THE SPANISH BANKS' STRATEGY IN LATIN AMERICA

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Abstract

The expansion of Spanish banks in Latin America is one of the most important elements of bank internationalisation in recent years. At first glance, it is paradoxical that at a time of notable progress in the process of European integration, there is an intensification of Spanish investment flows to Latin America. Macroeconomic performance, deregulation, pure banking elements and cultural factors explain the decision of Spanish banks to establish themselves in the region. Given that only a few years have passed since the beginning of the expansion in Latin America, and the economic and financial turbulence experienced by the region in the last two years, it is a little early to properly evaluate the success of this expansion. However, preliminary evidence supports the idea that Latin American revenues have to some extent offset the decline in Spanish net interest income caused by the low interest rate environment in Europe. The presence of Spanish banks in Latin American will increase competition and improve risk management and financial stability.

Contents

1 Introduction

The internationalisation of banking is a wide phenomenon which, in turn, forms part of a broader process of business globalisation. The introduction of new technologies are reducing the segmentation of domestic markets and magnifying the advantages of economies of scale, fostering the creation of bigger companies with a presence in various countries. The process has been underpinned by institutional and regulatory frameworks that, in most cases, have encouraged the integration of goods and services markets. The birth of the Economic and Monetary Union (EMU) in Europe, the recent free trade agreement between the European Union and Mexico, following the NAFTA agreement, and Mercosur in Latin America provide evidence that the increase in the degree of openness of economies is spreading to all countries regardless of their level of economic development. The reference for big companies in Europe is no longer the domestic market, but rather the European, or even the global market. More multinational companies are emerging as a result, speeding up the process.

The appearance of multinational banks has come about in response to the above-mentioned factors, although the reasons that have led banks to embark on international expansion have differed over time and have depended on geographical location. The strict banking regulations prevailing in the United States in the 1970s, in contrast to the liberal nature of British legislation, were the main driving force behind the establishment of U.S. banks in London. This process led to the capital of the United Kingdom becoming one of the leading international financial centres. The expansion towards other financial centres characterised by relatively lax financial legislation encouraged the expansion of banking activities towards tax havens and off-shore centres.

In other cases, the expansion of banking systems has been determined by different factors. The establishment of Spanish banks in Latin America, or the expansion of German banks into Eastern Europe, is chiefly aimed at increasing client bases and attaining greater investment diversification in economic areas with high growth potential.

Consequently, the literature reflects a sharp distinction between what may be called expansion towards developed and developing countries. According to Waheed and Mathur (1995), the announcement of expansion in the developed countries is associated with unusually negative market returns, whereas establishment in emerging market countries is connected with the presence of unusually high returns. Claessens, Demirgüç-Kunt and Huizinga (1998) report that in the developed countries foreign banks tend to have smaller margins and profits than local banks, whereas the reverse is true in emerging market countries. As the authors note, there are a variety of explanations for this phenomenon. Banks establish themselves in developed countries following the expansion of their corporate clients, and margins in corporate banking are lower than in retail banking. A further possible cause of the weaker results of expansion in developed countries is the greater difficulty experienced in exporting technology and know-how, implying that the potential gains of setting up in another country fail to compensate for the technical and information disadvantages involved in operating abroad.

In a number of developing countries, in contrast, foreign banks can obtain higher margins owing to the presence of a large state-owned banking sector, that sometimes translates into an allocation of credit that has little to do with commercial criteria, thus providing scope for foreign private banks to do business. Finally, superior technology and bank management practices in the developed countries make it possible to offset the information disadvantages encountered by banks when they establish themselves in emerging market countries.

Therefore, the study of international expansion provides no easy generalisations. The analysis of the strategy pursued when a bank establishes itself in a foreign country may be undertaken on the basis of the choice of the target market. The choice of the investment destination, in turn, depends upon the reasons underlying the decision to expand. The aim of this paper is to examine how and why Spanish banks have expanded in Latin America. The rest of the paper is structured as follows: the next section reviews the degree of internationalisation of the Spanish banking system today. Section 3 sets out the strategy applied by Spanish banks in their expansion in Latin America. Section 4 looks at the macroeconomic and strictly banking determinants that have driven this expansion. Section 5 seeks to identify the repercussions of this expansion on Spanish banks and Latin American financial systems. The final section draws together the paper's conclusions.

2. The internationalisation of the Spanish banking system

The Spanish banking system bears witness to the increase in international financial integration that has taken place in recent years. A key contributing factor to this phenomenon was the complete liberalisation of capital flows in February 1992. The concept of internationalisation is nonetheless sometimes ambiguous. Globalisation, market integration and advances in information technology – upon which the banking industry is highly dependent – do not necessarily require a physical presence in order to achieve some degree of internationalisation. As a result, internationalisation can be analysed at different levels. We shall now briefly examine the evolution of Spanish banking activity in foreign countries from two standpoints: first, in terms of the share of international assets in its balance sheet; and second, in terms of the physical establishment of banks in foreign countries, which is the main focus for the present study.

Graphs 1 and 2 depict the path of the external assets and liabilities of Spanish banks according to the data compiled by the BIS in *International Banking and Financial Market Developments*[1]. Taking 1983 as the base year, the graphs confirm that the international expansion of Spanish banks has been much more intense than in the rest of the developed world. Since the end of 1983, the external assets of the Spanish banking system have increased by seven or eight times, compared with a fourfold rise in the gross lending of all BIS reporting banks. The increase in external liabilities has been even more spectacular. On BIS data, the debit position vis-à-vis foreign countries has increased almost eleven times since 1983, while the total external bank liabilities of all BIS reporting countries have "only" risen by four times.

The last seven years have witnessed an acceleration in the international activity of Spanish banks, in contrast to the relatively constant rate of growth shown by the rest of the world throughout the period under consideration. Regarding assets, growth accelerated in 1992 and 1993, probably as a result of the complete liberalisation of capital flows. Nonetheless, international lending activity seems to be levelling off in recent years. As far as liabilities are concerned, an acceleration is also observed around 1992, with the rate of

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[1] These statistics are compiled on a non-consolidated basis, that is, they measure cross-border flows between the host country and the rest of the world.

growth picking up further in the 1995-97 period and accelerating sharply from 1998 onwards.

As a result of the above developments, Spanish banks now have a substantial net debit international position (see Graph 3).

It is to be expected that the expansion of Spanish banks in Latin America has played a role in the sharp increase in the foreign exposure of the Spanish banking system. However, the graphs above only show unconsolidated statements, not recording financial transactions of foreign subsidiaries. A portion of these operations may, however, stem from the financial transactions that take place between foreign subsidiaries and the Spanish parent banks, which fail to accurately reflect the share of traditional international banking business in balance sheets. The *Consolidated International Banking Statistics* of the BIS allow us to ascertain whether there has in fact been an increase in bank financial flows towards foreign countries in addition to those arising between institutions of the same financial group.

Between 1996 and 1999, the consolidated financial assets of the Spanish banking system increased by 62 %, compared with the 8 % decline registered by the non-consolidated data. These data therefore reveal an intensification of the process of bank internationalisation over recent years, over and above intra-group transactions.

As the graph 4 shows, Latin America has been one of the main destinations for Spanish bank financing. Since 1996, the consolidated credit position of the banking system versus the region increased by 108 %, a rise only exceeded by the 312 % surge in financing to the Middle East (though this was much smaller in volume terms). Latin America has become one of the key areas for the development of Spanish international banking activity. By the end of 1999, more than a quarter of total Spanish bank financing to foreign countries was to Latin America. The Spanish financial system was the second biggest supplier of funds to the region, with 14 % of the total, only exceeded by the 22 % contribution of the U.S. banking system.

Argentina is by far the Latin American country which has received the largest share of financing from the Spanish banking system, with 41 % of total flows to the region. Mexico comes next with 15 %, followed by Peru and Brazil with 10 %. These four countries together account for three quarters of Spanish bank financing to Latin America (Table 1).

Nonetheless, the most striking aspect of the internationalisation of the Spanish banking system has been the establishment of a physical presence in Latin America. As reported in Table 2, the internationalisation of Spanish banks through the opening of representative offices, branches and subsidiaries has been intense in recent years. The trend observed in the establishment of Spanish banks in foreign countries signals a decline in the number of branches overseas (from 123 in 1994 to 78 at the end of 1999), a slight increase in the number of representative offices (from 109 to 111) and a bigger rise in the number of subsidiaries (from 53 to 72). Latin America has had a growing share in this expansion, especially with regard to representative offices (58 at the end of 1998) and subsidiaries (38). The increase recorded in the latter was mainly due to the acquisition of Latin American banks (16 new subsidiaries between 1994 and 1999). The Spanish expansion into Latin America has been centred on the big banks, i.e. those that already had a strong presence in Spain. More specifically, the main players in he international expansion have been the two biggest Spanish banks, BBVA and BSCH.

3. The expansion strategy in Latin America

Expansion in Latin America got under way slowly in 1995, before intensifying sharply in the 1996-99 period. The Spanish banks acquired large shareholdings in Latin American banks with a major involvement in their local markets. The process of privatisation's and the withdrawal of the U.S. banks from the Latin American market contributed to the timing of this expansion and to entry via acquisitions rather than through the organic growth of the Spanish banks. This provided favourable conditions for the retail banking business on which the Spanish banks aimed to focus, since it is faster to acquire the extensive branch network needed for this through already established banks.

The objective of the Spanish banks was not only to grow in size. Executives of the big Spanish banks considered that there was plenty of scope for improving the management of the banks acquired. Accordingly, rather than being satisfied with a more or less substantial stake, they seek control of the management of these banks. The two major banks followed slightly different strategies, however. In the case of BSCH, more emphasis was placed on banks with a greater share in investment banking and on the acquisition of large shareholdings from the outset. As for the BBVA, the expansion was based initially on small shareholdings which were then gradually built-up over time, forming partnerships with local banks.

As a result of this process, Spanish banks head the rankings for foreign banks in Latin America (see Table 3).

Although the expansion of banks in Latin America is still going on (the Spanish presence may increase in Brazil), the focus for expansion has recently extended to pension fund management. Most of Latin American countries have adopted private pension systems in recent years, and Spanish banks, notably the BBVA, have taken up strong positions in this business segment (Table 4).

The past two years have been characterised by high volatility in the region, and the market value of banks established there has suffered as a result. Nonetheless, the long-term horizon of the Spanish banks' strategy has not prevented them from expanding their presence in the region in spite of the real and financial turbulence. This decision contrasts with that of other financial institutions which have chosen to pull out of the region. According to *The Banker*, the number of foreign banks that withdrew from Latin America (excluding Mexico) in 1999 was more than double the number that came in. The number of foreign banks in the region fell from 373 to 351. Table 5 summarises the Latin American franchise of Spanish banks.

4. Determinants of the expansion of Spanish banks in Latin America

4.1 Macroeconomic determinants

As noted in the introduction, banks establish themselves in foreign countries for a variety of reasons. The expansion of Spanish banks in Latin America is part of a broader process that has encouraged Spanish firms to become multinational. Graph 5 depicts Spanish foreign direct investment (outward and inward) as a percentage of GDP. From the mid-1980s onwards, both series increased, though inward foreign direct investment in Spain far outstripped Spanish foreign direct investment abroad. This trend was reversed in 1997, and thereafter there was a remarkable surge in outward foreign direct investment. This development is a reflection of a variety of factors. Chief among these are, first, the process of deregulation experienced by the Spanish economy in recent years, as a result of which big companies, many of them previously state-own companies, have adopted more market-oriented business strategies while seeking to benefit as much as possible from economies of scale. Second, the progress made in real convergence in recent years has narrowed the gap between the level of development in Spain and European standards, both regarding productivity and costs, so that in some ways the domestic market can be regarded as a mature market. And third, once a company is big enough, international expansion is a way of increasing the client base and diversifying risks.

Just as important as the decision to invest overseas is the choice in which countries to operate. In fact, the emergence of specific investment opportunities at a given point in time (for instance, a privatisation process) may sometimes be a key factor behind a company's decision to establish itself abroad. Spain is a country with very close ties to Europe. In 1999, Spanish exports to the European Union accounted for 72 % of total exports, while European imports accounted for 68 % of the total. Portfolio investment from the European Union made up 110 % of total foreign financial investments[2]. Offsetting this, Spanish portfolio investment in the European Union was 82 % of the total.

[2] These figures represent net foreign portfolio investment. The capital outflows to non-European countries explain why European portfolio investment in Spain exceeded the total.

In the case of Spain, membership of EMU and the adoption of the euro imply that Europe is taken as the reference market. It should have been observed Spanish companies expanding into European markets given the greater ease of access provided by the existence of something of a common legislative base and the disappearance of the exchange rate risk.

However, the data are at odds with these arguments. In 1999, while almost 80 % of the foreign direct investment (FDI) in Spain had its origin in the European Union, the proportion of Spanish FDI to the European Union was only 16 %. Latin America was the main recipient of Spanish FDI, with a share of 4.9 % in Spain's GDP according to estimates for 1999, compared with the 1.8 % share in GDP of FDI to Europe. As shown in Table 6, the situation has changed markedly since Spain joined the EEC in 1986. At that time, Spanish investment in Europe made up half of total foreign direct investment. According to the available data for 1999, Spain has exceeded United States in some segments of FDI such as mergers and acquisitions. The bulk of this investment was carried out by a few multinational companies in the telecommunications, energy and banking sectors.

Several macroeconomic factors account for the fact that Spanish companies have preferred Latin America.

The first conditioning factor is the deregulation processes that have taken place since the beginning of the 1990s, and which have made room for the entry of foreign companies into key economic sectors such as banking, telecommunications and utilities. According to CEPAL, 93 of the 500 leading Latin American companies existing in the period 1990-92 were state-owned. By 1998, this number had fallen to 40.

Second, it is interesting to note some determinants related to the growth potential of the Latin American market:

– Population. Expansion in the European market is constrained by negative population developments. According to the World Bank, the population of the European Union will fall by 0.2 % over the next 50 years. This decline in population is expected to be particularly marked in Spain, where a fall of an annual 0.5 % is forecasted. In contrast, the population of Latin America is expected to increase by 0.8 %. By 2050, Latin America will be a market of almost 700 million people, while Europe will barely gather 330.

– Developed market maturity. Europe is a mature market in many business areas. Byway of example, in France and Germany there are 57 telephone lines per 100 inhabitants, compared with 20 in Argentina and 7 in Peru. Similar comparisons can be made using other types of product or infrastructure development.

– Potential economic growth. Economic growth in Europe has been slowing gradually. After a rate of growth of almost 5 % between 1961 and 1970, growth in the 1990s fell back to 2.1 %. And potential growth in the European economy can be put at around this figure. Economic growth in Latin America in the past 18 years has been very similar to that of Europe, at 2.5 %. This includes the lost decade of the 1980s, however. The far-reaching structural reforms undertaken by Latin American governments should provide scope for higher growth in the coming years. On the basis of a 1.3 % rate of population growth, a 1.4 % increase in the stock of capital and a 1.8 % rate of productivity growth, BBVA Economics Research Department estimates that potential growth in Latin America is around 4.5 %.

Third, the advantages of diversification must also be borne in mind. The Spanish economic cycle is highly correlated with that of the euro area, a correlation that has increased to 0.8 since the beginning of the 1990s as a result of the process of nominal convergence with the more stable EMU members. Conversely, the Spanish and Latin American economic cycles have been negatively correlated in the past 15 years, with a coefficient of –0.7 for the period 1985-99. In addition to the low correlation between cycles for the region as a whole, the correlation among the cycles of Latin American countries themselves is not very high, making it possible to capitalise further on the advantages of diversification and to help dispel the notion that investment in Latin America involves an excessive concentration of risk (see table 7).

The fourth consideration is the price factor. The high stock market valuations of companies in the developed countries considerably increase the cost of gaining a significant market position via acquisitions. The valuations of Latin American companies, in contrast, make it easier to attain a large market share with a lower cost . We analyse this factor for the specific case of the banking sector in the next section.

4.2 Pure banking determinants

As a result of technological advances, banks no longer need a large physical presence to do business in foreign countries, especially in business areas such as investment banking. If Spanish banks have chosen to establish themselves overseas it is because their objective is to replicate the model of banking that has proven successful in Spain. That is, the universal banking model, which includes competing with local banks in retail banking.

The macroeconomic factors that have motivated Spanish industrial groups to invest in Latin America mentioned above, can easily be extrapolated to banking.

During the 1990s, several countries implemented programmes of financial liberalisation. State participation in banking was very high. Thus, in 1994, 36 % of the Argentine banking system's assets were owned by the state, while in Venezuela this percentage was 30 %. In 2000 only the 26 % of the Argentina banking system and the 5 % of the Venezuela banking system is owned by the state. The privatisation of state-owned banks was aimed at fostering competition and importing know-how and banking technology, and in this regard it was decided to allow foreign banks a greater involvement in the market.

Europe is a mature banking market. Tables 8 and 9 present a number of measures of the different development of European and Latin American banking systems. If we measure the size of the financial system in terms of the ratio of M3 to GDP it can be seen that, in comparison with the high proportions exhibited by the euro area (77 %) and the United States (71 %), Latin America has a very underdeveloped financial sector (28 %). The percentage of the population over 18 years that has a bank account in Spain is double that of Latin America. The reason for this may be the small number of branches, as the number of clients per branch is in some cases 27 times higher in Latin American countries than in Spain. Unlike in Europe, therefore, there is considerable potential for the expansion of bank branch networks.

The demographic structure is a further reason for projecting an increase in the demand for financial services (see table 10). Latin America has a very young population. The proportion of those aged 14 and under is 34 %, compared with 17 % in the euro area. This demographic structure will have a positive effect on banking in two ways. First, because of the future access of this segment of the population to financial services. And second, because of the increase in savings derived from the accumulation of capital by the intermediate generations (the life cycle hypothesis). The latter effect will be particularly significant for the pension funds industry.

On the other hand, the lower multiples at which Latin American banks are trading relative to financial institutions in the developed countries make it possible to reach a given market share at a lower cost. Table 11 illustrates this fact. On the basis of the stock market capitalisation of each country's biggest banks and their share of deposits at then end of 1999, we have constructed a price reflecting the value of a 1 % market share in the corresponding country. Given that acquisitions generally include a premium, sometimes stem from the privatisation of state-owned banks with no market price, or are settled in the form of share exchanges, this exercise is only useful as a rough indication of a market's degree of accessibility.

Using this calculation, a 1 % share of the German deposit market in 1999 cost $ 2.285 million if this was attained by purchasing shares in the major listed banks (Deutsche Bank, Bayerische Hypo und Vereinsbank, Dresdner Bank, Commerzbank, and Bankgesellschaft Berlin in this case). The same share would have represented an outlay of $ 196 million in Argentina or $ 205 million in Mexico. As can be seen in Table 12, the valuations of European banks are much higher than those of Latin American banks, an important factor when the objective is to secure a substantial presence via acquisitions in a relatively short period of time.

On the other hand, the Latin American banking sector offers much better prospects for increasing returns to credit institutions such as the Spanish banks whose initial ROEs are high in comparison with their Central European counterparts. As regards income, we noted earlier the high growth potential of the banking business. In addition, however, the intermediation margins with which banks operate in these countries were considerably higher than in the developed world. As can be seen in table 13, average margins on assets in Latin America for the period 1990-94 were above 5 % (in some countries, such as Argentina, they were closer to 10 %), compared with the 3 % level at which they were running in the United States and Spain. This is a reflection of both banking regulations and the high interest rates prevailing in Latin America as a result of the region's emerging market status. As far as costs are concerned, the potential gains in efficiency are high. The ratio of operating costs to assets was again above 5 % in most of Latin America (with the exception of Chile and Mexico), whereas in Spain operating expenses were running at under 3 % of assets. Nonetheless, efficiency gains in the short term are difficult to secure, given the need for an expansionary strategy in the first stage of market penetration consisting of building up branch networks, the import of new technology, and, in some cases, the adoption of technological platforms from the parent institution. Initial operating costs are higher as a result, delaying the achievement of higher returns.

So far we have reviewed the arguments that make Latin America a good investment destination. However, Latin America's potential has not been tapped by the financial institutions of other developed countries operating in similar economic environments to that of Spain. The fact that a destination is attractive for investment does not mean that banks from any country are in a position to compete successfully in a market that is not their own.

Consequently, any analysis of the expansion of the Spanish banking system in Latin America should not ignore the factors that have encouraged Spanish banks to "dance to a Latin beat" (The Banker, December 1997).

The literature on the determinants of bank internationalisation is very extensive, as banks opt to establish themselves in foreign countries for a variety of reasons which are not applicable in every case. In this respect, there may be said to be several theories or paradigms on which banks base their decision to expand overseas. In keeping with the theory of competitive gain, only those banks with some type of advantage that allows them to "produce" financial services at a lower cost will be able to establish themselves successfully in other markets. Banks that establish themselves in other countries must have some characteristic that differentiates them from domestic banks, which have a better knowledge of their own banking regulations and of their market and are unhampered by the costs of being physically separated from the parent institution. This comparative advantage may derive from a bank's particular characteristics, regardless of its nationality, or may be specific to the banks of a given country.

Naylor (1997) reviews the literature that has attempted to explain the determinants of the internationalisation of U.S. banks. The decision to follow domestic companies abroad, the desire to capitalise on the benefits of diversification and management prestige are some of the reasons put forward, though the empirical evidence for some of these is rather inconclusive.

Grosse and Goldbert (1991) find a positive relationship between the presence of a foreign bank in the United States, the size of the financial system in the country of origin, foreign investment in the country of origin, trade with the United States and, weakly, geographical distance. Brealey and Kaplanis (1996) undertake an empirical analysis of the factors determining the overseas location of almost 2000 branches of 1000 banks from around the world. They conclude that there is a positive relationship between branch location and the GDP of both countries (though it is more intense with the GDP of the country of origin), trade and the outward foreign direct investment of the country of origin. In the Spanish case, the empirical literature on the internationalisation of banks is rather sparse, and here it is only worth noting a number of studies, such as that of García Blandón (1996), in which the aspect analysed is the decision of a foreign bank to enter the Spanish market. The variables that emerge as being significant in these studies are the bank's size, its experience in an international environment and distance from the country of origin, the latter with a negative sign.

Have the above factors been significant in the expansion of Spanish banks into Latin America?

The establishment of Spanish banks in Latin America seems to be unconnected with any strategy oriented towards tracking Spanish companies into the region. Foreign direct investment began to increase in 1994, but has been concentrated on only a few companies, notably in telecommunications and the energy sectors.

The diversification factor is a good reason, although the results are difficult to gauge given the very short time horizon and the intense economic and financial volatility experienced in the region during most of 1998 and 1999. Nonetheless, the divergence of the economic cycles suggests that considerable benefits may be gained from this aspect in the future, especially if, as is to be expected, the Spanish economic cycle moves more into line with that of the euro area. Indeed, a number of studies (Meric and Gulser (1989) or Grinold et al. (1989)) suggest that the benefits of international diversification in a single industry are higher than those from diversification by investing in several industries.

As regards the prestige factor, the expansion into Latin America may be associated with the carrying-over to the new continent of the competition between Spanish banks in the domestic arena. This factor would lie within the so-called oligopolistic reaction paradigm, which implies that banks follow in the footsteps of their rivals in their expansion into foreign countries. According to some analysts, the Spanish expansion into Latin America had its origin in this behaviour (The Banker (December, 1997) and Guillén and Tschoegl (1999)). The fact that Spanish expansion has been largely focused on two banks supports the idea that this factor may have had a significant weight during the early stages of expansion. Nonetheless, this is not to say that banks, especially multinational banks, operate in a relatively uncompetitive environment.

The use of the size of the financial sector, or of the bank that is expanding, as an explicative variable is widespread in the literature, sometimes associated with the GDP of the country of origin. It seems clear that countries that are stronger economically have bigger banks, and that those banks have sufficient critical mass to expand in foreign countries, especially if their business is based on retail banking. In the Spanish case, only the big banks have chosen Latin America as a strategic investment destination. However, not all the world's big banks aspire to become multinationals. There are examples of successful banks, such as Britain's Lloyds TSB, which have chosen not to pursue an aggressive expansion strategy into other countries. Even among banks that are considered "global" there is no apparent relationship between the degree of internationalisation, as measured by the proportion of their assets in other countries, and size (see Graph 8). The size of Spanish banks relative to big banks in other countries would on the face of it appear to be a secondary argument in the case of Latin American expansion. In this respect, it is interesting to note the very different strategy adopted to deal with the new financial environment created by the advent of the euro, as in this case a larger size does become essential if a bank is to play a significant role in the European banking map.

To the above-mentioned factors might be added one noteworthy aspect of the Spanish banking system, namely solvency. A surplus of equity is always of great help in financing expansion. Nonetheless, in the case of expansion into Latin America, a high level of solvency is important for other reasons that may act as competitive advantages. First, it makes it easier for a bank to obtain an operating licence from the authorities, as it is supposed to contribute to the stability of the financial system, one of the main objectives when financial systems are opened up to foreign banks. Second, the commitment to maintain a high level of capital helps to gain the confidence of depositors. Indeed, a graphic analysis (see Graph 9) suggests that solvency may have some explanatory power for the degree of internationalisation of banks that have opted for an international expansion strategy.

Another possible reason behind the expansion into Latin America is the competitive environment in which the banking business has operated in Spain in recent years. This factor has made it easier for the managers of Spanish banks to launch their expansion into new markets. In this respect, it is important to bear in mind that the macroeconomic situation in Latin America is not unlike that of Spain ten years ago (see Table 14), so that the managers of banks established in the region have faced economic and banking crises in the past twenty years from which they will have drawn valuable lessons for their operations in Latin America.

In the past ten years, the Spanish banking system has adapted to a highly competitive environment. The process of liberalisation that got under way in the financial sector in the middle of the 1970s lasted for over twenty years. The liberalisation of bank interest rates and commissions did not come to an end until 1987. Savings banks were barred from opening branches throughout Spain until 1989. Restrictions on capital flows were not removed until early 1992, and foreign banks were only granted total freedom to establish themselves in Spain at the end of the same year. Credit institutions responded to this environment by stepping up competition. In 1989, Banco de Santander broke the banking status quo with the commercialisation of its "supercuenta", a high-interest bearing savings account, while savings banks began their expansion into all regions of Spain and a few foreign banks managed to secure a position of some importance in the Spanish financial system (for instance, Deutsche Bank or Barclays Bank).

Banks have had to cope with a relatively unfavourable economic environment for their business. First, the shift in households' saving habits from deposits towards alternative products such as mutual funds increased the cost of funds, although Spanish banks opted to commercialise such products right from the outset. This enabled them to become market leaders in investment and pension funds and to substantially increase their income from commissions. Second, the decline in interest rates deriving from the process of nominal convergence with the more economically stable countries of the euro area also had a negative impact on banks' traditional intermediation margins. Third, adaptation to the euro and the reduction or loss of some sources of income, such as currency trading or currency exchange commissions, had negative implications for profits.

The Latin American strategy may be interpreted as a response to this more competitive environment, in which several factors were eroding income from traditional banking business. If the strategic orientation of Spanish banks is proving successful it is because banks are accustomed to operating in an environment characterised by stiff competition.

Oligopolistic structures are characterised by a lack of innovation. The aim of cartels is to obtain oligopoly income, which generally translates into the maintenance of margins and profits. This is certainly not the context in which the Spanish financial sector has operated in the past ten years. Spanish banks have been very active in the commercialisation of alternative products to their deposits, sometimes before these were even fully regulated (e.g. unit-linked instruments), which testifies to a high capacity for innovation. Moreover, as Graph 10 shows, banks have more than passed on the cuts in official interest rates to their customers. The differential between the 3-month Mibor and the interest rate on the current accounts of Spanish banks has narrowed by some 500 basis points in the past 11 years. The graph illustrates how the episodes of strong competition have affected margins. The so-called “deposits war” in the beginning of the 90s, had a narrowing effect on the Mibor-mortgage rate differential of roughly 300 basis points in spite of the fact that subsequently nearly all of this fall was transitorily retraced. As can be seen from the graph, the impact of the “lending war” was smaller, at around 200 basis points, and lower still if, as would be more appropriate, a long-term rate is used to calculate this margin. The decline in bank interest rates, therefore, does not exclusively reflect the reductions in official interest rates, rather it suggests that competition during this period has been intense.

If the Spanish banking industry were a cartel, credit institutions would set the same prices. This is far from true, however, in key business segments exposed to the stiffest competition, such as in mortgage lending. As Graph 12 shows, banks are charging their customers lower mortgage rates than the average of the euro area banks.

Finally, any analysis of the reasons that have encouraged Spanish banks to establish themselves in Latin America must take into account the need to build up a strong franchise in order to be well-placed to cope with European financial integration and to negotiate future strategic alliances with European banks. In this respect, the position of the Spanish banking system in Latin America can also be interpreted as a pre-emptive strategy aimed at ensuring a successful response to the challenge posed by the euro.

4.3 Non-economic determinants

Besides the above factors, there are other non-strictly-economic determinants that make expansion in Latin America more straightforward than in other world regions with much less affinity with the Spanish character. These factors have played a pivotal role in other cases, such as in the establishment of Portuguese banks in Brazil, or in the expansion of German banks towards Eastern Europe. Geographic proximity, a former colonial period or immigration are important factors in order to explain why a bank decides to establish in a foreign country. A shared common language and culture, along with the presence of a relatively large Spanish community in a number of Latin American countries, is an enormous help to Spanish firms wishing to enter these markets.

From a strictly banking point of view, this furnishes several advantages. First, it makes it possible to commercialise the same products, which implies the use of common marketing techniques. For instance, deposits linked to lotteries have being as successful in Latin America as in Spain. The use of the same language facilitates the transfer of know-how, the installation of the same IT platforms and is conducive to the exchange of employees between the parent bank and its subsidiaries, thus accelerating the process of integration and the diffusion of the business culture.

Accordingly, cultural determinants are the link between the factors that make Latin America a good investment destination and the factors that have motivated Spanish banks or companies to launch their international expansion.

5. A preliminary assessment of the expansion in Latin America

5.1 Performance in Spain

After only three or four years of expansion in the region, it is too early to gauge whether or not the Latin American strategy has been a success in terms of Spanish bank results. This is particularly so bearing in mind that one of the strategic goals is to grow in the region, increase the number of branches and, in some cases, transplant the parent bank's systems, all of which translate into higher costs. Moreover, the past two years have coincided with a period of intense financial turbulence, accompanied by a severe economic crisis in the region, with the resulting impact on banking activity and the need for higher provisioning. Finally, Spanish banks have pursued an accelerated policy of writing down goodwill, which has further weakened results.

In any case, the comparison between consolidate and non-consolidate statements of Spanish banks reflect that Latin American revenues are offsetting the decline recorded in Spanish net interest income caused by the decline of Spanish interest rates related to the EMU convergence process. According to the Bank of Spain the difference between net interest income reported by Spanish banks in consolidate and non-consolidate basis represented 0.79 % of average total assets from –0.04 in 1995. The opposite effect is observed in operating expenses (0.83 % of average total assets in a consolidated basis from –0.22 % in 1995), although this should be a transitory effect due to the factors mentioned above.

The market has reacted positively to banks that have established themselves in the region, however. As can be seen in Graph 12, the P/E ratio of Spanish banks stood at between 11-13 % in 1995. Three years later, the banks that opted to expand in Latin America had pulled away from their competitors, especially from those banks that chose to stick to their traditional business in Spain. The increase in exposure to Latin America, however, together with the volatile financial situation experienced by the region in recent years, has heightened the risk attached to these banks' shares. Table 14 reports the betas estimated for the shares of the leading Spanish banks vis-à-vis the IBEX for two-year periods. During the period 1995-96, which saw the start of the expansion in Latin America, Spanish banks had betas of between 0.8 and 1.0. In the years 1997-98, a period that includes the international financial crisis, the betas of banks with a presence in the region were running above 1, that is, they began to be more volatile than the index, whereas the betas of the rest of the banking sector remained around 1. In the 1999 – October 2000 period, the betas of biggest Spanish banks experienced a decline in line with the more stable economic and financial environment in Latin American countries.

5.2. Performance in Latin America

One of the functions of the financial system in an economy is to channel the financial resources of companies and families into more productive uses. The role of banks in this function is particularly important in the emerging market countries given that, in the absence of liquid financial markets (these only arise when the financial system reaches some degree of maturity), they are the main financial intermediaries. Consequently, the growth of the banking industry in the region is the first step towards achieving the degree of financial development typical of industrial economies.

On the other hand, the setting-up of private pension systems, in which the Spanish banks are playing a growing role, will also have a positive effect on savings. The experience of a number of countries, such as Chile and Singapore, points to an increase in the savings rate after the introduction of these systems. The higher level of savings is the result of the imposition of an element of compulsory saving, on the one hand, and a greater awareness of the need to save for the future, on the other, under a system in which contributions to the pension fund are owned by the person contributing and may even be left as a bequest.

The need to increase the savings rate in Latin America is particularly important given its structurally low savings rate. As Table 15 shows, the average savings rate since the mid 80s has not only failed to increase, in contrast to developments in other emerging market areas such as South-East Asia, but has registered a fall. An increase in internal savings should contribute to make the region much less dependent on external capital flows.

Moreover, the development of private pension systems also contributes to the development of the financial system insofar as the sustained flow of capital to pension fund institutions fosters the emergence of liquid capital markets.

The relationship between contributions and benefits in private pension systems eliminates the sustainability problems that characterise state pension regimes, shielding pension provision from potential budgetary risks. As a result, a potentially destabilising factor is removed from the volatile macroeconomic picture of these countries.

The opening up of Latin American countries to foreign banks was aimed at breaking up the oligopolistic situation that characterised local banking. The greater competition brought by the Spanish banks has served to shake up the sector. More competition translates into a need for greater efficiency and competitiveness in order to maintain market share, implying pricing polices that are more in line with clients' risk profiles; that is, it implies a better allocation of credit.

In this sense, foreign banks not only export capital in the form of FDI, but also export technology, management and enhanced banking practices, contributing to increase the stability of the financial system and reduce its vulnerability to possible crises.

Although not much time has passed for an assessment to be made of the specific influence of the Spanish banks, there is some literature on the effects on the financial sector of the arrival of foreign banks. Barajas, Steiner and Salazar (1999) analyse the case of Colombia. This study concludes that foreign banks behave in a different way to local banks. Foreign banks have lower costs and a much sounder loan portfolio, which enables them to charge somewhat lower margins than those of other banks. As a result, foreign banks influence the behaviour of local banks by increasing competition and reducing intermediation margins. They also have an influence on other aspects of their management. When local banks are bought up by foreign institutions it is observed that they tend to reduce their operating costs. The study also concludes that credit differentials become more responsive to the evolution of credit quality, suggesting an improvement in risk management systems. Nonetheless, it is observed that the entry of foreign banks has a negative impact on the credit quality of local banks, which may be attributed to the increase in competition or to a loss of the most creditworthy clients to the foreign banks entering the market.

The study by Claessens, Demirgüç-Kunt and Huizinga (1998) also finds that the presence of foreign competitors has negative implications for local banks, as it is related to a decline in their profits and expenses, suggesting an increase in competition. They also detect an increase in the provisioning of local banks, which, as in the case above, may stem from more prudent risk management or from a loss of the best clients. It is interesting to note that the significant variable in this analysis is not the foreign banks' market share, but rather the number of banks operating in the market, irrespective of their importance or the success of their strategies. The threat of entry or the announcement of the presence of foreign banks seems to be the factor that shapes the behaviour of domestic banks, more than the success of the foreign banks' strategy.

Other studies (Goldberg, Dages and Kinney (2000)), analyses the credit policy of foreign and domestic banks in periods financial turbulence in Mexico and Argentina. The authors conclude that healthy banks, especially foreign ones, show higher loan growth and less volatility of lending during financial crisis, contributing to a more stable financial environment.

6. Conclusions

The most noteworthy aspect of the expansion of the Spanish banking system in Latin America has been the establishment of a physical presence in the region. A process of expansion led by the biggest Spanish banks got under way in 1995, and intensified in the 1996-98 period. As a result, they now head the rankings of foreign banks in the region. Spanish banks not only acquired large shareholdings in Latin American institutions, but also strove to control the management of these banks. As the expansion was aimed at replicating Spain's banking business, including entry into retail banking, the model chosen was one of acquisitions and agreements with other banks, which made it possible to increase branch networks in a relatively short time. The financial crisis in 1998 and 1999 has not prevented Spanish financial institutions from increasing their presence in Latin America. The emphasis of the process of expansion has nonetheless focused recently on activities related to asset management, and more specifically, the acquisition of private pension fund institutions, in which several Spanish banks have taken up a prominent position.

At first glance, it is paradoxical that at a time of notable progress in the process of European integration, there is an intensification of investment flows to Latin America. Several types of factors account for the expansion of Spanish banks to Latin America. First of all, there are the macroeconomic determinants.

The deregulation and privatisation processes undertaken have been conducive to the opening-up of Latin American markets to foreign companies. Moreover, the faster rate of population growth, the scant development of services markets and a higher rate of potential growth provide much better prospects for growth in the banking sector. Further, the negative correlation between the economic cycles of Latin America and Spain, in contrast to the increasing alignment of the Spanish and European cycles, increases diversification. Finally, the high stock market valuations of European companies, compared with Latin American valuations, reduce the cost of attaining a significant market share.

From a strictly banking standpoint, the low ratios of M3 to GDP, or the large number of clients per branch are indicators of the underdevelopment of the banking sector in contrast to the saturation observed in the European market.

The Latin American banking system shows higher margins and costs than those of the developed countries, which furnishes institutions such as the Spanish banks, with their high ROEs, with great potential for increasing returns.

In spite of the above, it still has to be explained why the prime movers in this process have been Spanish banks and not the credit institutions of other European countries faced with similar domestic environments. There are several explanations for this. First, with regard to the differences, the Spanish macroeconomic environment of 15 years ago has not been so different from that of Latin America. In this respect, Spanish managers have accumulated a store of very valuable experience for operating in the Latin American financial environment. Second, the Spanish banking system, in spite of the most recent round of consolidation, is characterised by a highly competitive environment. Spanish banks have learnt to operate successfully in such an environment and have transferred it to the countries which they have entered. Finally, there are important cultural links which serve to connect the factors that make Latin America a good investment destination and the determinants that are pushing Spanish companies to expand overseas.

Given that only a few years have passed since Spanish banks established themselves in Latin America, it is a little early to form a judgement on the success of this expansion. This is particularly so because the region has been battered by intense financial turbulence in the past two years, because the expansionary nature of the entry of Spanish banks into these markets has pushed up costs and because Spanish banks have undertaken a rapid write down of goodwill. The early evidence as to the market's assessment of the Spanish banks' strategic decision is favourable. The P/E ratios of the shares of banks that opted for this strategy have risen more than those of banks that decided to pursue a domestic strategy. Nonetheless, their stock market volatility has increased in recent years, reflecting the increased exposure of the Spanish banking system to Latin America and the financial turmoil that has recently hit the region.

The establishment of Spanish banks will have a number of positive effects on Latin American economies and financial systems. First, it is to be expected that the savings rate will rise, which is particularly important if the region is to reduce its dependency on external financing. The increase in competition among banks implies an improvement in the allocation of credit in environments that were characterised by a lack of competition. The introduction of new bank management techniques contributes to a more appropriate management of financial risk and enhances the stability of the financial system. Nonetheless, in a number of cases, foreign bank entry is seen to have a negative impact on the quality of the loan portfolios of local banks. This idea may be associated with a strand of the literature that analyses the relationship between deregulation processes and banking crises. In this regard, financial liberalisation must be accompanied by solid regulatory and supervisory structures to safeguard against excessive risk-taking. The opening-up of financial systems is always risky, but in no way should a direct relationship between liberalisation processes and financial crises be established.

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ANNEX TABLES

Table 1: Spanish bank financing to Latin America

(% of total)	
Argentina	41
Mexico	15
Brazil	10
Peru	10
Chile	8
Colombia	4
Bolivia	3
Uruguay	3
Venezuela	3
Dominican Rep.	1
Rest	2
TOTAL	**100**

Source: BIS

Table 2: Spanish bank in foreign countries

	1994		1999		∆ 99-94	
	Total	LATAM	Total	LATAM	Total	LATAM
Representative Offices	109	51	111	58	2	7
Branches	123	13	78	5	-45	-8
Subsidiaries	53	22	72	38	19	16

Source: Spanish Banking Association (AEB)

Table 3: Biggest foreign banks in Latin America by assets (Sept. 2000)

Mn USD

	Country	ARG	BRA	CHI	COL	MEX	VEN	Total
BSCH	Spain	26 130	13 182	30 200	1 376	20 100	2 556	93 544
BBVA	Spain	9 714	5 004	4 900	2 811	37 300	3 700	63 429
Citibank	USA	10 429	8 798	6 350	1 137	7 739	686	
Bank Boston	USA	11 350	9 315	6 800	108	358		27 931
HSBC	UK	5 016	9 126			15 202		29 344
ABN Amro	Netherlands	2 801	15 581	2 900	110	154	95	21 641

Source: BBVA Research Department based on Latin American central bank and supervisors

Table 4: Spanish banks – Pension Funds in LATAM (2000)

ESP bn	BSCH		BBVA	
	Assets under management	Position in ranking	Assets under management	Position in ranking
Argentina	542	2	666	1
Bolivia	-	-	413	1
Chile	701	5	1998	1
Colombia	108	3	374	1
Ecuador	-	-	2	-
El Salvador	-	-	35	2
Mexico	201	2	823	1
Peru	130	1	116	2
Uruguay	11	4	-	-
TOTAL	**1693**		**4427**	

Source: BBVA

Table 5: Spanish subsidiaries in LATAM – September 2000

		Shareholding (%)	Group
Argentina	Banco Francés	67	BBVA
	Banco Río de la Plata	79	BSCH
Bolivia	Banco Santa Cruz	90	BSCH
Brazil	BBV-Brasil	100	BBVA
	Excel Banco de Investi.	100	BBVA
	BBV Credito Financ.e Inv.	100	BBVA
	Banco Santander Brasil	100	BSCH
	Banco Meridional	97	BSCH
Chile	BBV Banco BHIF	53	BBVA
	Banco Santander Chile	86	BSCH
	Banco Santiago	44	BSCH
Colombia	Banco Ganadero	63	BBVA
	Banco Santander Col.	60	BSCH
Mexico	BBVA-Bancomer	33	BBVA
	Serfín	100	BSCH
	Banco Bital	8	BSCH
	Banco Mexicano	100	BSCH
Peru	Banco Continental	41	BBVA
	Banco Santander Perú	100	BSCH
Venezuela	Banco Provincial	53	BBVA
	Banco de Venezuela	98	BSCH

Source: BBVA

Table 6: Spanish foreign direct investment (% of GDP)

	1986	1997	1998	1999
LATAM	0,0	1,0	1,4	4,9
EU	0,1	0,8	1,1	1,0
Other	0,1	0,4	0,6	0,5
Total	**0,2**	**2,1**	**3,1**	**6,4**

Source: Bank of Spain, BBVA Research Department

Table 7: Correlations between Latin American countries

	ARG	BRA	CHI	BOL	COL	ECU	PER	VEN	MEX
ARGENTINA	-	*	*	*	0,41	*	0,58	0,41	*
BRAZIL		-	*	0,43	0,6	0,55	0,5	0,46	*
CHILE			-	*	0,51	*	*	0,38	0,64
BOLIVIA				-		0,52	*	0,67	0,59
COLOMBIA					-	0,49	0,39	0,42	0,47
ECUADOR						-	*	0,4	*
PERU							-	*	*
VENEZUELA								-	*
MEXICO									-

* Non significant or negative

Source: BBVA Research Department

Table 8: M3/GDP

USA	71
EMU	77
Spain	103
LATAM	28

Source: IMF, BBVA Research Department

Table 9: Development of the banking system

	> 18 pop. with current account (%)	Clients per branch ('000)
Spain	95	1
Argentina	35	8
Brazil	48	19
Chile	50	8
Mexico	35	13
Peru	37	27

Source: BBVA

Table 10: Demographic Structure

(age)	USA	EMU	LATAM
0-14	22	17	34
15-59	63	62	59
60 +	15	21	7

Source: World Bank

Table 11: Approximate cost of a 1% market share of deposits (*)

(1999)	mn USD
Germany	2285
France	1673
Spain	2263
Argentina	196
Chile	172
Mexico	205

(*) Calculated from each country´s biggest private banks and saving banks

Source: BBVA Research Department, Fitch Ibca

Table 12: Banking Statistics – Average 1990–1994 (*)

	Operating Costs	Net Interest Margins
Argentina	8,5	9,2
Brazil	6,0	6,8
Chile	3,0	6,1
Colombia	7,3	8,3
Mexico	3,9	5,1
Venezuela	5,7	8,1
Germany	1,1	1,4
Spain	2,4	3,1
USA	3,7	3,7

(*) Percentage of total assets

Source: Guillén, Tschoegl (1999)

Table 13: Macroeconomic Situation

	Spain	**Latam**
%	Avge. 80-95	Avge. 96-99
Inflation	7,9	13,4
Currency depr.	5,0	8,3
Eco. Growth	2,5	2,4
Max. Growth	5,6	5,5
Min. Growth	-1,2	-0,2

Source: Bank of Spain, INE, BBVA Research Department

Table 14: Betas versus IBEX 35

	95-96	97-98	98-99	99-00
BSCH	1,05	1,47	1,46	0,69
BBVA	0,84	1,57	1,57	0,88
B.Popular	0,80	1,02	0,73	0,16
Bankinter	0,86	1,03	0,86	0,76

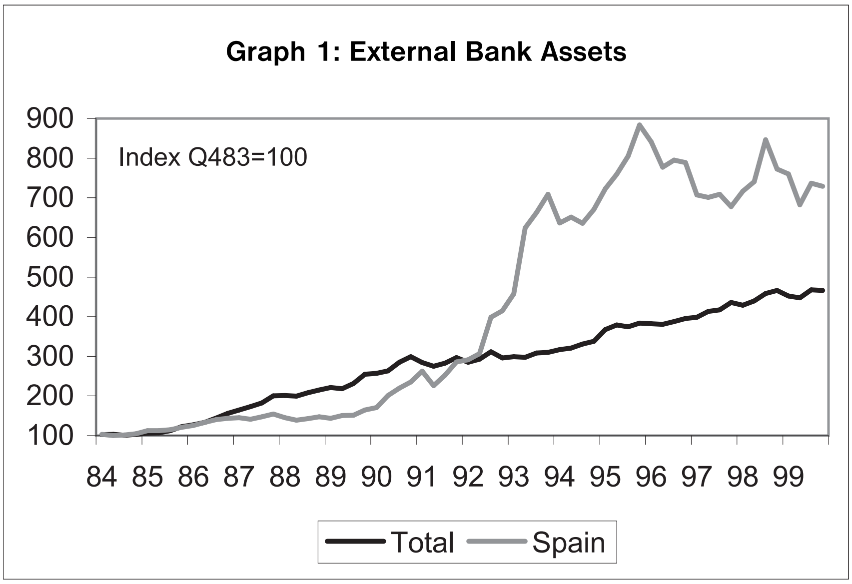
Example: SCH=α +β * IBEX

Table 15: Private savings as % of GDP

Period average	1986-93	1994-99	2000
Industrial Countries	20,4	20,2	18,7
Latin America	19,2	18,3	17,3
South-East Asia	28,7	32,5	31,8

Source: World Bank

ANNEX GRAPHS



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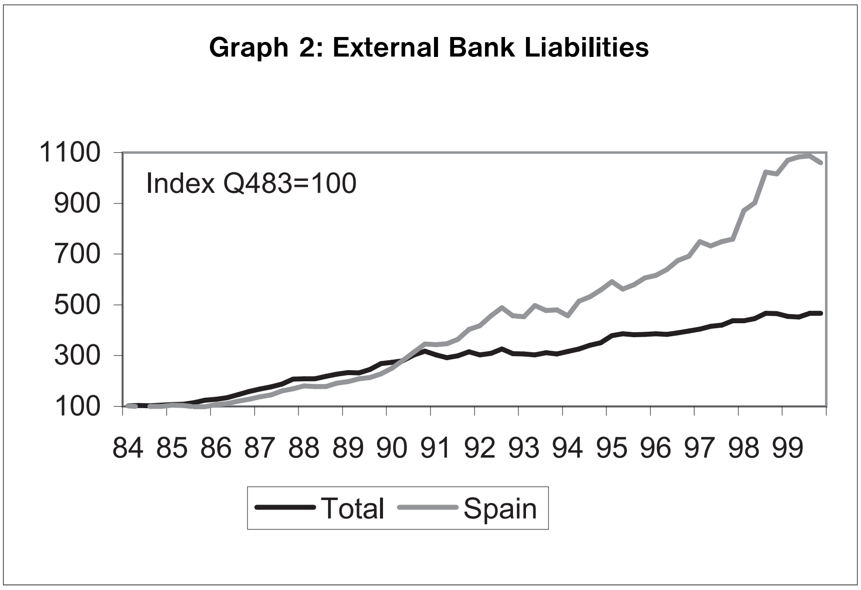

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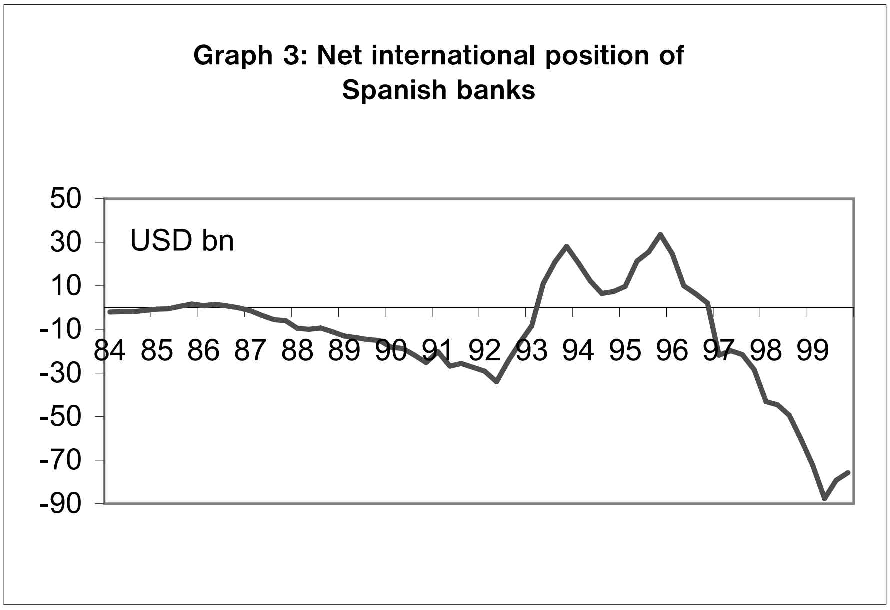

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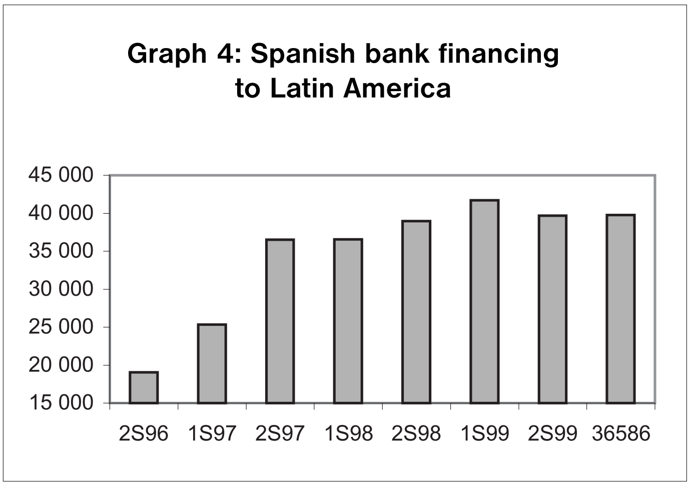

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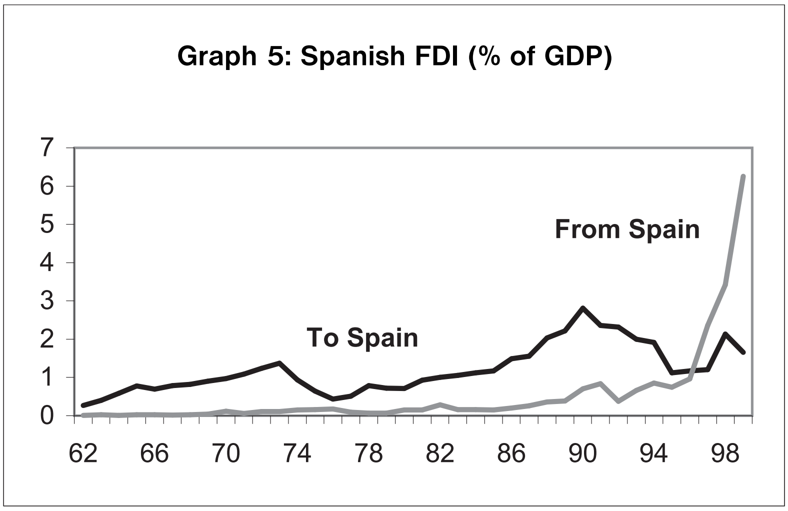
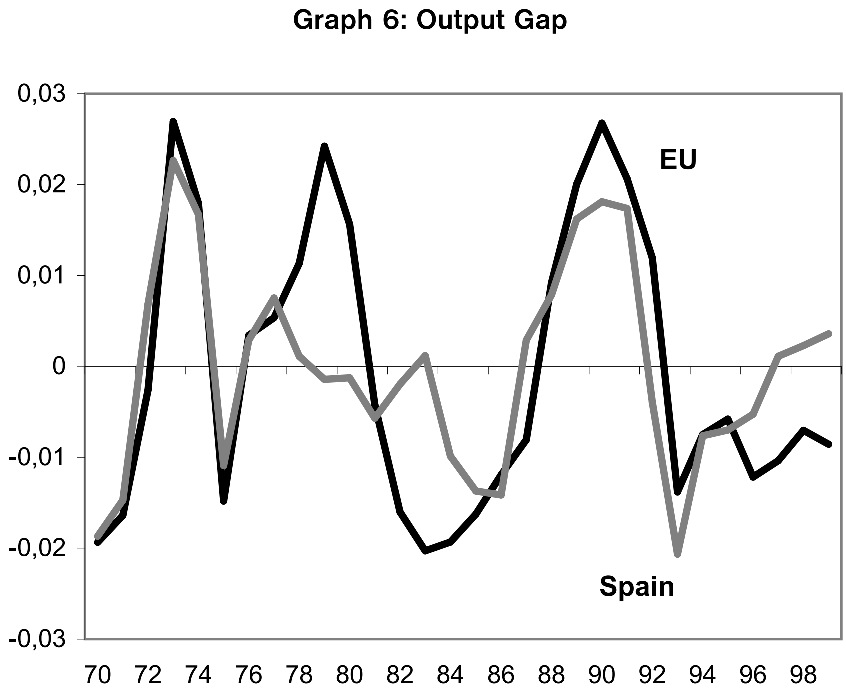
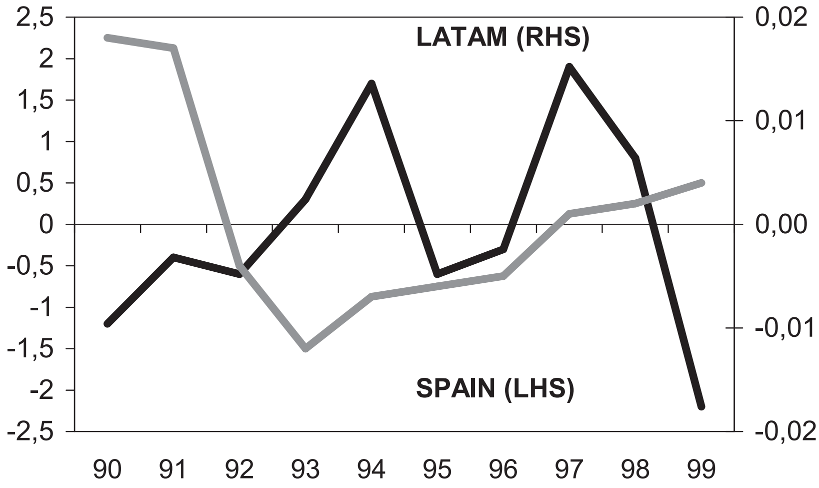


Source: Bank of Spain



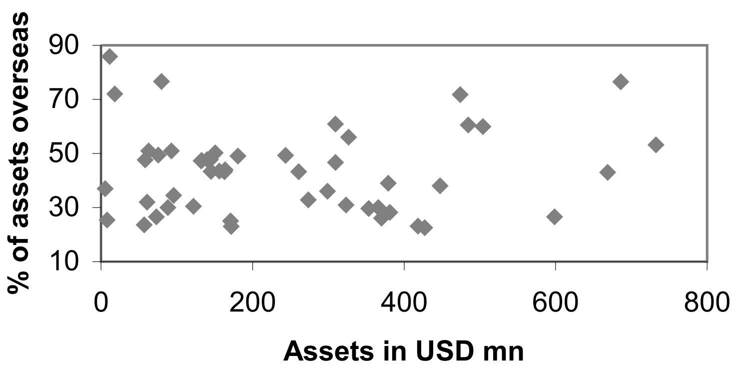
Source: BBVA Research Department

Graph 7: Economic Cycles

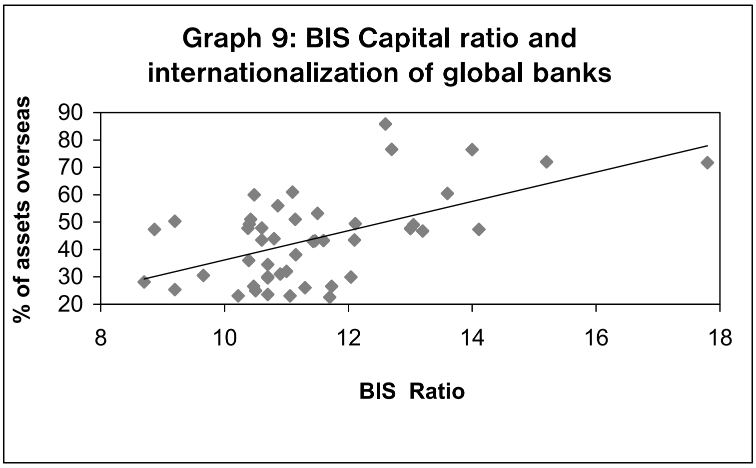


Source: BBVA Research Department

Graph 8: Bank assets and internationalization (Top 50 global banks)



Source: The Banker



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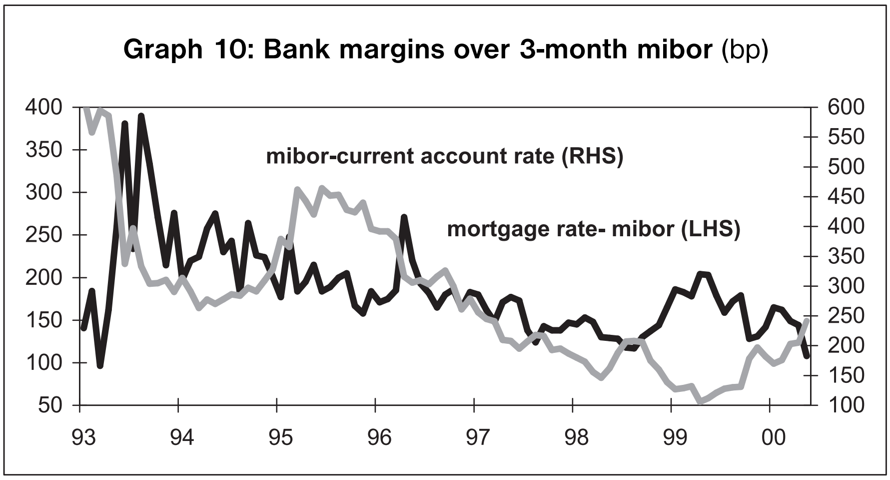

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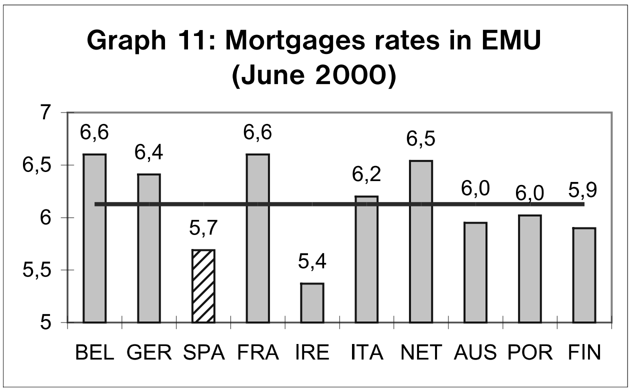
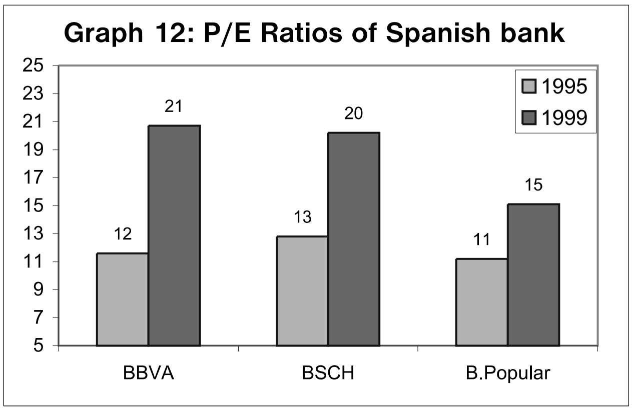


Source: European Mortgage Association



Source: Bloomberg

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