

Ownership and Structure of the Financial Sector

Increasing the efficiency of the financial sector is key to improving the flow of financial resources toward profitable firms. Without an orderly and effective financial sector, economies cannot be competitive and profitable firms cannot grow. Three of the most common and important issues concerning the structure and governance of financial sectors in Latin America and the Caribbean in recent years have been the role of public institutions in banking, the internationalization of the banking sector, and whether to allow universal banking or focus on specialized financial institutions.

From a theoretical perspective, there have been a considerable number of arguments on both sides of each of these issues. But until recent years, empirical evidence was far from conclusive. Several authors have since joined efforts and collected valuable cross-country information from around the world concerning public banking and regulations and restrictions on foreign and universal banking.¹ These data have led to more exhaustive empirical analysis of the benefits and drawbacks of the various positions on these issues. The consensus has supported private, internationally open and universal banking as a means of achieving more developed and stable financial systems.

This chapter presents the discussion from a theoretical perspective, describes some recent trends in Latin America in each of these areas, and provides relevant and up-to-date empirical evidence. The findings sug-

gest the need for important transformations in these areas in Latin America in order to achieve more competitive financial sectors, and hence better financial services for growing businesses.

Public Banking

Throughout the world, government-owned financial institutions have been developed to reduce the cost of credit, increase access to it, allocate resources toward strategically chosen projects, design new financial services, and control excessive risk-taking by the financial sector.² In short, in order to promote financial and economic development, governments have taken up the task of intermediating the public's savings.

Despite the recent era of worldwide privatization, public banking has remained in place. While in the 1970s governments owned on average 59 percent of the assets of the 10 largest banks, in 1995 this proportion had only fallen to 42 percent.³

To what extent is it desirable to have the government owning banks? Economists offer conflicting views regarding the impact of public ownership of banks on financial development. Supporters of public banking suggest that government ownership is desirable because it directs savings toward strategic sectors that can have a positive long-term impact on the economy,⁴ provides greater financial services at lower costs, and increases access to credit. This "optimal" allocation of resources is possible in principle because public banks have better information, and have the proper incentives to allocate capital toward socially desirable objectives. In that way, public banking can overcome capital market failures and promote economic development.

¹ See Barth, Caprio and Levine (2000 and 2001b) and La Porta et al. (2000).

² See Fry (1995).

³ Based on data provided by La Porta et al. (2000) and Barth, Caprio and Levine (2001b).

⁴ See Lewis (1950) and Myrdal (1968).

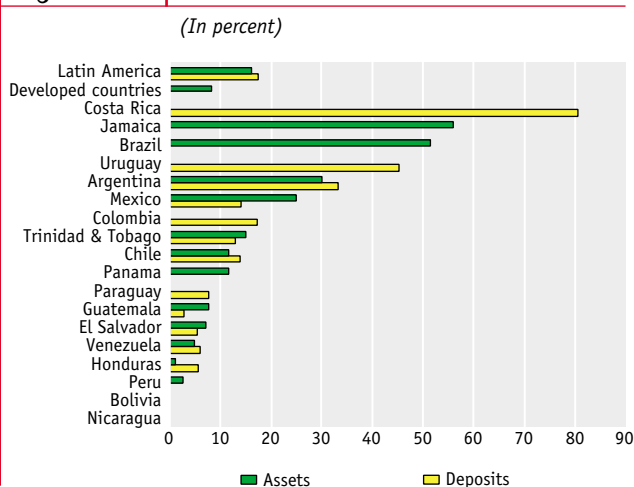
According to this view, public banks also consider other types of social returns beyond financial profits, such as more equitable income distribution and the provision of credit to marginalized social and economic groups. Such socially profitable decisions are less likely to be a concern of the private sector. If the social benefit of intervention in these areas is greater than the social cost induced by the distortions it generates, expanding the scope of public banks is clearly worthwhile.

The contrary view is that government ownership of banks is undesirable because it politicizes lending decisions, softens budget constraints, and diverts funds towards politically attractive projects instead of economically viable ones.⁵ From this perspective, state-owned banks, far from looking out for social welfare, respond more to political incentives. Private banks tend to be better managed than public banks, in many cases can hire and retain better staff than government ones due to salary considerations, and have incentives to allocate resources as efficiently as possible in order to attain higher profits. In the process, the argument goes, they promote economic growth.

Even if there are market distortions in an economy, government intervention through public banking is not necessarily the best way to deal with them. Public spending aimed at correcting the fundamentals of the market distortions can be more profitable and less costly than directing credit towards sectors that for whatever reason have been rationed out. In many cases, the distortions are induced by government rather than by market failures, so the social benefits of solving the problems directly are greater than any benefit from intervening in the credit market. Restrictions on the use of collateral, intervention in financial contracts, or the imposition of limits on information sharing are problems that commonly translate into financial constraints on specific sectors.

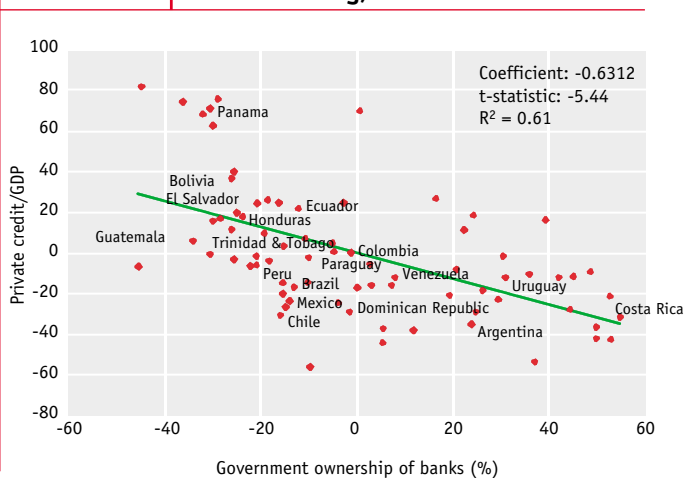
The privatization trend in the early 1990s that decreased public sector involvement in banking by nearly half slowed considerably towards the end of the decade. Data on government ownership of banks for over 120 countries recently collected by Barth, Caprio and Levine (2001b) show relatively widespread government involvement in Latin America's banking sector. As shown in Figure 6.1, Latin American governments on average own nearly 20 percent of total assets of the banking systems and nearly 15 percent of deposits. In contrast, government ownership of banking assets in developed

Figure 6.1 State-owned Banks



Sources: Deposits: IDB Survey of Banking Superintendencies, Ministries of Finance and Central Banks (2000). Assets: Barth, Caprio and Levine (2001a).

Figure 6.2 Financial Development and Public Banking, 1995



Notes: Figures adjusted by average GDP growth, inflation, income per capita (log) and rule of law.

Sources: Bank ownership from La Porta et al. (2000); private credit/GDP and other controls (inflation, log [GDP], average GDP growth rates of previous years) from World Bank (2000); rule of law from Kaufmann, Kraay and Zoido-Lobaton (1999).

countries is about 8 percent. However, while in Jamaica and Brazil the government holds more than 50 percent of banking assets, the figure for El Salvador, Guatemala, Peru and Honduras is less than 10 percent.

Recent empirical evidence supports the hypothesis that public banking has a negative impact on the banking industry and economic performance by impeding

⁵ See Shleifer and Vishny (1994).

Table 6.1 Minimum Conditions for Successful Public Banking**Economic Environment**

- Macroeconomic stability
- Open economy
- Industry competitiveness
- Repayment culture
- Adequate legal and regulatory framework
- Functioning judicial system
- Appropriate supervisory oversight
- Functioning private markets

Project design

- Policy consistency
- Market-like source of funds
- Small, targeted to imperfections
- Select only profitable projects with positive development impact
- Multisectoral: problem-oriented, not sector-specific
- Professional management
- Political independence
- Temporary nature and limited size

Source: Vives and Staking (1997).

the efficient allocation of financial resources. Studies show that countries with (initially) higher levels of government ownership of banks have slower rates of (subsequent) financial development and economic growth,⁶ and that greater government ownership is associated with less efficient, underdeveloped and more fragile financial systems.⁷ Instead of reducing banking and macroeconomic risks, public banking increases them. As a result, interest spreads become wider and financial instability in the form of systemic or nearly systemic banking crises more common. The importance of public banking is greater in countries where governments are less efficient and more corrupt, and where property rights are not protected. Yet, the presence of public banks in these countries exacerbates rather than reduces these problems. The ultimate effect is an overall reduction in productivity, and hence constraints to long-term economic performance.

Figure 6.2 shows the relationship between the current ratio of private credit to GDP and the share of assets of the top 10 banks owned by the government in 1995, once controlled for inflation, the size of the economy, past economic growth, and law enforcement—all factors that also influence financial development.⁸ A strong significant negative relationship between the development of the financial system and public participation in banking is evident.⁹

These findings suggest that the Latin American countries have much to gain from privatizing public banks. Reducing government involvement can lead to efficiency gains at the financial system level, improve the allocation of credit, remove distortions in interest rates associated with implicit bailout premiums, and reduce the fiscal strain on governments that results from owning institutions that are usually inefficient and un-

profitable. The empirical estimations above suggest that reducing government ownership of banking from current levels to developed country levels—which would imply reducing it by more than half—could increase the size of Latin America’s financial sector (as a share of GDP) by nearly 10 percentage points. This of course is just a direct effect—additional positive economic impacts would be expected once governments were free of the fiscal burden of public banks, and citizens free from the obligation of financing, via tax collection, the costs of these inefficient institutions.

However, despite the problems commonly associated with public banking, there are particular cases in Latin America and elsewhere where it has been successful. Table 6.1 divides the conditions needed for successful public banking into environment-specific and project-specific conditions.¹⁰

Public banking is justified only when there are true market distortions as opposed to government-created or macroeconomic distortions. That is, specific sectors are being rationed out of credit not because governments have failed to establish the proper institutional framework, but because of a market distortion. If there are macroeconomic distortions, or the regulatory framework is weak, public lending will likely lead to misallocation of resources at a high social cost.

Even if the environment calls for public lending due to true market distortions, government intervention can

⁶ See La Porta et al. (2000).

⁷ See Barth, Caprio and Levine (2001a).

⁸ As constructed by La Porta et al. (2000).

⁹ Regression results are presented in Appendix Table 6.1.

¹⁰ See Vives and Staking (1997).

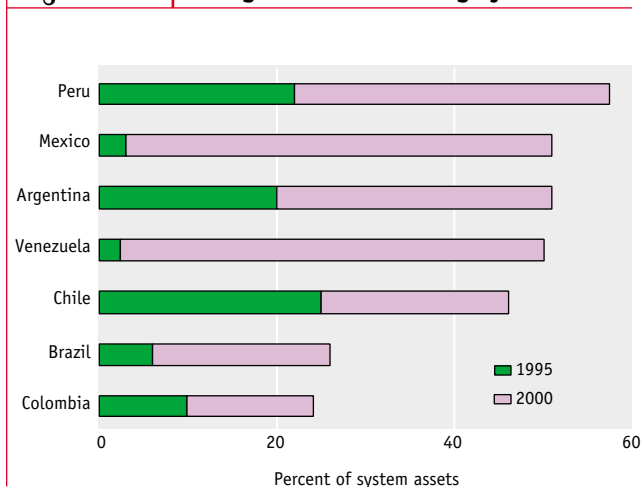
be unsuccessful if the lending program has a faulty design, since there is always the potential for abuse and distortions. The right column of Table 6.1 provides a list of conditions vital to achieving a successful lending program. Project design issues focus on dealing with particular distortions in a transparent way, both from a political and fiscal perspective. However, a lending program must be accompanied by initiatives that target the source of the distortions, so that while the groups affected by the distortion receive temporary relief, action is also under way to correct the distortion itself.

Clearly it is not easy to combine these varying conditions, a difficulty that in fact is what drives the empirical evidence documented above. Given the current stance of Latin American financial markets, governments should direct their efforts towards ensuring the proper functioning of these markets. Governments can have a greater impact by concentrating on macroeconomic stability, keeping their economies open, maintaining a competitive structure for industries, and developing a proper legal and judicial system where property and individual rights are protected, and which allows for the safe and sound functioning of private financial markets. Once these conditions are met, public lending programs that attack the problems and not the symptoms can be designed.

Internationalization of the Banking System

During the second half of the 1990s, the share of foreign ownership of commercial banks in Latin America increased significantly. Restrictions on entry of foreign banks were removed as part of the liberalization process; formerly public banks were privatized, with foreign investors participating in that process; and the banking sector used international funds to recapitalize after the external shocks that hit the region. Figure 6.3 shows the share of assets in foreign-owned (or partially foreign-owned) banking institutions with respect to total banking assets in 1995 and 2000. In all countries except Chile, the share of assets in foreign-owned institutions at least doubled. In Argentina, Chile, Mexico, Peru and Venezuela, the share of assets in such banks was approximately 50 percent of total banking system assets.

Figure 6.3 Foreign Share of Banking System Assets



Notes: These figures do not include the acquisition of Banamex by Citibank in Mexico.

Sources: Crystal, Dages and Goldberg (2001).

Several authors have discussed the potential benefits of more foreign ownership in the banking sector. Levine (1996) argues that it can promote competition and import modern banking skills and technologies, thus improving the quality and availability of financial services. Foreign ownership in the banking sector can also stimulate the development of the underlying bank supervisory and legal framework and increase a country's access to international capital. Recent studies have shown that it can also reduce the vulnerability of the banking sector to domestic shocks.

Recent empirical findings provide evidence on the effects of the internationalization of the banking sector for emerging economies, particularly the Latin American countries. Differences between the way that foreign banks operate as opposed to domestic ones suggest that they can increase overall efficiency and stability. Claessens, Demirguc-Kunt and Huizinga (1998) find that countries that allow foreign participation in banking experience lower average gross interest margins and operating costs¹¹ and have a more competitive banking sector. Martínez Peria and Schmukler (1999) also find that more foreign participation in banking reduces profit margins for domestic banks and increases efficiency. This

¹¹ The authors base their estimates on a bank-level panel for 80 countries over 1988-95. They measure foreign ownership as the share of foreign-owned assets in the banking sector, and as the number of banks that have foreign ownership as a portion of the total.

benefits consumers, who have more access to financial services at lower costs and can take advantage of new financial products offered by the foreign institutions.

Lending by foreign banks is also more stable than that of domestic institutions and depends less on domestic financial cycles.¹² Using information on lending decisions of U.S. banks in the rest of the world, Goldberg (2001) finds that the credit supply from these institutions is linked to U.S. cycles and not correlated with country-specific fluctuations. This finding shows that countries with foreign participation in the banking sector are less vulnerable to idiosyncratic shocks. The potential drawback, however, is that this further opens up channels for international transmission of shocks. However, even though this is a potential source of vulnerability, the overall effect of foreign banking on credit volatility can be expected to be favorable (reduce volatility), given that developed economies are usually more stable than developing ones. In any case, further research has shown that foreign banks have not fled from Latin American countries during financial crises.¹³

Foreign banks have had other positive effects on the health of Latin American financial systems. Crystal, Dages and Goldberg (2001) find that institutions acquired by foreign entities behave more prudently than their domestically owned counterparts. They provision more for loan losses, which reflects a more aggressive approach to loan loss recognition and a greater capacity to absorb losses. This is probably driven by the fact that foreign banks have greater access to capital than local banks, for whom raising additional equity can be much more costly. However, higher provisioning can also reflect a more deficient loan portfolio. In part, this finding is influenced by the fact that in many cases banks acquired by foreign entities were in trouble to begin with. Foreign banks have lower leverage ratios and higher capital ratios than domestic banks.

Under the new Basel Accord, foreign banks will surely play an important role in the transfer of credit risk evaluation methodologies into emerging markets. Foreign banks have greater experience than local ones in risk management, and hence will be able to provide international risk management standards that will increase the effectiveness of prudential regulation in Latin America.

The major claim against foreign entry of banks is that they frequently follow “cherry picking” practices—that is, they select the lowest risk clients for themselves and concentrate the worst risks in the domestic

financial institutions. Evidence regarding this finding is inconclusive. Crystal, Dages and Goldberg (2001) argue that higher provisioning by these banks can be interpreted as evidence against this critique. More provisioning can also reflect relative deterioration of the loan portfolio, which would imply that their loans are no more creditworthy than those of the rest of the system.

Empirical evidence on the impact of foreign banks in Latin America is scarce or preliminary. However, the fragmented evidence available suggests positive effects from internationalizing the banking system. The banking system becomes more efficient and credit volatility is reduced. Other measures that ensure future stability—such as more aggressive provisioning standards and higher capital ratios—are also apparently fostered by foreign entry.

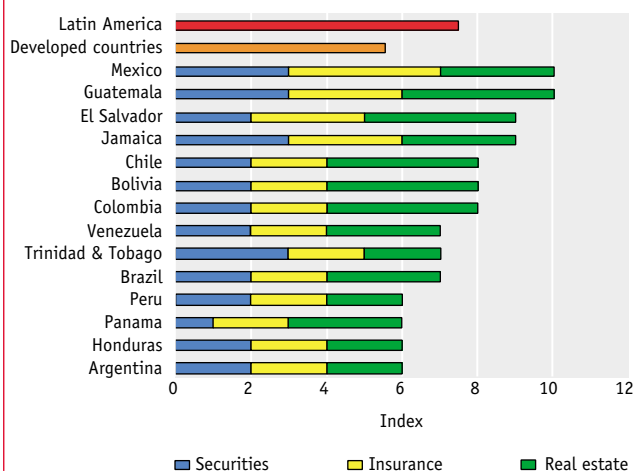
Specialized or Universal Banking?

Should commercial banks be allowed to participate in activities different from those strictly related to banking? Should banking activities be restricted? Viewpoints in the theoretical literature vary regarding whether to allow banks to engage in multiple tasks. On the one hand, supporters maintain that allowing banks to engage in several activities takes advantage of economies of scale and scope (gathering and processing information about clients, risk management, advertisement, etc.), encourages prudent behavior that can increase a bank’s franchise value, and increases banking stability by promoting diversification of income streams. In addition, some believe that allowing mergers between the commercial banking and securities industries increases competition and generates multiple benefits by reducing the price paid for the security by the general public. If competition in the securities industry is allowed, there will be more bidders to underwrite the issue of new securities, reducing the spread between the price guaranteed to the issuer of the security and the price to the public, benefiting both issuers (borrowers) and purchasers (lenders).¹⁴

¹² Dages, Goldberg and Kinney (2000) analyze foreign banking in Argentina and Mexico. Crystal, Dages and Goldberg (2001) also analyze Colombia and Chile.

¹³ See Crystal, Dages and Goldberg (2001).

¹⁴ See Mishkin (1997).

Figure 6.4 Restrictions on Bank Activities

Sources: Barth, Caprio and Levine (2001a) and Superintendencia Bancaria de Colombia.

Others claim, however, that banking activities must be restricted because banks may attempt to shift security related risks to uninformed investors, and conflicts of interests may ensue. They also maintain that deposit insurance and limited liability, without restrictions on banking activities, create perverse effects that can lead commercial banks to undertake riskier transactions (moral hazard). If banks are allowed to engage in the securities industry, instability in the banking sector could increase, since the securities business is usually more risky than traditional banking. The problem could be magnified if there is deposit insurance, since this would promote moral hazard behavior on behalf of banks given that they would be tempted to take high risks in the securities market at the expense of government protected deposits. Banks could also purchase securities either directly or through a trust fund that they themselves underwrote if they were unable to sell them in the market. (However, the argument that this can deteriorate the quality of a bank's assets and contribute to a possible failure can easily be countered by imposing and enforcing proper regulations that avoid this type of pervasive behavior.) The mix of banking and commerce may also lead to the formation of huge entities that can be extremely difficult to monitor or discipline. And these big entities could drive smaller ones out of business, reducing competition and the overall efficiency of the market. This could also lead to unfair competition, since commercial banks can absorb deposits at lower

costs, given that they are usually protected by some sort of deposit insurance. Others argue that specialization can speed the pace of securities market development. Fry (1995) cites countries with universal banking, such as Germany and France, that tend to have weaker equity markets because bank services crowd out other alternative financing sources.

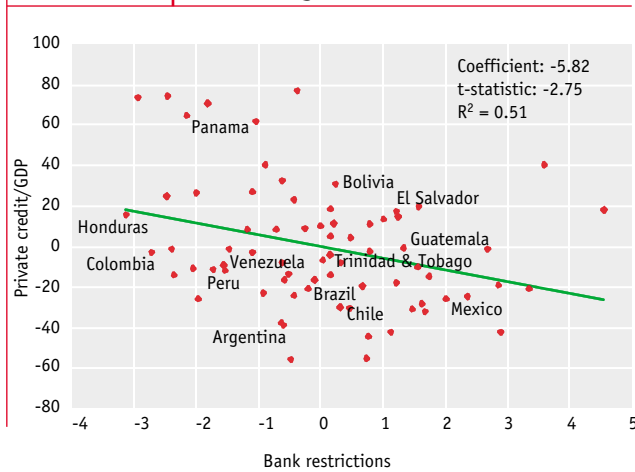
In many countries, the banking and securities industries are forced to remain separate.¹⁵ Banks are allowed to sell new offerings of government securities, but cannot underwrite corporate securities or engage in brokerage activities. Not all countries, however, have followed such a scheme. For example, Japan has adopted a similar structure in the sense that banking and insurance industries are separated, but it allows banks to own equity in commercial firms. In Germany, the Netherlands, Switzerland and, more recently, the United States, there is no separation between commercial banking, securities and insurance industries. One single legal entity is allowed to operate any of these activities, and banks usually hold commercial firms' equity. The United Kingdom, Canada and Australia abide by universal banking principles as well, but in a slightly different style. The combination of banking and insurance is less common in these countries, and different operations are usually carried out through separate legal subsidiaries of the bank. The Japanese banking industry is evolving, and appears to be leaning toward the British style of organization.¹⁶

In many Latin American countries, there are major restrictions on the types of business opportunities in which commercial banks are allowed to engage (see Figure 6.4). Following the activity index as constructed by Barth, Caprio and Levine (2001b),¹⁷ the size of the bars in Figure 6.4 denotes the degree to which each activity is restricted. Larger bars imply higher restrictions. In countries such as Mexico, Guatemala, El Salvador and Jamaica, banks cannot freely undertake in securities underwriting, insurance or real estate activities. In Brazil, Bolivia, Chile, Peru and Venezuela, only bank sub-

¹⁵ As in the United States from the time of the passage of the Glass-Steagall Act in 1933 until it was repealed in 1999.

¹⁶ See Mishkin (1997).

¹⁷ On a scale of 1 to 4, the index measures the extent to which securities, insurance and real estate activities are restricted. Four means the highest restrictions. Figure 6.4 presents the three individual indexes in one unique measure.

Figure 6.5 Financial Development and Restrictions on Banking

Notes: Figures adjusted by average GDP growth, inflation, income per capita (log) and rule of law.

Sources: Bank restrictions from Barth, Caprio and Levine (2001a) and Banco de la República de Colombia; private credit/GDP and other controls (inflation, log [GDP], average GDP growth rates of previous years) from World Bank (2000); rule of law from Kaufmann, Kraay and Zoido-Lobaton (1999).

subsidiaries can engage in such activities. To some extent, the least restricted are the banks in Argentina, Panama and Honduras. Comparing the index for the 13 Latin American countries surveyed to that of developed countries, it is clear that the former group tends to have more restrictive banking systems than the latter.

As with most of these regulatory issues, the impact of these restrictions on financial sector development and stability boils down to an empirical matter. There is no unique theoretical case in favor of or against universal banking, and empirical analyses are scant due to lack of comparative information across countries. Barth, Caprio and Levine (2000 and 2001a) construct an extended database for over 100 countries and use their data to show that restrictions on banking activities are associated with less financial development and less stable banking systems. Figure 6.5 shows the relationship between the overall activity index and the ratio of credit to GDP, after controlling for various factors such as the size of the economy, previous GDP growth, inflation and overall law enforcement. The figure and the regression results underlying it (as reported in Appendix Table 6.1), suggest that there is an important negative relationship between the degree of restrictiveness and the size of the financial sector.

Latin American countries have various opportunities to promote financial sector development on this

front. The empirical estimates suggest that reducing restrictions to developed country levels would imply on average an enlargement of the financial sector of nearly 15 percentage points of GDP. Allowing banks to assume more risks—provided that proper regulations are in place to support responsible risk taking—can widen financial services and promote business development.

Conclusions

The Latin American and Caribbean countries have comparatively large government-owned banking sectors and impose more restrictions on banking activities than elsewhere in the world. Research shows that public banking worldwide generates distortions in the financial sector and leads to inefficient allocation of capital. It also generates pressure on government finances that discourages inflows of international capital and deteriorates the competitiveness of local firms. Latin American businesses could increase their access to credit markets substantially if state banking were reduced. Because the overall efficiency of financial services would then improve, there would be less dependence on external finance and improved financial stability. Because fiscal pressure would be alleviated, investment and overall efficiency would increase.

Traditionally, public banking has been directed towards providing financial services to economic sectors that have been rationed out of credit. However, governments can contribute to credit expansion and better access to credit through other mechanisms, such as the design and enforcement of an arrangement compatible with incentives.

The share of foreign banking in Latin American countries has increased dramatically in the past years. In many countries foreign banks own nearly half or more of the financial system. Although much of the impact of this recent trend has not been studied, preliminary evidence suggests it will lead to greater efficiency and more stability in domestic financial sectors.

Regarding universal banking, evidence suggests that increasing the scope of financial activity can also promote financial sector depth and stability. Increasing the scope of action of banks stabilizes income flows. However, this is valid only up to a point, and must be interpreted with caution. In order to achieve such diversification, it is necessary to have some development

of securities markets. Many Latin American countries lag behind in this respect, which would imply that even if universal banking were more widespread, the gains from diversification, if any, would not be immediate. Expanding the scope of action of banks also requires a prudent institutional arrangement that allows for the monitoring and control of larger financial entities. This in turn points to the importance of dealing with regulatory deficiencies such as those described in the previous chapter before turning to universal banking as a means of promoting wider access to credit.

Appendix Table 6.1 Financial Development and Government Ownership of Banks and Restrictions on Commercial Bank Activities: Regression Results

	Dependent variable: private credit/GDP	
	Reg. 1	Reg. 2
Constant	-42.560 (-0.82)	8.010 (0.16)
Income per capita (log)	3.938 (3.88)***	2.730 (1.48)
Average economic growth ¹	7.072 (4.59)***	7.410 (4.01)***
Inflation	0.006 (0.210)	-0.102 (-0.570)
Rule of law	16.207 (3.88)***	16.190 (3.34)***
Government ownership of assets of 10 largest banks	-0.631 (-5.44)***	
Restriction index		-5.820 (-2.75)***
R ²	0.61	0.51
No. of observations	75	74

¹ Average growth of per capita GDP from 1980-97.

Note: t-statistics in parentheses.

* Significant at the 10% level.

** Significant at the 5% level.

*** Significant at the 1% level.