



Talking point



Latin American banks: Profiting from a better macroeconomic environment

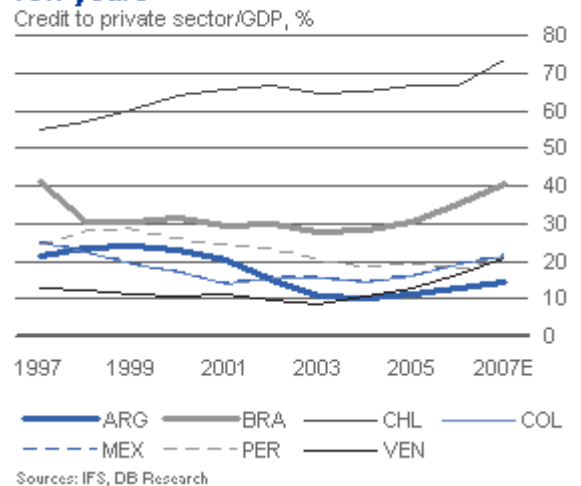
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Latin America's economic development has historically been characterised by boom-and-bust cycles and deep economic crises. But in the last four years real GDP growth has become stronger and less volatile, reaching a respectable 5.2% yoy in 2004-07, way above the historical average. A benign external environment with high commodity prices and low interest rates has boosted exports and capital inflows, but better domestic policies have also helped.

Banking sector depth differs across countries but generally remains low

A more stable economic background has boosted the size and depth of the region's banking sectors. Credit to the private sector expanded to 32% of GDP on average for the region* in 2007, up from 23% in 2003. However, this ratio varies greatly across countries. While it reached 74% of GDP in Chile (2007), it was 40% in Brazil and Colombia and only about 20% in Mexico, Venezuela and Peru. Also, despite recent growth, the depth of banking systems in Latin America remains small when compared with that of other emerging and developed markets (Asia: 91% of GDP; Euroland: 122% of GDP).

Credit expansion in the last few years



Relatively robust asset quality and capitalisation, high overhead costs

A healthier macroeconomic environment has helped to improve credit quality. Non-performing loans decreased to 2.9% in 2007 from 5.3% in 2003. This ratio is better than in all other EM regions (to the extent that NPL measurement can be compared across countries or regions), and provisions to cover those NPLs are adequate. Capitalisation also looks fine: the capital adequacy ratio was 16.6% on average in 2007, above minimum requirements. Finally, Latin American banks seem relatively profitable when looking at their net interest margin of 8.2%, but overhead costs are a high 5.8% of assets. Both indicators reflect the nature of the core business of the region's banks, namely retail, which is characterised by sizeable margins but high costs. Still, overhead costs have been decreasing in recent years, signalling efficiency gains.

Lower dollarisation ratios but sovereign exposure remains too high

High "dollarisation", i.e. a substantial number of deposits and loans denominated in foreign currency, was a dominant feature in many of the banking sectors in Latin America in the 1990s, driven by persistently high inflation and currency depreciation. In recent years, however, inflation has come down and local currencies have stabilised or appreciated. Thus, the dollarisation process has slowed down or even reversed. This means that, were high inflation to return or currencies to depreciate sharply, local banks would be facing lower risks of currency mismatches or credit risks arising from FX lending to unhedged borrowers. The gradual development of other segments of the local capital markets (stocks and bonds) should also contribute to diversifying financing sources and reducing FX risks.

Currently, the main source of vulnerability for some of the region's banking sectors is their exposure to the public sector. For example, claims on government entities represented 41% and 45% of total assets in Argentina and Brazil, respectively, in 2006. In other cases, such as Venezuela, banks are subject to strong government intervention, for instance via mandatory credit allocations to favoured sectors and regulated interest rates.

Adoption of Basel II targeted by 2010



Despite the rapid expansion of the banking sector, Latin American progress in terms of transparency and compliance with international standards has been limited. Low transparency (in the context of Pillar 3 of Basel II) makes it difficult for investors to acquire information about banks, restricts private monitoring and limits competition. Latin America has a long history of being slow to comply with international standards. However, many countries have taken some steps to improve regulation and supervision over the last few years. Except for Venezuela (not even implementing Basel I), the rest of Latin America is planning to adopt Basel II at the latest in 2010. Many countries will adopt market risk requirements and the standardised approach for credit risk, while Brazil, Mexico and Peru are also planning to implement more advanced credit risk approaches (IRB). The biggest challenges will be the required technical supervisory expertise and the installation of a risk management culture and infrastructure in banking institutions. So far, compliance with prudential regulations has been mechanistic in many of these countries. However, even modest implementation of Basel II will help supervisors to better understand risks and will improve risk management practices.

How do Latin American banking sectors fare compared with other regions?

The comparison of macro- and microprudential indicators yields a mixed picture (see table). While the Latin American banking sectors (and capital markets) are smaller than those in most other regions, their asset quality and profitability are acceptable. In terms of financial freedom, the region is similar to other emerging markets but, not surprisingly, restrictions are tighter than in Euroland or the US. Finally, transparency and compliance with international standards remain below average, confirming the country-by-country findings mentioned above.

LatAm vs emerging and developed markets, weighted average 2006

	GDP growth %	Private credit % of GDP	Bank overhead costs % of assets	Net interest margin % of assets	Stock market capitalisation % GDP	Private bond market capitalisation* % GDP	Public bond market capitalisation* % GDP	ROA %	NPL % of loans
LatAm	5,2	28,2	5,8	8,2	45,8	12,0	30,5	2,6	3,0
Asia (non Japan)	8,6	91,2	1,6	2,9	72,1	18,2	28,7	1,1	6,1
Eastern Europe	6,4	31,7	5,7	5,1	64,9	n.a	16,3	2,5	4,5
Middle East	6,0	46,5	3,3	4,1	44,8	n.a.	n.a.	1,8	6,8
Euroland	2,9	121,8	2,5	2,1	83,9	42,1	51,2	0,7	2,6
US	2,9	57,8	3,4	4,0	135,0	114,4	46,4	1,3	0,8

Source: IMF, World Bank, DB Research calculations, * 2005

For more details, see accompanying presentation: [Latin American banking systems - Developments over the last decade](#)

* We refer here to the seven largest countries by GDP, i.e. Brazil, Mexico, Argentina, Venezuela, Colombia, Chile and Peru.



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