Citibank and BBVA – which accounted for 44.8% of total assets of foreign banks in Latin America in 1998 (ECLAC, 2000, p. 61). Interestingly, these are among the few banks in the world to have achieved top positions outside their natural markets. Their market share increased further, since they purchased some of the big domestic banks after 1998, such as Bancomer by BBVA (June 2000), Serfin (May 2000) and Banespa (November 2000) by BSCH, and Banacci (May 2001) by Citigroup. Furthermore, they are the only banks with an extensive network of branches in the six biggest countries of the region. Although ABN-Amro has investments in various Latin American countries, it is only in Brazil that it has relatively important presence, in particular due to the purchase of the Banco Real in Brazil in 1998. HSBC assets are concentrated in the three main countries of Latin America: Mexico, Brazil and Argentina. One should also notice in Table 4 that Citibank – part of the Citigroup - became the second biggest foreign bank in Latin America after the purchase of Mexico's top financial institution, Banacci.

The really big European investors in Latin America are the two big Spanish banks, which have recently developed an aggressive strategy of expansion in the region. BSCH and BBVA together have more than US$ 170,000 million of assets in Latin America and around 55.8% of the total assets of the top 6 foreign banks in the region (Table 4). BSCH, after the purchase of Banco Serfin in Mexico and Banespa in Brazil, became the biggest private bank of the region, with more than US$ 100,000 million of assets. BSCH is the leader among foreign banks in

[18] According to HSBC's Annual Review 2000, the acquisition of the French bank, CCF (Credit Commercial de France) "was a major step forward for our wealth management strategy and gives us a substantial platform in the euro zone" (p.3). Indeed, with 692 branches, CCF is one of the largest banks in France.

Argentina, Brazil and Chile, while BBVA is the leader in Colombia and Venezuela, and the second major bank in Mexico. The difference in terms of total assets between BSCH and BBVA in Latin America is due mainly to Brazil, where recently BSCH bought Banespa and BBVA has only a small market share.

ABN-Amro, in the Dutch market, and BSCH and BBVA, in the Spanish market, grew substantially in their domestic market-pursuing growth strategies based on M&As in order to obtain a leadership position in their national markets. This policy allowed them to increase their competitiveness and to reach the necessary size to develop their international expansion. After they consolidated their positions in their domestic market (and sometimes at the same time), they expanded abroad, probably preparing themselves for the increase in European competition under the context of the economic and monetary union[19]. ABN-Amro[20], BSCH and BBVA are big banks in small or medium highly concentrated systems that are increasingly expanding their operations to other geographical markets, since domestic alternatives are limited.

HSBC is one of the largest banking and financial services organisations in the world. Like Citigroup, HSBC Group is a global universal bank with around 6,500 offices in 79 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. The group moved its domicile from Hong Kong to London only recently, in 1992, after the Mindland acquisition. HSBC is still a bank strongly rooted in Asia, in spite of its worldwide presence. However, this feature has changed since the last decade. Its strategy of 'managing for value' emphasises the group's balance of business and earnings between the older, mature and faster-growing emerging markets[21]. The motivation of the recent expansion to Latin America, as well as other investments in different regions, seems to be related to the strategy of risk diversification, through geographic diversification of their activities, so that the bank is no longer so Asia-dependent.

5. The reaction of domestic private banks

5.1. The effects of the entry of foreign banks on domestic banking market

The literature on the effects of entry of foreign banks into domestic banking markets (Deminguc-Kunt and Huizinga, 1998; Claessens et al, 1998; Levine, 1996), developed mainly by economists with linkages to the World Bank, notes two main impacts:

a) First, *foreign banks are less efficient than domestic banks in developed countries, but more efficient than domestic banks in emerging economies*.

[19] With reference to the Spanish banks, Guillen & Tschoegl (1999, p. 4) state that by the late 1980s "competition [in Spain] for market share intensified and the government encouraged mergers as a way to break the cartel and to prepare for European integration. Net interest margins fell, and, though still solid, the banks worried about their long-term profitability. Besides entering new product market – stock brokerage, pension funds, and value-added services – several of the big banks began to view international expansion as a way to enhance profitability by exploiting their skills more fully".

[20] ABN-Amro's two most important markets outside the Netherlands are the US Midwest and Brazil, where the group bought Banco Real in July 1998, that was the fourth biggest private bank in Brazil.

[21] According to the HSBC's Annual Review 2000, the group made 48.2% its profits in Asia, 39.0% in Europe, 9.6% in North America, and 3.2% in Latin America in 2000.

There are various sources for their superior efficiency over domestic institutions in emerging countries, including greater stability of foreign banks, easier access to foreign sources of funds, greater propensity to innovation, and, finally, foreign banks in emerging countries generally are subject to more rigorous supervision in their native country.

b) Second, *foreign banks entry can render national banking markets more competitive, and thereby force domestic banks to operate more efficiently*, making them reduce their operating costs, and, at the same time, expand their activities. It is argued that the benefits of entry in terms of improved financial services and regulation should outweigh the potential costs of entry, that are cream skimming, foreign market dominance, destabilising rapid outflows of capital, etc. The entry of foreign banks raises the quantity and quality of financial products, stimulates government authorities to adopt a stronger and more transparent banking supervisory system, increases the country's access to foreign capital and, finally reduces the banking spreads due to the increase of competition. Foreign banks enter niches and introduce new services to exploit opportunities and, in doing so, increase competition for domestic banks. Financial institutions within nations may engage in M&As to help to fend off potential foreign competitors, and to protect their existing market power.

Carvalho (2001) shows that, according to recent data, there is no clear evidence that foreign banks are more efficient than domestic private banks and that foreign banks contribute to a strategic reorientation of financial activity towards supporting the private sector in Brazil. My research supports this hypothesis. On the other hand, there is some evidence that foreign banks entry has made banking markets more competitive, forcing domestic private banks to operate more efficiently. In fact, the biggest ones have actively participated in the process of consolidation of the Brazilian banking sector, probably due to competitive pressure from the acquisitions made by foreign banks.

Two indicators may be used to measure the cost efficiency of the biggest domestic private banks in Brazil: (a) *operating efficiency* that, as the name suggests, is used to measure the operating efficiency of the banks, including both intermediation and non-intermediation activities; (b) *cost to income ratio*, ratio typically used to measure bank efficiency in its traditional activity of bank intermediation[22]. Two conventional ratios are used to measure the *performance* of the banks: return on equity – ROE (net profit/equity), and return on assets – ROA (net profit/total assets).

Indicators of labour productivity cannot be used, since this data has not been available for a long period. On the other hand, one needs to be very careful comparing indicators of bank productivity and performance, because of recent changes in the banking industry where the mix of products of each bank as well as its relative share in its earnings varies substantially. Thus, no definitive conclusion can be drawn from comparisons involving banking efficiency. Hence, the analysis in the next two sections serves to show some general trends in the performance and efficiency of private banks in Brazil.

[22] The precise definition of these indicators can be seen in the notes of the Table 5.

5.2. The recent behaviour of the biggest domestic private banks

Table 5 presents some indicators of efficiency and performance of the three biggest domestic private banks – Bradesco, Itau and Unibanco for the period 1997-2000, using 'unconsolidated' data[23]. They are big retail and universal banks with a large customer base and strong position in a variety of financial activities (insurance, credit cards, asset management, etc.), which allows them to develop significant cross-selling activities. Therefore, they have the potentiality to reach both scale and scope economies with positive effects on their operational efficiency and profitability.

TABLE 5
Indicators of efficiency and performance, top three domestic private banks, 1997-2000

	Bradesco				Itau				Unibanco			
	Dec-97	Dec-98	Dec-99	Dec-00	Dec-97	Dec-98	Dec-99	Dec-00	Dec-97	Dec-98	Dec-99	Dec-00
Operating efficiency*	88.3%	92.4%	93.8%	90.8%	87.2%	85.1%	83.0%	79.2%	90.8%	91.1%	90.7%	92.4%
Expenses/Costs**	75.7%	72.3%	78.4%	76.4%	78.9%	74.7%	73.9%	67.6%	73.8%	67.5%	64.9%	68.8%
Return on Equity (ROE)	14.9%	16.0%	16.3%	21.5%	17.1%	25.6%	30.5%	25.6%	16.4%	15.6%	14.8%	18.5%
Return on Assets (ROA)	2.0%	2.1%	2.0%	2.7%	2.0%	3.3%	4.4%	3.2%	1.7%	1.7%	1.9%	1.8%
Loans revenues/Financial revenues***	67.7%	65.6%	63.9%	63.3%	67.3%	44.3%	45.9%	47.7%	69.4%	59.5%	68.3%	64.2%
Securities revenues/Financial revenues	21.0%	23.3%	20.4%	26.1%	25.8%	50.5%	49.1%	49.0%	25.3%	35.2%	28.2%	33.9%
Fees revenues/Financial revenues	20.5%	18.7%	16.9%	27.7%	41.6%	22.9%	31.5%	32.3%	18.4%	16.7%	15.6%	19.2%

Source: Own elaboration using data from the bank's balance sheets (only multiple banks)

Notes:(*)Operating revenues (loans+securities+trade finance+compulsory deposits+services fees+income of subsidiaries)/operating expenses (deposits+borrowings+provision for loan losses+salaries+overhead)

(**) (salaries expenses + overhead)/(gross margin of intermediation + banking services fees + provision for loan losses)

(***) Financial revenues = loans + leases + securities + trade finance + compulsory deposits

Generally speaking, indicators show that there is an overall improvement in the performance of these banks, but no clear tendency with respect to efficiency. The latter behaviour can partly be explained by the short-term effect of the recent acquisitions. The return on equity of the top 3 domestic private banks in 1997-2000 was around 19.0%, much higher than the return of 12.0% in the Brazilian private banking sector in 1989-1993. Itaú, the second-largest private bank, was the most efficient bank among the top 3 in the period, and also presented higher levels of profitability. Its leading performance strategy has been achieved with a conservative strategy of low loan exposure and profitability based mostly on securities revenues (see Table 5), taking advantage of the high rates of interest in Brazil during 1997-2000. Bradesco, the largest private bank in Brazil, increased its profitability (ROE) from 16.9% in 1999 to 21.5% in 2000. Revenue losses due to falling domestic interest rates in 2000 were more than compensated for by a 41% surge in credit and leasing operations, a 32% hike in funds under management and

[23] 'Unconsolidated' data involve only banking assets, while 'consolidated' data also involve assets of non-bank subsidiaries.

a 25% increase in deposits (The Banker, March 2001, p. 83). Unibanco, the fourth-largest private bank's profitability ratio was not as high as the others mainly due to its high administrative expenses, which increased after the acquisition of Bandeirantes in 2000. Unibanco's profitability traditionally occupied the middle tier among large Brazilian banks, with overall returns on assets and equity below those of Bradesco and Itau. Therefore, recent data shows some evidence that Brazilian private banks are performing well and costs are decreasing or at least are under control.

5.3. Domestic private banks versus foreign banks

Table 6 shows selected data on capital quality, asset quality, efficiency and performance of the four domestic private banks (Bradesco, Itau, Unibanco and Safra), four European banks (ABN-Amro Real, HSBC, Sudameris and BBV) and two American banks (Bank Boston and Citibank), with data extracted from a recent extensive BSCH report (Guimaraes et al, 2001). Unfortunately, the report does not include data from Banco Santander do Brasil, the leading foreign bank in Brazil. Care must be taken when comparing these banks due to the large differences in size, ranging from Bradesco, with almost 11% share of the banking market until middle sized banks, such as BBV Banco and Sudameris, with modest 1% to 2% market share (total assets criteria). The scale of production and mix of products differ among the selected banks as do the relative share of these in the revenues of each bank.

The indicators of efficiency in 1999-2000, in particular the index of efficiency and the ratio 'net income/employees', show that domestic banks, on average, improved slightly, and compared well to the foreign banks. However, the subset of American banks – Citibank and BankBoston – presents a better performance than the subset of European ones. One needs to be careful in analysing these data. First, the top 3 domestic banks are big retail banks, which permits them, ceteris paribus, to reap the benefits of economies of scale and scope, and mainly revenues economies. Second, when one compares the European banks with American banks, one has to take into account that the latter have their businesses focused on a selected segment of the retail market – private banking and corporate banking – as well as the fact that they did not participate in the recent wave of M&As in Brazil. Thus, they did not have problems related to the absorption of new banks.

TABLE 6

Selected indicators, some of the major Brazilian banks, 1999-2000

	Efficiency						Performance					
	Index of efficiency*		Employees / branches		Net income/ employees		Return on equity		Return on assets		Net interest margin	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
Bradesco	70.41%	65.62%	7	7	20.6	32.0	16.32%	21.50%	1.38%	1.83%	7.19%	7.12%
Itaú	66.12%	66.54%	15	16	49.6	50.9	31.65%	27.71%	3.60%	2.65%	7.56%	7.09%
Unibanco	69.44%	70.10%	13	18	31.6	36.0	14.76%	13.43%	1.64%	1.44%	7.31%	6.04%
Safra	61.40%	54.16%	NA	40	NA	88.5	19.33%	22.11%	1.10%	1.32%	4.91%	4.01%
ABN-Amro Real	69.95%	72.92%	NA	15	9.2	13.3	10.32%	5.47%	1.04%	0.93%	6.34%	13.17%
HSBC	79.27%	94.20%	NA	13	NA	9.7	25.76%	21.48%	1.84%	1.21%	10.39%	8.02%
Sudameris	130.5%	105.5%	NA	18	-15.1	-46.1	-14.85%	-38.28%	-0.73%	-1.83%	3.36%	4.31%
BBVA	78.40%	87.42%	NA	12	NA	13.8	28.49%	9.25%	2.12%	0.67%	6.49%	5.29%
Bank Boston	49.41%	52.78%	NA	20	NA	131.0	22.23%	20.57%	1.19%	1.16%	8.27%	5.83%
Citibank	38.25%	76.30%	NA	24	NA	92.8	48.45%	19.37%	4.02%	1.43%	11.79%	3.95%

Source: Own elaboration with data from Guimaraes et al (2001)

Notes: (*) Efficiency index = (salaries + overhead + fees)/net interest income

Finally, according to the ratios ROE and ROA, the performance of the domestic banks, with the exception of Unibanco, is better than the performance of the foreign banks. Once more, there are differences in banking profitability, if we compare the subset European banks with American banks, since the latter show a better performance in 1999-2000. The better performance of domestic banks can be explained partly by the fact that they have a bigger customer basis, providing them with cheaper funding to support their operations on the asset side, according to the findings of Guimaraes et al (2001). It is worth noting that middle size banks, such as Sudameris and BBV, not performed well in 1999-2000. This could be evidence of the difficulties that middle-sized banks face in a competitive market should they not have enough scale to compete with big retail banks, and also should they not have a clear niche to focus their activities in the retail market.

To summarise, even though the evidence does not permit having definitive conclusions concerning the recent behaviour of domestic and foreign banks, there is some evidence that the three top domestic private banks in Brazil presented, at least in 1999-2000, better results in banking indicators than the foreign banks.

6. Conclusions

The main conclusions to be drawn from the analyses of this paper are:

a) There are some impediments to M&As within the European Union and incentives for such activity outside the region. One of these incentives is the absence of a single regulatory agency in the EU, which limited the benefits of expanding areas of activity across borders. Although the Single Market Act and the various European commission financial directives should have created some uniformity, difficulties have arisen and hampered cross-border operations. There are multiple supervisory agencies within European countries and no co-ordinating agency or single bank regulatory body for the entire euro area. Consequently, M&As remain, to a greater extent, confined within national borders.

b) For some European banks expanding abroad is not only a source of diversification earnings, but also a means to prepare themselves for the competitive environment in the euro zone. The Latin American strategy can be interpreted as a response to this more competitive environment, in which several factors have eroded income from traditional banking business.

c) The recent wave of banking internationalisation is characterised not only by financial institutions following their existing relationships – serving mainly home country customers – but also for a greater integration with local market. Therefore, although historically the pattern of bank international shareholdings followed that of the economic integration between countries, today the actual pattern of expansion depends on a wider range of factors than just the overall degree of economic integration between countries. In this connection, Grubel's theory of internalisation – that states that the ability to draw on the information and personal contacts between banks and manufacturing firm's parent in a foreign country at very low cost is the main source of comparative advantage of the multinational banks – does not apply to the recent wave of foreign banks expansion in the emerging countries' banking retail market. This is typically the case of Latin American and Brazilian experiences during the nineties, where some European banks – BSCH, BBVA, HSBC and ABN-Amro - have mostly local customers with no previous connection with parents firms from the bank's home country.

d) There is some evidence that, especially the three major domestic private banks, Brazilian banks have been reacting positively to the entry of foreign banks, since they have participated actively in the wave of acquisitions, and have improved their efficiency and performance. Moreover, the top 3 domestic private banks presented better results than the big foreign banks. Therefore, there is no clear evidence that foreign banks are more efficient than domestic banks in Brazil in the recent period. Domestic private banks have some advantages over foreign banks that they can exploit, since they are more adapted to the peculiarities of Brazilian banking market. Their active reaction to the foreign banks entry, cultural differences and high level of development and sophistication of the banking sector in Brazil, which resulted from its ability to adapt to the period of high inflation, may explain this behaviour.

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