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Cost efficiency in the Latin American and Caribbean banking systems

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Abstract

A common cost frontier with country-specific environmental variables was estimated for a panel of 481 banks from 16 Latin American countries. A stochastic frontier model was used to estimate cost inefficiency and scale and scope economies. The results suggest that there is a wide range of inefficiency levels across countries. Very small and very large banks are significantly more inefficient than large banks. Underperforming banks tend to be smaller, to be undercapitalized, to present a poor profit performance, to be more dependent on non-interest income, to be more risky, to have a less stable deposit base and to intermediate less.
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1. Introduction

In recent years, the liberalization of financial markets at a global scale, the increasing use of advanced technology, and the information revolution have put competitive pressure on banking firms both domestically and internationally. This competitive pressure is particularly important for emerging markets, where banks constitute the main financial intermediaries to channel savings and investment. Due to these developments in the banking

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sectors, banks are trying to find ways to enhance their efficiency, and to exploit scale and scope economies.

Although entry of foreign banks was not unknown to emerging markets, the last decade witnessed a wave of foreign entry activity in these markets. There has also been an active trend toward cross-border mergers and acquisitions among financial institutions across world regions. There is still discussion on the benefits of such process but it has undeniably changed the competitive landscape (Berger, 2000).

Latin America and the Caribbean is a region where this trend has been particularly intense. Many countries suffered financial crises after the initial period of liberalization since the beginning of the 1990s. The cycle of liberalization-crisis-re-liberalization has created three important phenomena: a reduction in the total number of banks, a decline in the participation of state-owned banks in total intermediation, and finally, perhaps most importantly, an increase in the market shares of foreign banks. Table 1 reports changes in the market share of foreign and state-owned banks. As seen in the Table 1, the market share of foreign banks increased tremendously over the period 1995–2001.

Large international banks like Banco Bilbao Vizcaya Argentaria, Santander Central Hispano, Citibank, HSCB Bank, Fleet Boston, ABN AMRO Bank, Scotiabank and JP Morgan are very active players across all markets. The operations of these financial institutions, at a regional level, have increased dramatically compared to intraregional integration among native banks. As reported in Table 1, the market share of foreign banks from other Latin American countries is very small in large economies in Latin America. The share of Spanish and American banks in foreign banking, on the other hand, is large. Therefore, inter-country financial integration has been accomplished by international banking institutions. Domestic regulation has also been updated to international standards.

Although the market share of state-owned banks has decreased over the years, they are still major players in the Latin American and Caribbean banking systems. The prevailing organizational forms in the region are commercial banks. Only 12% of all banks are specialized credit institutions. With variations from country to country, most of the commercial

Table 1
The market share of foreign and state-owned banks, 1995–2001

Country	The market share of foreign banks (1995–2001) (%)	The share of foreign banks from other Latin American countries in foreign banking 2001 (%)	The share of Spanish and American banks in foreign banking 2001 (%)	The market share of state-owned banks (1995–2001) (%)
Argentina	21.7–48.5	3.4	57.1	36.0–32.4
Brazil	8.4–29.7	0.3	52.9	52.3–33.4
Chile	15.7–46.8	0.4	86.1	16.3–13.3
Mexico	6.2–75.5	0.0	90.9	−21.7
Venezuela	3.3–43.2	0.5	89.3	33.7–6.9

Source: All the figures are taken from Bankscope IBCA (own calculations), Latin Banking—Citibank Guide and Directory 2002, Miami August 2002, and the book “La banca en Latinoamérica: reformas recientes y perspectivas”, by J.M. Liso, M. Soler, M. Manero, M.P. Buil (Liso et al., 2002). The figures do not include local credit cooperatives for Brazil. Note: Mexico had a nationalized banking system during the period 1982–1991. The market share is calculated with respect to total assets.

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