Multinational Banking in Peru

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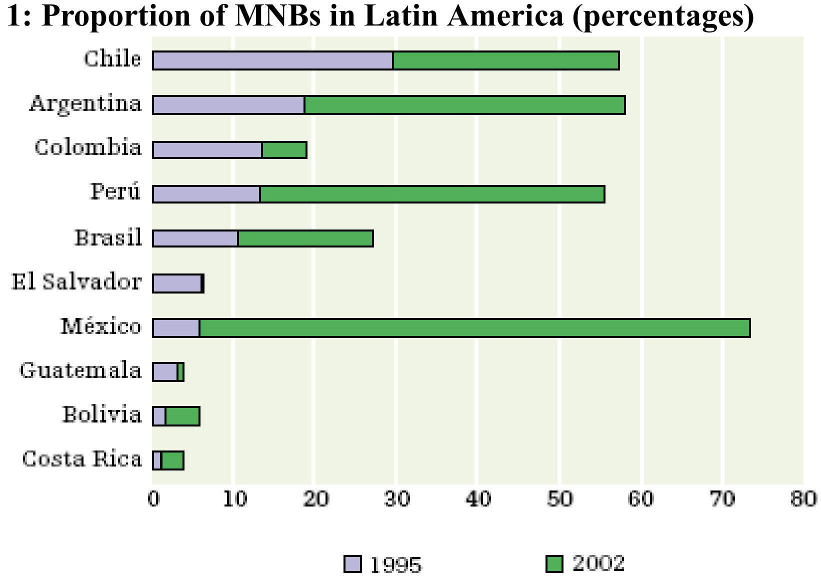
Abstract

Multinational Corporation (MNC) investment in banking in Peru acquired a new vigor after the liberalization of the financial system in the early 1990s. There are now six foreign banks operating in Peru. The aim of this short paper is to explain why a multinational bank decides to operate in Peru, what have been the results of these investments vis-à-vis the Peruvian financial system, and what the obstacles that these banks face in Peru are. We found that MNC in banking behave in the same way as other MNCs do; MNC banks in Peru do not perform better than the system average, and MNC banks face a liability of foreignness in the type of client they deal with and recovering delinquent or defaulted loans.

I. Introduction

One of the most salient features of financial systems in Latin America, according to the Latin American Shadow Financial Regulatory Committee (2001), is the growing role of multinational banks (MNBs); as of the end of 2001, foreign banks controlled more than 50% of the assets in the financial systems in many countries in the region; this highly contrasts the situation of 1995 when MNBs did not account for even a quarter of the assets in the financial system (see Figure 1).

Figure 1: Proportion of MNBs in Latin America (percentages)



Source: Interamerican Development Bank, 2005

According to the Superintendency of Banking, Insurance and Private Pension Funds (Peru's banking regulator), almost 50% of all deposits in Peru are captured by foreign banks. Rojas (1999) notes that multinational corporations (MNCs) become more important in the Peruvian economy after the liberalization process of the 1990s. This short paper mostly surveys the banking sector in Peru after the liberalization process; additionally, the paper aims to analyze the performance of MNBs when faced with liability of foreignness with regard to the type of clients they deal with and their success in dealing with delinquent credits.

Information regarding the history of MNBs currently operating in Peru comes from each of these banks internet portals. The data to perform the analysis comes exclusively from the internet portal of the Banking and Insurance Superintendency of Peru[1].

The paper is organized as follows: the next section deals with multinational banks and the reasons they decide to extend beyond their home country borders. Section III also discusses the pros and cons for governments that want to attract foreign banks. Section IV closes with a discussion of liability of foreignness for multinational banks moving into developing countries. Section V provides an overview of MNBs currently operating in Peru base on the most recent data as of the date of this paper from the Superintendency of Banks, Peru's banking regulator. Finally, the paper ends with a conclusion.

II. Multinational Banking

[1] http://www.sbs.gob.pe/PortalSBS/

This section provides a brief overview of multinational banking and explains the benefits and costs for a host country if it decides to open its financial system to multinational banking.

Multinational banks are multinational corporations; that is, businesses with physical presence in more than one country. This presence can be classified into four types depending on their organization: representation offices, agencies, branches, and subsidiaries (Micco & Panizza 2004).

Representation offices are the leanest structures of MNBs; they do not capture deposits or place credits. Representation offices perform services for customers from the home country that operate in the host country; another function of representation offices is to test the waters if the bank intends to expand into the host country. An agency is a type of structure that places credits, but does not operate at the retail level and does not capture deposits. A branch is an integral par of the home office; it provides more services than a representation office or an agency, but is limited by regulation in both the home and host countries; a branch typically operates at the wholesale level. A subsidiary is a bank incorporated in the host country, but fully owned by a foreign corporation; as opposed to a branch, the assets of the home office are not used to back the subsidiary's liabilities; subsidiaries perform the same activities as local banks and are subject to the same regulations.

According to an IDB report on banking in Latin America (Micco & Panizza 2004) there are multiple theories to explain the presence of MNBs. One of the most accepted views is that MNBs from one country follow foreign direct investment from that country; in effect, proponents of this view would argue that the internationalization of the financial sector is largely due to the growing importance of FDI; the evidence to support this theory is not conclusive, except in cases of large bilateral trade, and does not fully explain the entry of MNBs from developed countries to developing countries.

An alternative theory that does explain the emergence of MNBs in developing countries is that MNBs, as other multinational corporations, expand beyond their home country borders if they see profit opportunities in good institutional and macroeconomic environments. This theory proposes that MNBs do not necessarily follow their clients to other countries, but rather move into these countries in order to take advantage of profit opportunities from local customers.

What has been observed in practice is that multinational banks tend to enter countries with high economic growth, low inflation, large capitalization of stock markets and a less efficient banking system (Micco & Panizza 2004). This last item, a less efficient banking system, can be explained by the fact that multinational banks can obtain much higher profits in this kind of environment.

From the viewpoint of the host country, there are benefits, as well as costs, from the presence of MNBs; Weller and Scher (2001) consider that multinational banks can improve financial stability and credit supply; MNBs bring greater efficiency; they introduce technological innovation, and they bring improvements to the normative environment and the recognition of property rights (Micco & Panizza 2004). Despite these benefits, there are also costs (real or imagined) associated with the presence of MNBs, which are potential monetary crises and instable political environments.

The first benefit of multinational banks is efficiency improvements to the financial system. This is because MNBs have a greater scale due to the fact that they operate globally, and the return on technological investment is large once it is installed while the marginal cost of technological investment is small. Moreover, MNBs bring experience and best practices that have been proven to work in other operations around the world. Finally, the competitive advantage possessed by MNBs pressures domestic banks to become more productive. As a result, there are improvements in productivity throughout the whole system. Based on the performance of MNBs in Latin America, they have been able to profit from the benefits of expanding beyond their borders as their profits and efficiency indicators have improved (Moguillansky et al.2004).

Governments aiming to attract foreign investment need to have clear rules of the game. This fact is not different for the financial sector; therefore, the entry of MNBs into a previously closed economy brings a normative environment that benefits the whole system, not just the new foreign entrants. Moreover, these normative changes emphasize property rights; this is observed in improved systems of loan collaterals, and more importantly on the right of the bank owners not to be expropriated capriciously.

Because an MNB is faced with potential monetary crises and unstable political environments, it may choose to withdraw from the host country if it sees an imminent crisis (real or imagined). A country in the process of liberalizing its financial markets needs to consider that multinational banks are an avenue for potential capital outflows; multinational banks could replace investments from domestic banks, and foreign banks may reduce the government's ability to manage the domestic economy (Micco & Panizzo 2004).

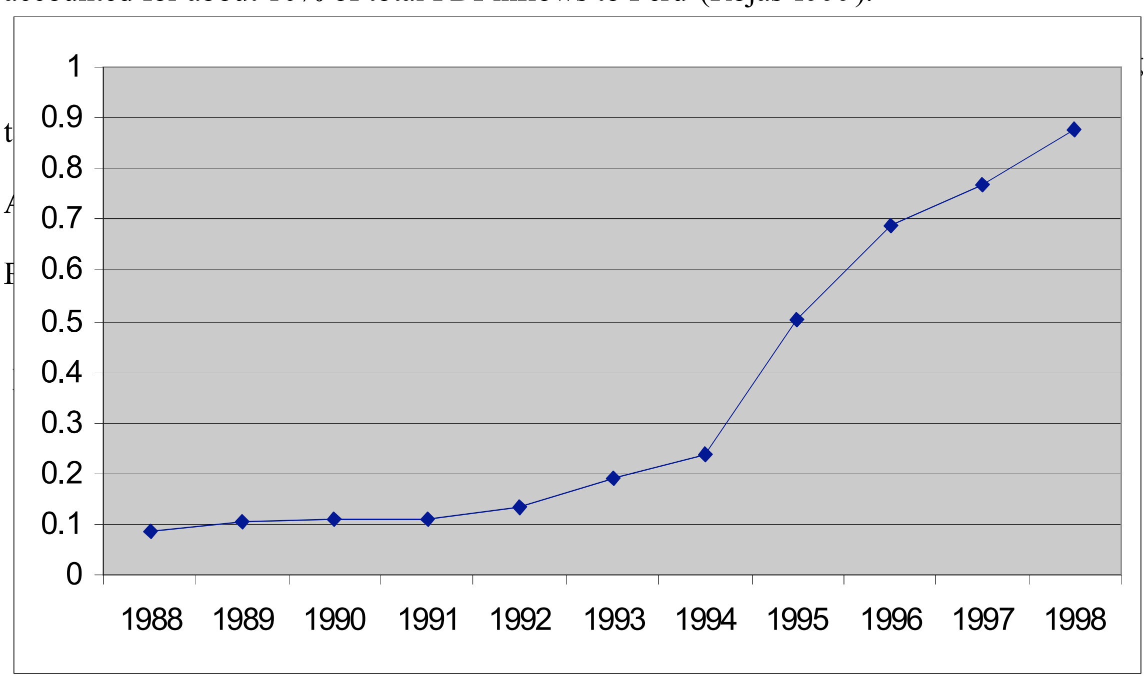
A potential cost of MNBs to a host country is that they can serve as avenues of capital outflows if investors (banks included) fear a crisis. Moreover, if the banking sector is overwhelmingly foreign, the ability of the government to control the economy may be undermined if there is a conflict between the interests of the MNBs' headquarters and those of the government.

MNBs are not immune to liability of foreignness, or the costs that arise from the unfamiliarity from cultural, political, and economic differences between the home and host countries (Zaheer 1995). Mian (2006) identifies two areas where MNBs are at a disadvantage with respect to domestic banks: MNBs are limited in the type of customer they can deal with, and MNBs find it more difficult to negotiate and recover defaults.

Section III gives an overview of the banking system in Peru, and a brief history of the MNBs that are operating in Peru. The analysis of the performance of these banks will be done in a subsequent section.

III. Multinational Banking in Peru

In July1987, President Alan Garcia announced the expropriation and nationalization of all private banks; however, the government later excluded foreign banks from the nationalization process (The New York Times 1987). The nationalization of the banking system was stopped by the courts, but there was very little foreign direct investment after that (See Figure 1). The presence of multinational banking in Peru today is largely due to the process of liberalization started by President Alberto Fujimori in the early 1990s. From 1988 to 1998, FDI inflows into the financial sector have consistently accounted for about 10% of total FDI inflows to Peru (Rojas 1999).



Source: Rojas 1999

Rojas (1999) and Cortez (2000) agree that financial liberalization was an important pull factor in attracting foreign investment to the banking sector. Peru has one of the most liberalized regimes for foreign capital in the world; multinational corporations operating in Peru are protected against discrimination and have access to all sectors of the economy. Moreover, MNCs do not have capital controls and are free to remit capital and profits. Finally, MNCs have the option of signing an agreement with the State to protect their investments (Rojas 1999).

Nowadays the banking sector in Peru has eleven players supervised and regulated by the Banking and Insurance Superintendency operating in the retail sector under the category of universal banking; all of these banks are private (the government auctioned all state-owned banks in the early 1990s). All financial institutions, insurance companies and pension fund administrators are supervised by the Banking and Insurance Superintendency. Bank deposits are insured by the Deposit Insurance Fund[2].

[2] The Deposit Insurance Fund Internet portal is available at http://www.fsd.org.pe/

In spite of MNBs capturing 50% of deposits, the largest bank in Peru is Banco de Credito, a domestic bank who itself is a MNB. Banco de Credito clearly dominates the banking market in Peru by capturing 42.36% of demand deposits; its closest competitor, Banco Continental BBVA, captures 24.87% of demand deposits.

One striking feature of the banking system is its increased concentration; Grosse (2001) notes that similar trends are observed in other countries and other sectors where MNCs have entered into previously closed economies in Latin America. In April 1998, there were twenty five banks operating in the sector of universal banking; in February 2007, that number is eleven. Some banks have exited the market quietly by selling their interests to larger banks, but a large majority was intervened by the Banking and Insurance Superintendency after these banks suffered liquidity crises. Eleven banking institutions are under liquidation by the Banking and Insurance Superintendency[3]; moreover, some of these banks' former managers are under investigation for corruption charges (agenciaperu.com 2001).

Currently, there are six MNBs operating in Peru: Banco Continental BBVA, Scotiabank Peru, Banco Financiero, Banco Interamericano de Finanzas, Citibank Peru, and HSBC Bank Peru. Together, these banks capture roughly 50% of all deposits in Peru (see Table 1 below). MNBs operating in Peru entered the market as early as 1920 and as late as 2006, and came in the form of both acquisitions and greenfield investments mostly from developed countries, with the exception of Banco Financiero, which is headquatered in Ecuador. What follows is a brief description of MNBs present in Peru.

Table 1: Deposits by Type, February 2007

	Demand Deposits	Savings Accounts	Term Deposits	Totals

[3] Up-to-date information on the status of these interventions is available on line at http://www.sbs.gob.pe/liquidaciones_sbs/inicio.htm

Domestic Banks	7051661	7647828	14618999	29318488
Foreign Banks	7287795	5664345	15358691	28310831
Totals	14339456	13312173	29977690	57629319

Source: SBS Peru, 2007

Banco Continental BBVA is the second largest bank in Peru and the largest MNB. The bank is a FDI of Banco Bilbao Vizcaya y Argentaria from Spain, which acquired Banco Continental, a former state-owned bank, in a government auction of state-owned enterprises in 1995. Banco Continental BBVA has 21% participation in demand deposits, second behind Banco de Crédito.

The third largest bank, but the second largest MNB is Scotiabank Peru. This bank emerged from the merger of Banco Sudamericano and Banco Wiese Sudameris. Banco Sudamericano had been a Sotiabank investment (33% equity) since 1997; in 2006, however, Scotiabank acquired the remainder of Banco Sudamericano and a majority stake in Banco Wiese Sudameris (an investment from Italy's Intesa Group), and effectively merged the two banks to form Scotiabank Peru (Scotia Bank 2007). Scotiabank's participation in demand deposits is 18.1% as of February 2007.

The next MNB with presence in Peru is Banco Interamericano de Finanzas (BIF). The bank is a greenfield investment from the Ignacio Fierro Group from Spain. Even though the group has had presence in Peru for over 30 years, the bank was only formed in 1991 (Creditos Peru b). Their per cent participation in demand deposits is 2.67%.

Citibank, is the oldest current MNB investment in Peru, it entered the market as a greenfield investment in 1920 as part of the expansion plans of National City Bank of New York (Bardella 1989). Today, the bank captures 3.84% of demand deposits in Peru.

Banco Financiero is the fifth largest MNB in Peru. This is a greenfield investment from a less developed country to another less developed country. Banco Financiero is a foreign subsidiary of Banco del Pichincha, Ecuador's largest bank. Pichincha entered the Peruvian market in 1964 with Financiera y Promotora de la Construcción, a development bank in the housing and construction sector. In 1986, Banco del Pichincha decides to turn its investment in Peru into a full service bank and renames the company Banco Financiero.

The latest entry into the system is HSBC Bank Peru, a greenfield investment from the London based bank. In spite of being a new player in the banking sector in Peru, HSBC Bank's management comes from the now defunct BankBoston Peru, which had been operating in Peru for eight years; moreover, the ratio of employees to managers (almost 2 to 1) points to the long term plans of the bank in Peru(Creditos Peru b).

In short, the MNB investment in Peru consists of two acquisitions and four greenfield investments. MNBs that entered the market through acquisitions have had greater success in penetrating the market. Together, Banco Continental BBVA and Scotiabank Peru, both acquisitions, have over 40% participation in capturing deposits while greenfield institutions (Citibank, Banco Interamericano de Finanzas, Banco Financiero, and HSBC Bank Peru) capture only 7.84% of demand deposits.

Recently, the banking system in Peru has seen three MNB exits: Banco Santander Central Hispano, Banco Wiese Sudameris, and BankBoston Peru. Banco Santander had operated in the Peruvian market for ten years prior to selling its operations to Banco de Credito in 2002. Italy's Intesa Group controlled Banco Wiese Sudameris from 1996 to 2006, when it sold it to Canada's Scotiabank. Finally, BankBoston sold its operations to Banco de Credito in 2004 after operating in Peru for eight years.

IV. Analysis of Peruvian MNBs

The analysis is this section is based on financial information reported to the Banking and Insurance Superintendency. First, we compare profitability, quality of portfolio and efficiency indicators with the system average to determine the relative performance of MNBs in Peru. Second, we use the geographic distribution of MNB branches and the breakdown of MNB delinquent portfolio to test for distance constraints; namely the type of client MNBs deal with and their ability to recover delinquent loans.

The analysis of the performance of MNBs in Peru does not indicate that these banks outperform their domestic counterparts. Table 2 presents selected financial indicators of profitability, quality of portfolio, and cost efficiency for all MNBs in Peru.

Table 2: Some Financial Indicators for Multinational Banks in Peru, February 2007

	Continental BBVA	Financiero	BIF	Scotiabank	Citibank	HSBC	System Total
ROE	32.15	7.75	15.07	25.34	8.31	-11.24	25.34
ROA	2.75	0.94	0.96	2.21	1.38	-6.34	2.32
Delinquency Rate	1.23	4.35	1.74	2.34	2.06	NA	1.67
Operational Costs / Financial Margin	37.4	55.27	62.07	44.67	50.55	382	45.02
Administrative Costs / Average Profitable Assets	2.82	4.96	3.52	5.18	7.55	10.08	4.52

Source: SBS Peru, 2007

The first two financial indicators measure profitability, ROE (return on equity) is defined as the ratio of net income over shareholder's equity, and ROA (return on assets) is defined the ratio between net income and total assets. These two profitability indicators are below the system average for all MNBs except Banco Continental BBVA and

Scotiabank Peru. With respect to quality, the financial indicator chosen was the delinquency rate; only Banco Continental BBVA performed better than the system average. Finally, the cost efficiency analysis of MNBs in Peru gives the same results, only two out of the six MNBs have lower cost efficiency ratios than the system average; again, these banks are Banco Continental BBVA and Scotiabank Peru. The inclusion of HSBC Bank Peru in the analysis influences the overall performance of MNBs because it is operating at a loss since it the short time it has been operating has not been able to recoup its start up investment. Similar results were found in other countries where there was no significant difference in the performance of foreign and domestic private banks (Crystal et al. 2002, Moguillansky er al. 2004).

The next item up for analysis is to determine if MNBs in Peru are limited in the type of client they can service and if they are worse than domestic banks in dealing with delinquent and defaulted accounts.

77% of MNB branches in Peru are located in the Lima-Callao metropolitan area (Table 3). Moreover, 68% of all credits placed are in the corporate sector, while only 2% where placed with entrepreneurs (Table 4). Mian (2006) argues that this is explained because MNBs are not good at dealing with soft information thus limiting themselves to clients who can provide hard information, such as the kind of information that appears in a credit report. MNBs do not know how to deal with potential customers who operate in the informal economy.

Table 3: Bank Branches in Lima-Callao Metropolitan Area, February 2007

	Offices in Lima-Callao	Total Offices
Banco Continental	129	180
Scotiabank	113	143
Banco Financiero	31	39
BIF	30	34

Citibank	14	14
HSBC	1	1
Total	318	411

Source: SBS Peru, 2007

Table 4: Credits Placed by Type and Financial Institution, February 2007

	Corporate	Microenterprise	Consumption	Mortgage	Row total
Continental BBVA	9295328	45423	1399418	2150816	12890985
Scotiabank	5132093	448586	1555965	938885	8075529
BIF	1323795	1262	206215	358660	1889932
Citibank	1176414	0	747541	10908	1934863
Financiero	814021	51201	348490	234069	1447781
HSBC	80321	0	0	0	80321
Column total	17821972	546472	4257629	3693338	26319411

Source: SBS Peru, 2007

The second constraint observed by Mian is the higher litigation rate of MNBs vis-à-vis domestic banks (Mian 2006). The analysis of MNBs' delinquent portfolio shows that 45.73% of it has gone to court, while the system average is only 37.1%.

Table 5: Multinational Bank Delinquent Portfolio by Institution, February 2007

	Banco Continental BBVA	Banco Financiero	BIF	Scotiabank	Citibank	HSBC	System Total
Delinquent	156,928	63,779	32,713	191,322	40,375	0	485,117
Late	27,661	29,494	10,966	164,959	30,213	0	263,293
Court ordered	129,267	34,285	21,747	26,363	10,162	0	221,824
Total	313,856	127,558	65,426	382,644	80,750	0	970,234

Source: SBS Peru, 2007

Crystal et al. (2002), nevertheless found the opposite; in their study of MNBs in Argentina, Chile and Colombia, foreign banks fared better at recovering loans than domestic private and state-owned banks (Crystal et al. 2002). They attribute this to tighter credit reviews and policies.

The LASFRC (2002) and an ECLAC (Moguillansky et al. 2004) study found that MNBs contribute to financial stability; the banking system has also benefited from improved efficiency from increased competition and the implementation of new technologies. Nevertheless, private customers and corporations have not seen these improvements translated to lower fees and commissions (Moguillansky et al. 2004).

V. Conclusion

Foreign banks control almost 50% of the deposits in Peru, following similar trends in all of Latin America. The emergence of foreign capital in the banking sector in Peru coincides with worldwide surges in FDI in all sectors; however, the liberalization program started by President Fujimori attracted these flows into Peru because of the incentives it provided to foreign investors.

MNBs in Peru do not necessarily perform better than the system average, and face the same liability of foreignness as other MNBs in other markets when they see themselves constrained to the type of clients they can deal with and their inability in negotiating with delinquent and defaulted accounts.

The analysis of the levels of access to banking services indicates that large segments of the population still are not serviced by the banking sector.

Policy makers need to look further than allowing foreign banks to operate in Peru in order to improve the levels of access to financial services. Even though MNB offices are highly concentrated in the Lima-Callao area, this is not much different from the geographic distribution of the offices of domestic banks.

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