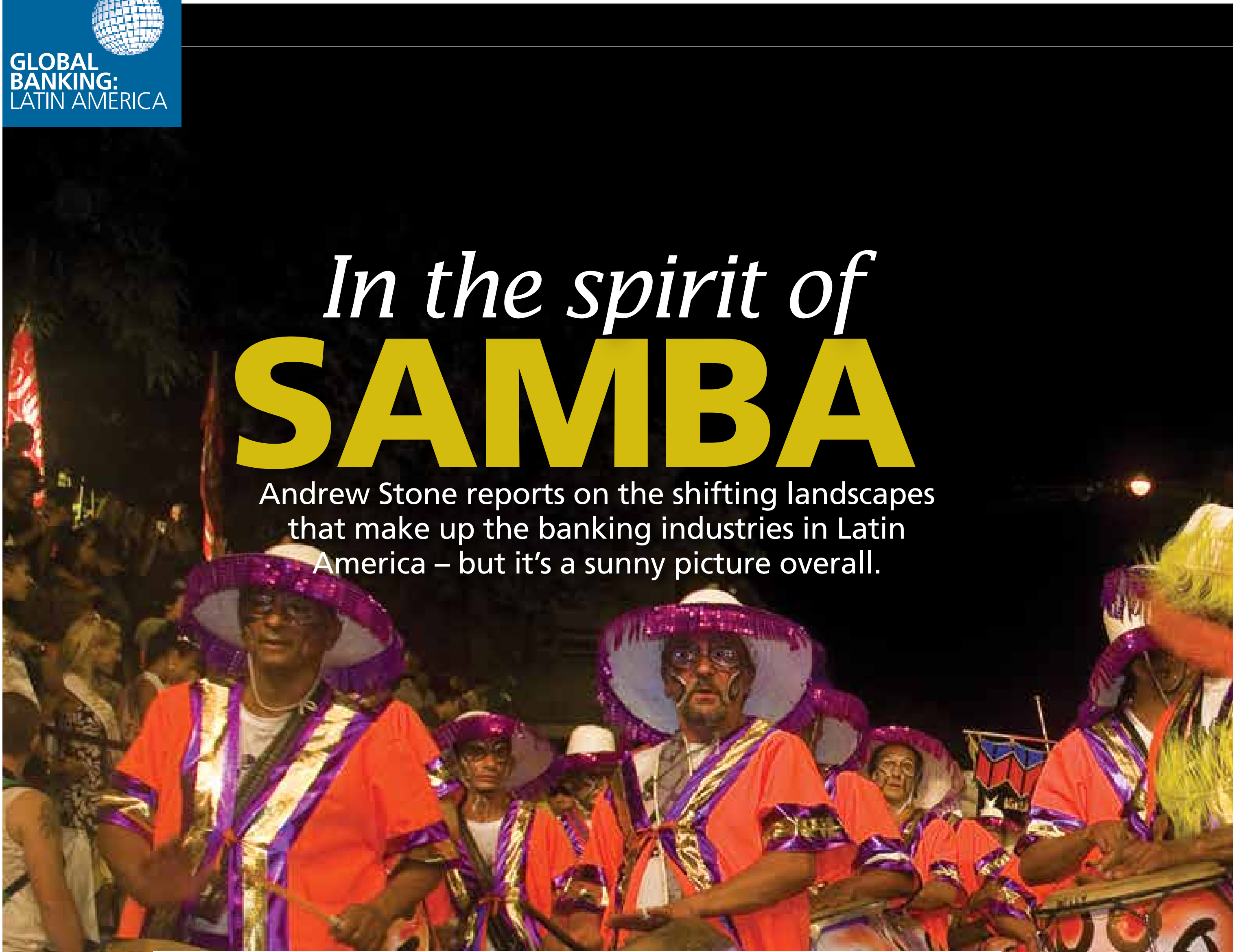

In the spirit of SAMBA

Andrew Stone reports on the shifting landscapes that make up the banking industries in Latin America – but it's a sunny picture overall.

In 2014 as the world heads to Brazil to witness how well it can host, as well as play, the beautiful game during the World Cup, it may surprise some to see how far it and Latin America as a whole have come in just a few years.

With 600 million inhabitants, a regional economy worth $4.8 trillion and increasingly extensive modern infrastructure, Latin America, along with its fast-emerging middle class, is getting wealthier all the time. It also happens to have some of the most modern and profitable banks in the world.

The future looks promising too. The number of working-age Latin Americans will grow by 41 million people between 2010 and 2020, which will see demand for discretionary spending items like computers, cars and travel soar – and with it demand for associated financial services. It is a demographic dividend expected to last for 30-40 years.

By far the region's largest economy and with about a third of the region's population, Brazil has the most potential in this respect. Its economy is the broadest and strongest compared to its regional peers. Its middle class has almost doubled in the last five years, leading to rapid growth in financial services such as current account banking as well as credit cards.

The image of Brazilian banks in particular as being hostage to and victim of a volatile economy, masks the fact that they are probably the most sophisticated in the region. They have emerged from serial shocks as robust institutions, says Dr William Cox, CEO of research consultant Management & Excellence, and a co-author of the 2013 Investor Outlook for the Latin American Banking Sector report.

All the same, Brazil's banks are not immune to risks. Its state-owned banks are pushing through loans under political pressure and as a result there are concerns about asset quality in the medium term. Meanwhile, the share of the lending book of publicly held banks has been falling backwards, says Natan Levy, at Latin American business intelligence firm BNAmericas.

Banco do Brazil, Latin America's largest bank by assets is still partially state-owned and run accordingly. General political corruption as well as bureaucracy and a high tax burden together with interference in forex, oil prices and consumer interest rates are also factors local banks must contend with.

As an example of the tangled regulatory landscape facing financial services firms in Brazil, insurance, a sector with great potential in the country where coverage is only 3-4 per cent compared with more like 50 per cent in the Organisation for Economic Co-operation Development (OECD), is held back because three

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GLOBAL IT PIONEERS

Perceptions of Latin America as being behind the curve, even backward, when it comes to efficient banking services are outdated. Banks in the rest of the world are now beating a path to their counterparts' offices in Central and South America to learn how they have deployed and used some state-of-the-art IT systems.

Integrated IT systems are driving progress in everything from product development and mobile banking to marketing and measuring client satisfaction in the region. It is shortening the time to market for new initiatives as well as streamlining risk management and governance processes, says Cox. "Let's take Bradesco, one of the biggest banks in Brazil. It has invested $5-6bn in IT and is the most modern I've seen anywhere. It's very impressive way they have integrated all their management processes. We've not seen the problems with rogue trading in Latin America in part because of the way IT regulates everything."

Banks' management systems in Brazil help make them highly transparent compared to banks outside the region or even to leading multinational blue chips, says Cox. "Across the board their transparency levels are high, even compared to the US."

ministries and several other regulatory institutions have overlapping oversight duties in the sector.

Brazil is not the only country where regulators are active. Chile's sound banking sector, operating in a low-inflation, high-growth economy, has to contend with regulators that have strongly come out in support of consumers in terms of the fees they are charged and the rates they pay. This is putting pressure on banks' margins, says Levy.

But this is inconsequential compared to the environment for banks in Mexico, the region's greatest underachiever despite its long history of Northern American and Western European involvement and its proximity to the US.

At just 18 per cent, bank penetration in terms of loans to GDP in Mexico is only just above Argentina – which is widely seen as the region's sickest economy thanks in large part to serial political mismanagement – while organised and often violent crime continues to be a problem. "The business culture is also fundamental to slower growth in Mexico. They could have double what they have if they were more proactive. It's a major inhibiting factor," says Cox.

Despite this, there are signs of change with insurance market, fiscal and tax reforms being driven through in Mexico, as well as the recent successful £3.18bn IPO of Santander Mexico.

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"COLOMBIA IS THE EMERGING STAR IN THE REGION, WITH STRONG GROWTH PROSPECTS AND A PROMISING MACROECONOMIC AND POLITICAL OUTLOOK."

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BANKING THE UNBANKED

Opening banks aboard riverboats might seem a surreal notion but Brazil's Bradesco does exactly that. It makes sense in a region with relatively underdeveloped fixed infrastructure and widely dispersed populations that often use rivers as the primary travel and communication networks.

Floating banks are also a reminder that despite the rapid growth of its fast-emerging middle class, swathes of the least wealthy have historically had little or no access to banking services in Latin America.

But things are changing and the unbanked represent a new opportunity for the region's financial players. Debit cards and micro insurance are set to be strong growth areas along with mobile banking and micro payments. Latin America's banks are busy working with local telecoms providers to roll out many of these services.

macroeconomic and political outlook, says Cox. "The Government is headed by an LSE graduate and the finance minister is from NYU. They are basically financial managers, unlike most political leaders, and that can't be bad. We're seeing growth and stability and the drug image is slowly disappearing."

While the growth rate has slowed across the region from 4.4 per cent in 2011 to 3.2 per cent in 2012 and 4 per cent in 2013, the growing wealth of the emerging middle class is expected to drive continued steady financial sector growth, which might theoretically make Latin America an expansion target for overseas banks.

Yet while there has been periodic interest from large global banks looking to expand, it has been limited to an extent by the huge investment required to enter the region in a meaningful way. They have also tended to pull back because of domestic constraints or after becoming spooked by volatility, so the sector has largely evolved domestically.

Consolidation within the region may be the most likely development from here, offering the best ways for some banks to achieve significant growth, says Levy. "The top four Colombian banks have most of the market, for example, so a lot of players will have to go abroad to get credit growth going."

A lot of the smaller deals have already been done in the region and any new ones going forward are going to be much larger. "That's not going to happen overnight," he adds.

This is happening fitfully for now with a handful of acquisitive banks such as Brazilian investment bank BTG Pactaul, Mexican bank Inbursa "controlled by multi-billionaire Carlos Slim", publicly owned Brazilian bank ITAU Unibanco and Colombia's largest bank BanColombia all expanding or looking to expand regionally.

"INCOMERS MAY ALSO BE TEMPTED BY THE FACT THAT LATIN AMERICAN BANKS ARE AMONG THE MOST PROFITABLE IN THE WORLD AND AMONG THE CHEAPEST."

The pattern of consolidation partly reflects the region's geography with banking groups developing, says Levy, in two broad regions: Andean (down the continent's narrow rocky spine) and Amazonian (into the huge region inland from the east coast).

A factor that may also drive consolidation in Brazil in particular but also to an extent across the region is the shortage of highly educated and qualified people, together with the profusion of mid-tier banks in Brazil, says Cox. There are rumours, he says, that one of the big Chinese banks is looking to buy into some of Brazil's big mid-cap banks.

The growth in trade financing agreements is one example of the growing Asian focus on the region. "We are seeing interest by Asian investors dramatically increasing in Latin America, particularly post-crisis," says Cox.

Incomers may also be tempted by the fact that Latin American banks are among the most profitable in the world and among the cheapest – trading in some cases at only three times book value, says Levy.

High inflation and interest rates together with lighter regulation have contributed to these generous rates of profitability. In addition, the region's banks don't have the legacy of European and US banks in terms of non-performing loans.

But this could all change. Their profitability is also partly down to the fact that the region is at a different stage of development, while their low prices are partly also reflected by the risks. "If interest rates in the region started converging to European levels we may see that profitability arbitraged away in the coming years," says Levy. "The hope for stability is not yet here either, especially when government interference determines profitability." CB

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