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Banking in North America

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**Mapping the New
North American Reality**

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Mapping the New North American Reality

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When discussing financial services integration in North America, we need a better understanding of what can be called the “Banking Industry Effect” and how this differs from the effects of Regional Integration of Financial Services (RIFS). This is an area in which we still lack a proper conceptual framework. Then we should also ask ourselves whether RIFS is worth pursuing. The answer to such a question does not have to do at all with gains from the globalization of banking (i.e. Banking Industry Effects); rather, it refers to the existence of at least one distinctive – “truly North American” – reason for the promotion of RIFS. Demographics can provide that reason.

The service sector has been the leading force in the recent economic performance of North America. Thus, if Mexico wants to achieve convergence to its northern neighbours, it is in its own interest to promote further integration in services. But we need to be clear about the forces driving such integration, especially of financial services.

It is not clear yet what we should understand by Regional Integration in Financial services (RIFS) and this lack of proper operational definition could be leading to an imprecise interpretation of North American reality in this area. What we might interpret as a “North American Effect” could actually represent a “Banking Industry Effect”!

The former does not mean that regional factors are not relevant for the banking business; in fact, I argue that RIFS offers a huge potential in North America. The problem is that we might have been looking at the wrong direction, i.e. that of industry-specific, rather than the regional-specific opportunities in the financial sector. These are ideas which require further elaboration, and the purpose of this note is to offer a preliminary outline of them.

¹ Department of Economic Research, Banamex. The opinions on this paper are those of the author and do not necessarily reflect Banamex’s point of view.

Banking in North America: a regional or a global phenomenon?

Regarding banking conditions in Canada, the US and Mexico since the mid-1990s, Mailander shows a great deal of insight when he points out that “..the three countries were debating change domestically, but in many ways the banking sector challenges were international”². Banks in North America were reacting to the same forces shaping change in the banking industry worldwide:

- a) **Disintermediation**, which means that institutions such as pensions funds manage an increasing proportion of total financial resources. For banks, this trend implies an urgent need to increase their scope of activities (i.e. to compensate a shrinking balance sheet with off-balance transactions)
- b) **Technological change**. We are all familiar now with the idea that the efficiency of financial intermediation depends to a good extent on economies of scale (e.g. for pooling risk and credit monitoring). In this respect, an IT revolution can only mean one thing for banks: economies of scale on steroids. Size has become more important than ever.
- c) **Deregulation**. It is difficult to say if deregulation is an additional cause for change or a consequence of the aforementioned two forces. The fact of the matter is that deregulation means blurring differences in the traditional relevant markets of the financial industry.

In the mid-1990s, the three countries in North America were deeply involved with their own domestic circumstances in the financial realm--regional integration thus ranked lower in their priorities than re-regulation in response to the three forces discussed above. This fact might explain why we did not see a lot of activity in this front during the first few years of the NAFTA. That said, it could be argued that the stage of major financial reforms in the region at the national level is now finished and that recent developments are the dawn of a RIFS revolution in North America.

In this respect, Mexico’s experience offers a useful example. The dual challenges of consolidation in the number of players and the strengthening of the financial system were expressed in a decision to accelerate NAFTA’s original schedule of opening up to foreign ownership. Thus, it would be natural to think that such a decision paved the way for a rapid increase in the presence of foreign capital in Mexico’s banking sector. As the left-hand panel of the **chart below** shows, this has been indeed the case: presence of foreign banks

² Mailander, C. (1999) “Reshaping North American Banking”. Policy Papers on the Americas, CSIS.

operating in Mexico increased substantially after 1999. Nevertheless, two issues should be considered: a) although this trend has been particularly intense in Mexico, it is also present in other countries: the figures for Chile are relevant because they show that we cannot attribute this behaviour to macroeconomic instability; b) more importantly, both regional *and* extra-regional players are present in Mexico. As it can be seen in the right-hand side panel of the aforementioned chart, banks of North American origin in Mexico control a larger proportion of total assets than in Chile, but in both cases, the share of extra-regional banks is larger still.

These two observations lend credence to the hypothesis that the international expansion of banks does not necessarily follow trade-integration patterns, but is mostly driven by the primal necessity to grow; in our global world, banks need to achieve economies of scale independently of their countries of origin, let alone their geographical – or economic – regions.

The point to stress is that *banks are traders of commodities*. What they offer is the ability to intermediate between supply and demand of savings at the *national* level. What really makes the difference between financial intermediaries is the efficiency with which they perform the intermediation process, and that is intimately related to two factors:

- a) The technological base they possess;
- b) Their managerial capital and their risk-processing capabilities;

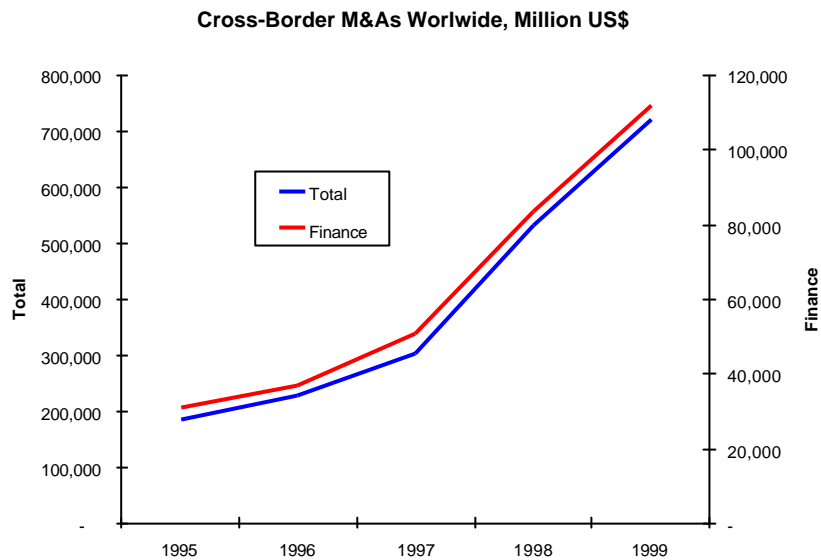
Both of these features represent fixed investments and as such, are subject to increasing returns to scale. Hence, there is an incentive to expand while at the same time there is no reason to pursue such a goal via the slower pace of organic growth: M&A are a better alternative³

It could be argued that financial expansion via “organic growth” makes sense in the context of financial activities where brand recognition is important (i.e. reputation, a long tradition of sound management). That

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is the reason why finance-related Cross-Border M&A have represented around 15% on average of the boom in this kind of operations worldwide at the end of the 1990s (see chart below).



Yet such a frantic rhythm of Cross-Border M&A activity in the financial industry is actually a global phenomenon. In fact, the foregoing argument is a general one, in the sense that it can actually explain both M&A operations within the same country and M&A operations across different regions of the world. In other words, the phenomenon is not conditional on the existence of a process of regional integration at all!

The former suggests we should be rather cautious in the way we interpret recent developments in North American banking. In particular, we should be careful not to attribute to RIFS what actually can be motivated by drivers operating in the financial industry worldwide. The good news is that there might be a more exciting and far-reaching dimension of RIFS in North America; we just have to look in the right direction.

The scope for RIFS in North America: an analytical framework In this respect, it is useful to start thinking in terms of product markets, where the primal condition for regional integration is clearly established—namely, a substantial reduction in transaction costs within the region.

Suppose we extend this definition further to include financial markets. Under this approach, what we should promote is a reduction in regulatory costs, particularly those implying an entry barrier into specific national markets within the region.

That said, who will benefit? Consumers can expect better conditions because of:

Efficiency gains in financial intermediation, and increased competition among (larger) regional banks. So far, what we have therefore is very much the textbook analysis of gains from trade in industries subject to economies of scale⁵. Nevertheless, the picture is somewhat different when we realize that, from the point of view of the financial institutions, the benefits are symmetrical, in the sense that both the banks from the region *and* those from outside the region stand to gain from regional integration! The reason is quite simple, once we think about it. When the opening up of Mexico's financial sector started, one of the most frequent things the public used to ask was: "given that foreign banks have more money, does it mean that I can have more credit?"

Perhaps amusing, this anecdote reminds us that banks intermediate *local* resources. More specifically, they take deposits from the public in order to lend that money to borrowers. Apart from capitalization requirements, the two sides of a bank's balance sheet must match, independently of whether that capital is of local or foreign origin. Therefore, financial intermediation can become more efficient as a consequence of regional integration arrangements as the ones that have been discussed so far. However, *the supply and demand of funds will be still determined at the national level.*

In this respect, regulatory convergence – including free entry of financial institutions in each national market – is perhaps necessary for achieving RIFS, but it is not a sufficient condition. For RIFS to happen, it must be reflected first and foremost in banks' balance sheets. For example, that the supply of funds in one country of the region could be used to meet the demand for resources from borrowers in a different country or – if

you prefer – a stage in which financial institutions are in the position to actually “merge” their different books into a single, “regional” balance sheet. Achieving such a status would require substantial changes, including major macroeconomic reforms. Therefore, the question is: are there equally substantial, “truly North American” benefits from pursuing RIFS in our region?

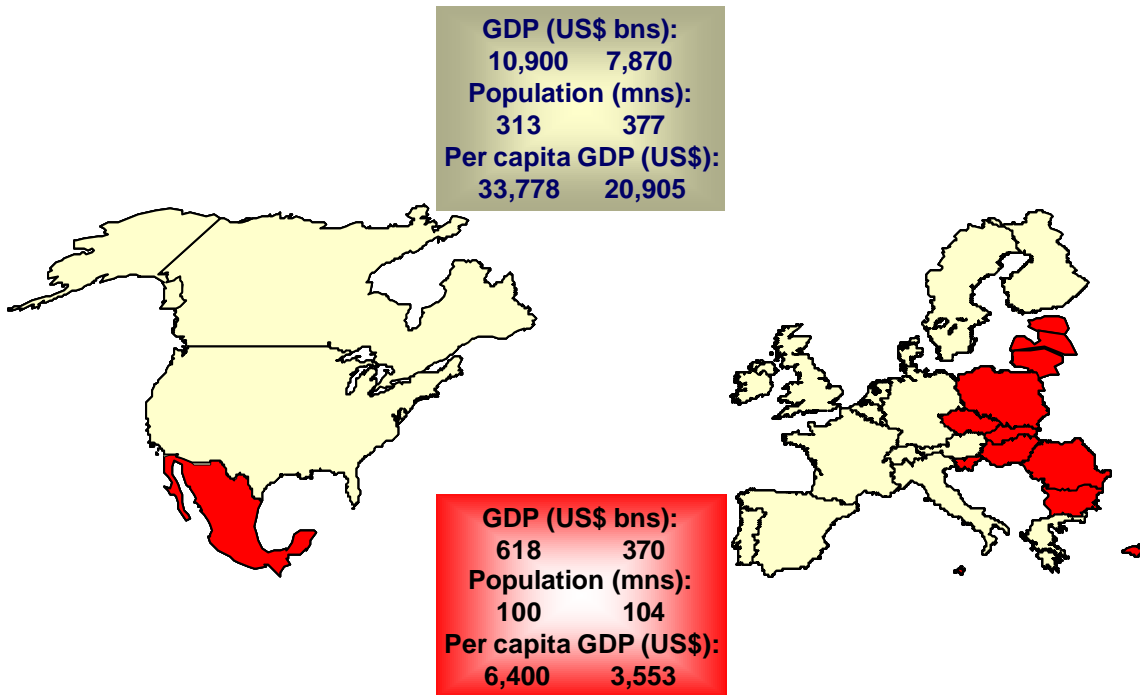
The strategic importance of RIFS in North America

It has been said that a decline of “cross-border” risk – along with regulatory convergence – would be required for achieving meaningful RIFS in our region. Suppose we reach that point: will financial services in North America have a better prospect *vis-à-vis* their counterparts in other integrated regions of the world (say, the Euro Area)?

This could be the case due to an intrinsic feature of the intermediation process: its *intertemporal nature*. RIFS – in addition to allowing seamless intermediation of funds across our three countries – would continue to operate as any other financial system, in the sense of using the *current* savings of households and corporation in order to finance the projects that will allow individuals and firms in the *future* to pay for the resources borrowed. In other words, *to mobilize savings in such a way so as to optimize the inter-generational allocation of resources on a regional scale*.

The potential here is unique. The chart below represents the map of the EU at the end of next year. It has been argued that one of the advantages of enlargement is that the EU will surpass North America (here represented by the US and Canada) in terms of GDP, population and per capita income. Nevertheless, and given that Mexico’s population, GDP and per capita income are above those for the “2004 EU generation”, an “enlarged EU” will still constitute a smaller market than “post-NAFTA North America”!

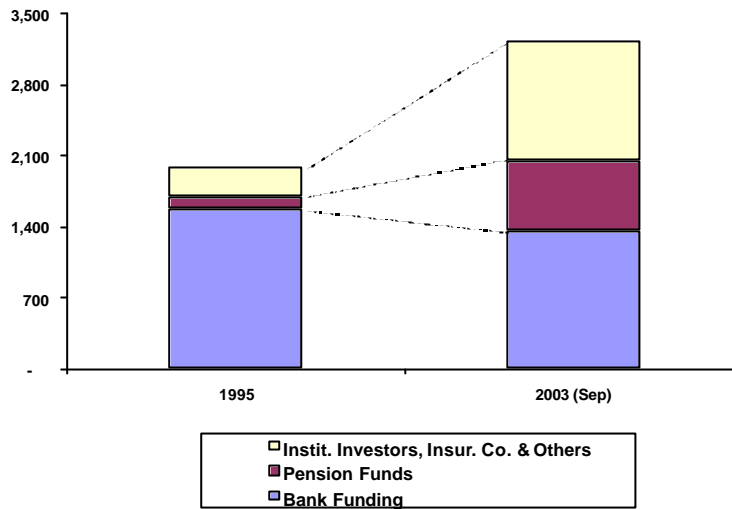
⁵ See for example, chapter 6 in: “Internacional Economics, Theory and Policy”, by Paul Krugman and Maurice Obstfeld (Harper Collins).



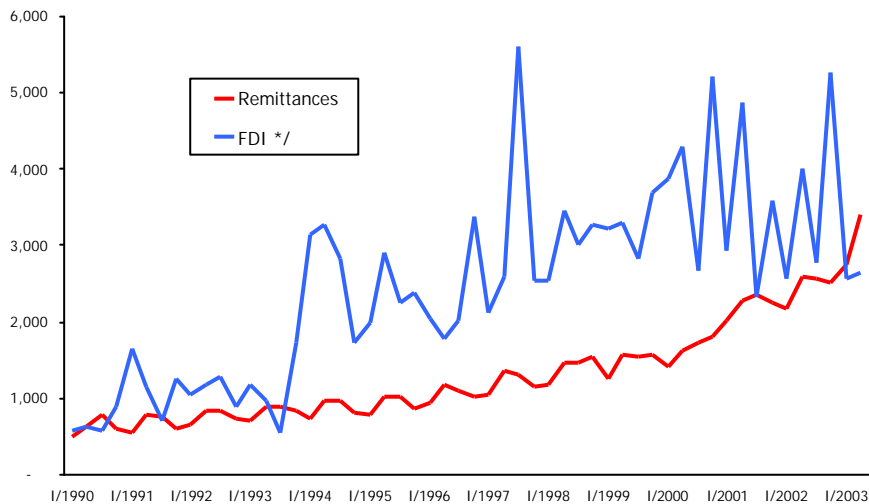
More importantly, this differential is bound to keep growing in the future. The reason? Demographics. The age-structures of the population in Eastern and Western Europe are quite similar, so 2004 will bring enlargement but no advantages in terms of demographic complementarity: by 2010, the size of the workforce in the EU will experience a reduction in absolute terms (approximately 180,000 less individuals) vs. levels in the year 2000. In sharp contrast, differing age-structures in North America mean that we can not only gain in terms of market size, but more importantly, in terms of demographic complementarity as well: by 2010, the size of the workforce in our region will increase in 27 *million* individuals, with 40% of that expansion explained by Mexico alone.

One of the forces shaping global finances – universal banking and the growing role of pension funds and institutional investors – is particularly well suited to take advantage of the opportunities offered by demographic complementarity in our region. Again, the case of Mexico is worth mentioning: in spite of a lower degree of financial deepness vis-à-vis the rest of our region, financial savings as a proportion of GDP have been growing rapidly in recent years and currently stand above 50%, the highest ever in Mexico. Institutional investors, other specialized intermediaries and pension funds – mostly driven by the reform to the country’s pension system – are the main force behind this expansion, while the role of traditional bank deposits has been losing importance (see chart below).

**Mexico: Structure of Financial Savings,
Billion 2002 Pesos**



**Mexico: Foreign Remittances and FDI
Million US\$**



*/ It excludes the 12.5 US\$ billion Citi's purchase of Banamex

In this respect, North America has the means at its disposal to meet the challenge that demographic change implies for financial systems. This constitutes a key strategic advantage vs. other regions. To a good extent, flexibility and innovation in the supply of financial services is the name of a game we have started to play: close to 20 million people in the US are of Mexican origin (either born in Mexico or of Mexican descent). What this trend implies is that our definition of households increasingly extends across borders and takes a distinctively regional character. As it is natural to expect, monetary transfers within these peculiar households also cross borders: a recent study by the Inter-American Development Bank estimates that

Mexico's income from foreign remittances will reach US\$ 14.5 billion in 2003, a figure likely to surpass Mexico's Foreign Direct Investment flows (see chart below). Financial institutions have started to exploit the potential that this change in demographic and economic conditions in North America implies.

This example is just one dimension of what RIFS can achieve in our region. It can be said that so far, financial services have started to cross national borders along with the individuals and/or companies; our aim should be for RIFS to allow financial resources to flow across our region by themselves, in order to meet firms and individuals right where they are and with the services that they specifically require.

From this strategic perspective, achieving RIFS in North America more than justifies its costs. The contribution of the financial system to the overall well-being of societies has to do with the allocation of savings to their most productive uses. Thus, a seamless, region-wide mobilization of these resources would allow us to capture the whole potential of demographic complementarity that our region possesses and would become a key element in the creation of a new – and better – North American reality.