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They might be giants

A special report on banking in emerging markets | May 15th 2010

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Also in this section

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Emerging-market banks have raced ahead despite the financial crisis as their Western colleagues have languished. Patrick Foulis asks how they will use their new-found strength

ALONG the breezy three-kilometre stretch of Mumbai's Marine Drive you pass cricket pitches, destitute people, luxury hotels, plump joggers and advertisements for Indian multinational companies, but almost no bank branches or cash machines. That absence, suggests O.P. Bhatt, chairman of State Bank of India, the country's biggest lender, gives the visitor a hint of the potential for the banking industry. Marine Drive has been underbanked since it was built in the 1930s. But now there is a palpable sense in India, as in most other emerging economies, that banking is thriving—just as it has fallen into disrepute in many Western countries.

The emerging world has a history of volatility and of bad-debt problems—indeed China is grappling with such a problem at the moment. But developing-country banks now have got things right on a number of fronts. Anti-poverty campaigners can admire their efforts to offer banking services to the illiterate. Technology gurus can see new mobile applications and low-cost IT platforms, and industrialists can count on banks that actually want to lend to their firms. Regulation buffs see an industry that is both armour-plated and wrapped in cotton wool after the crises of the late 1990s and early 2000s. In most emerging economies banks are viewed as engines of development rather than as rent-seeking parasites.

But it is by the hard stuff, money, that banks in the developing world now measure up. Not only are they well capitalised and well funded, they are really big—and are enjoying rapid growth. By profits, Tier-1 capital, dividends and market value they now account for a quarter to half of the global banking industry. China's lenders head the list of banks by market value, and Brazilian and Russian banks are among the world's top 25. At current growth rates India's banks will catch up in a decade. The crisis in Western banking, still reverberating in southern Europe, seems to have accelerated the shift in banking muscle from rich countries to the developing world.

This special report will argue that most of that muscle will be needed at home. To support the fast credit growth their populations and politicians demand, and the bad debts it may cause, emerging-market banks will need more capital than they can generate from retained profits. They are the pre-eminent gatherers of savings in the world, a mirror image of Western banks that became huge borrowers. But they will struggle to use those excess deposits abroad without taking dangerous currency risks, so the job of recycling excess savings abroad will remain with central banks and sovereign-wealth funds. The managers of emerging-market banks have plenty to do as it is. Some of them already run organisations that are far bigger than the biggest Western banks. Most also expect to lose corporate customers to local bond ▸▸

markets and to have to build up their consumer- and investment-banking operations to compensate. Many, too, are finding innovative ways to offer banking services to poor people without losing money.

If the crisis has transformed the status of emerging-market banks, it has also transformed the role of the state in banking. In China, which had been relaxing its grip on the industry for a decade, the government directed the banks to continue lending during 2008 and 2009—the main reason why the economy continued to grow fast. In Brazil, India and Russia the state banks have seen a sharp improvement in their fortunes, gaining market share at the expense of private banks. Some Western banks operating in developing countries have lived up to their reputation as unreliable partners. That is likely to have long-term consequences. The banking system most emerging economies now want is a mix of entrepreneurial private firms and state banks, with a few well-run foreign ones to keep the locals honest.

That has big implications for the long list of Western firms desperate to gain more exposure to emerging economies. The crisis has underscored the attractions of two business models. The network banks, such as Citigroup or HSBC, have a presence in lots of countries to make life easier for their customers. The "gone native" ones, such as Santander, have big retail operations with large market shares in just a few countries where they act like, and by and large are treated as, local firms. Both these models involve gathering deposits and operating branches on a large scale. The big investment banks are also active in emerging economies but may find the going increasingly tough as local banks get better.

Both those models are almost impossible to replicate now. The network banks are the products of a century of expansion. They are sufficiently entrenched for Citigroup's near-collapse in New York, for instance, to cause minimal damage to its emerging-market business. The "gone native" banks seized unique opportunities in the 1990s and early 2000s as Latin America sold off banks after bad-debt crises and eastern Europe privatised after communism's fall. No such sell-off looks remotely likely soon in China, India or Russia. Even the traditional last-resort technique for banks that want to become more international—setting up a few branches overseas and borrowing from headquarters or wholesale markets to fund lending there—has become much harder as regulators are clamping down on it.

The difficulty is mutual

The only consolation for Western firms that cannot get in is that emerging-market banks are facing exactly the same set of problems as they try to expand abroad. For them the crisis came too soon. With another decade under their belt they might have had the size, excess capital and skills to seize the moment and buy big bombed-out banks at the peak of the crisis. As it is, most are having to embrace gradualist strategies. All are building "strings of pearls"—branches in big partner countries to help service customers at home. Some are also offering banking services to diaspora populations in rich countries.

The Western banks have found that establishing a light presence in lots of countries is a great way to lose money. The same is likely to be true for emerging-market banks, so the smarter firms are trying to develop a competitive advantage that they can export. For the Indians that may be low-cost technology; for the Brazilians, investment-banking savvy. Some of the biggest emerging-market banks are experimenting with small acquisitions in their "near abroad". Going global requires the successful integration of lots of acquisitions, which Western banks have found hard to do.

This special report will show that the globalisation of banking, which has driven the industry for two decades, is in many ways on hold. If emerging economies are much more sceptical about unfettered finance and the role of foreign banks, Western societies are much more hostile to banks in general, let alone those run by foreigners or, worse still, foreign governments. Although emerging-market banks have far healthier business models than Western firms do, many of them will face a difficult trade-off. They will need access to foreign countries in order to build the sort of large-scale operations that make money. To get it, they may have to show that they are at arm's length, or even entirely detached, from their governments. Yet the crisis has pushed most banks in the developing world the other way.

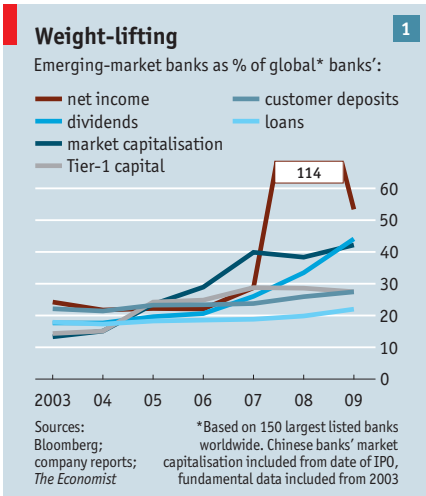
These banks have been pitched into the big league rather suddenly, helped by the woes of Western banks and the continued strong growth in their own economies. It seems inevitable that Mumbai's Marine Drive will soon be decked with ATM machines, its joggers will be stabbing mobile-banking screens, the firms on the billboards will be going on buying sprees overseas and even the destitute will have some access to finance. Whether emerging-market banks will soon punch their weight in global banking, let alone dominate it, is another question. ■

The bigger and bigger picture

The developing world's banks are flourishing

THERE is only one thing that is still small about banks in emerging economies: their bosses' pay packets. The head of China's ICBC, the world's biggest bank by market value, received just under $134,000 in 2009, a couple of decimal places shy of his Western counterparts. On all other measures these firms are big enough to make a Wall Street banker reconsider his status in the universe. In terms of market value they now account for almost half the industry's total worldwide, nearly twice as much as in 2005. That might reflect an excess of optimism, but emerging-market banks are big by other measures too. According to Tab Bowers, a consultant at McKinsey, they account for about a third of the industry's global revenues, matching the emerging countries' share of world GDP. By the most solid measures of all, profits, dividends and Tier-1 capital, listed banks domiciled in emerging markets now account for between 27% and 53% of the global industry (see chart 1, next page). China is responsible for about half of this share. Big Western banks' profits from developing countries add up to perhaps a quarter of the local firms'.

Despite their large size, most emerging-market banks are not household names in



the West. Most rich-world investors are aware of China's "big three" banks, at or near the top of the global rankings (see table 2), but know little about them. Aside from the Chinese banks, the global top 25 include a handful of big Russian and Brazilian firms, and lower down there is a long list of smaller banks that together add up to quite a lot. The average listed rich-country bank in the top 150 has a market value of about $36 billion, against $24 billion for emerging-market firms and just $15 billion if China is excluded. Many are state-controlled and most were handsomely profitable through the crisis and have good capital and funding profiles. Few have much business overseas.

The numbers game

League tables in banking are dangerous things. In 1990 all ten of the world's largest banks by assets were either Japanese or French. Such things can change quickly. The big emerging-market banks should therefore view their rise with a mixture of pride and nervousness. China's biggest banks are all still state-controlled. **ICBC**, spun out of the People's Bank of China in 1984, is run by Jiang Jianqing, a career banker. It has been making a flurry of investments in Asia and Africa. **China Construction Bank** (CCB) has its roots in development banking. Its boss is Guo Shuqing, who ran China's foreign-exchange fund before taking CCB public in 2005 in the first big bank flotation. **Bank of China** has a grand pedigree dating back to 1912. Traditionally China's foreign-exchange and trade bank, it still has the largest presence abroad. **Bank of Communications** is the only Shanghai-based big firm, in which HSBC holds a 19% share.

Brazil's two big private banks are widely admired. **Itaú Unibanco** was formed through a merger in 2008 which saw it overtake **Bradesco** by size. Both firms are battle-hardened survivors and have big insurance, credit-card and investment-banking operations. Listed but state-controlled, **Banco do Brazil** is the country's biggest financial firm, with a fifth of total assets. It has increased its market share since 2007 and is looking abroad.

Russia's banking system is fragmented, with only two giant firms, both state-controlled. **Sberbank** controls almost a third of the country's deposits and has a mixed loan book. Its newish management is trying to cut costs and spruce up its business at home. **VTB Bank** started as a merchant bank but has gradually built up its branch presence. About a quarter of its profits now come from retail banking.

India's banking system is small but growing fast. About three-quarters of the industry is in government hands, with the listed but state-controlled **State Bank of India** commanding about a quarter of the market. It has been revived under the watch of O.P. Bhatt, who became chairman in 2006. **ICICI Bank**, for a long time the pin-up of the private banks, paused for breath in 2009, rejigging its strategy to target industry as well as India's burgeoning middle classes. Its veteran boss, K.V. Kamath, became chairman in 2009, with Chanda Kochhar taking over as chief executive. **HDFC Bank** is still a tiddler by assets but its market value has shot up, reflecting confidence in its domestic strategy and its combative chief executive, Aditya Puri.

Singapore, Turkey and South Korea also have banks with market values in the $20 billion range. But perhaps the most notable firm outside the BRIC group of countries is **Standard Bank** of South Africa, run by Jacko Maree since 1999. Almost a quarter of its profits come from outside its domestic market, mainly the rest of Africa. It got a big boost in 2007 when ICBC bought a 20% stake. A takeover, both parties say, is not on the cards, but Mr Maree's business cards are now in both English and Chinese.

Just how big could such emerging-market banks get? Any self-respecting bank bull likes to whip out a chart comparing the ratio of bank loans with GDP in poor and rich countries. The poor countries generally have much lower ratios. The hope is that emerging-market banks will enjoy a double benefit. Not only will their economies grow fast but financial activity will become more intense, allowing banks to grow faster than GDP. Today quite a few banks in Asia, Africa and Latin America forecast that their loan books will rise by 20-30% annually over the next few years. Assuming that Western banks stagnate, that would mean China's biggest bank would take about two years to reach the size of, say, JPMorgan Chase, measured by risk-adjusted assets. The biggest banks in Brazil, Russia and India will take seven to ten years.

The idea that banks are "GDP-plus" businesses has obvious pitfalls. In 2008 and 2009 the loan books of emerging-market banks outside China grew relatively slowly, at about 10%, although in China they expanded by about 30%, and the pace elsewhere will pick up this year. And if credit grows too quickly for too long the system tends to explode, as America and some other Western countries have found.

In central and eastern Europe too,

The tops 2

Emerging-market banks and Western banks with an emerging-market presence
As of April 28th 2010

Bank	Market cap, $bn	Global rank	Country
Industrial and Commercial Bank of China	226	1	China
China Construction Bank	187	2	China
HSBC	176	5	Britain
Bank of China	145	7	China
Citigroup	126	8	US
Santander	98	9	Spain
Itaú Unibanco	84	11	Brazil
Sberbank	58	20	Russia
Bradesco	54	24	Brazil
Standard Chartered	54	25	Britain
Bank of Communications	53	26	China
UniCredit	50	29	Italy
BBVA	47	32	Spain
China Merchants Bank	45	33	China
Banco do Brasil	42	34	Brazil
Al Rajhi Bank	33	43	S. Arabia
State Bank of India	32	44	India
China CITIC Bank	32	45	China
VTB Bank	27	48	Russia
Shanghai Pudong Development Bank	26	50	China
DBS Group	25	53	Singapore
Standard Bank	23	54	S. Africa
ICICI Bank	23	55	India
China Minsheng Banking	22	57	China
United Overseas Bank	22	58	Singapore

Source: Bloomberg

where loans rose at twice the rate of nominal GDP between 2000 and 2007, they hit a brick wall in 2008 as overextended banks ran out of funding and bad debts mounted. In much poorer Nigeria, talked up in 2006 by Mayfair hedge-fund managers as the next great "frontier" banking market, credit as a share of GDP doubled in about three years to around 30%. With small branch networks and relatively few people in the formal economy, this was too much. About a third of the system by assets is now distressed. The lesson from the Asian crisis of the late 1990s is that systems generally shrink after a blow-up.

Credit relative to GDP, then, does not grow in a straight line, thanks to the economic cycle. But even in the longer term a rising trend is not inevitable. According to Credit Suisse, domestic credit to the private sector credit relative to the economy has been flat or falling between 2002 and 2008 in China, Mexico, Malaysia, Thailand and the Philippines. And even if borrowing levels are rising in the longer term, banks' role in supplying that credit is not assured. In America much of the work of financing companies is done through capital markets. Emerging-market banks may face a similar trend. Except in Brazil, most of their business consists of loans to industry. Fast-growing local capital markets could take some of this away. If so, the biggest part of the banks' balance-sheets would actually shrink relative to GDP.

Penetrating arguments

Yet for all the caveats, emerging-market banks can count on vast untapped demand. McKinsey estimates that most people in Latin America, Asia and Africa lack access to formal banking services. Slowly the supply is catching up. Bradesco in Brazil has recently opened the world's first floating bank branch (which sails down the Solimões River in Amazonas) and the first branch in Heliópolis, a big *favela* (slum) in São Paulo. State Bank of India has more than doubled its number of ATMs since March 2008 without seeing a decline in transactions per machine per day, currently about 300. Most banks are trying to reach the "unbanked". This is partly a question of technology—for example, providing biometric identity cards for illiterate people without papers. It is also a question of organisation. Mr Kamath, the chairman of ICICI, India's biggest private bank, is thinking about appointing an agent in each village who would be given the kit to link up with the bank's system. Indian government schemes to guarantee work for rural workers for 100 days a year and to introduce identification cards for all could be a catalyst for the spread of such schemes. Like most bank executives, Mr Kamath accepts that these will not make the industry money "for quite some time" but reckons that "no bank can afford not to be there." Mr Puri, the boss of rival HDFC Bank, says that on a "five-year horizon it can absolutely move the needle".

But the real boon for many emerging-market banks has been the rise of a credit culture among the middle classes. Well-off people behave in a way their parents would find unimaginable, buying homes and cars not by saving up but by borrowing. The ratio of household borrowing to GDP points to this in all big developing countries (see chart 3). If the world economy rebalances so that surplus countries save less and consume more, mortgages and consumer loans will become the banks' biggest source of profits.

Although competition may put pressure on emerging-market banks' high margins, there are offsetting factors. People will shift their savings from deposits to investment products with better yields that banks can charge fees for. Low-cost technology too could boost profits. India's banks say they have leapfrogged the expensive mainframe computers of their Western peers and expect a rapid move towards mobile-phone banking among the young. In China people do not use cheques but can get text-message confirmations when they have used their credit cards, reducing the risk of fraud. Noel Gordon, a consultant at Accenture, jokes that when Western banks were fiddling with rocket-science finance, emerging-market banks were innovating more productively by opening up entire new markets that will make sustainable profits.

Emerging-market companies also promise to give the banks lots of new business. This year there will be a boom in loans as they shrug off the downturn. In the longer term banks will have to adapt as local capital markets develop and businesses expand abroad. Most lenders are building up investment-banking skills and a presence overseas that will generate income as more local businesses turn to issuing bonds and shares for finance.

And even though all these opportunities still lie ahead, emerging-market banks have already taken a giant leap in size and profits in the past decade. They have also maintained adequate capital ratios and ample deposit funding. The combination of growth and strength would appear to give them enormous advantages, heralding a rebalancing of power in global finance. Yet are those rock-solid balance-sheets quite what they seem? ■

Rambo in cuffs

Balance-sheets are less powerful than they look

WESTERN bank bosses often suspend their critical faculties when discussing their emerging-market peers. Suddenly it is not the next quarter that matters but the long-term flow of world historical forces. "They think about time in a very different way," says one, Zen-like, before adding: "History always follows a course." What lies behind this mumbo-jumbo is the recognition that emerging-market banks are not just getting bigger but also have piles of excess deposits because they are based in countries with high levels of savings. This would appear to give them a decisive advantage over Western banks that rely on fickle borrowing markets to do business. To add to rich-world banks' discomfort, developing-world banks tend to have high capital ratios too. In banking, especially after the crisis, whoever has the deposits and the capital usually wins.

The reality is a bit more complicated than that. Banks are indeed mirrors of the economy, so banks' balance-sheets reflect the fact that the typical Westerner is a borrower and the typical Asian a saver. Emerging-market banks tend to have vast branch networks that suck in deposits from thrifty families and companies. Only some of these get lent out again. Banks park the surplus with the state, by buying government bonds or keeping it in central banks. The state in turn acts as the international recycling agent for those excess savings: it lends them to Western countries through its foreign reserves or through a sovereign-wealth fund, for example by buying US Treasuries, mortgage bonds or money-market instruments.

Overextended Western banks do the exact opposite: they borrow from capital markets to plug the hole created by having more loans than deposits. This shows up in the ratio of loans to deposits, which for rich-country banks rose to alarming heights in the run-up to the crisis (though they have since come down somewhat), whereas those for emerging-market banks remained healthier.

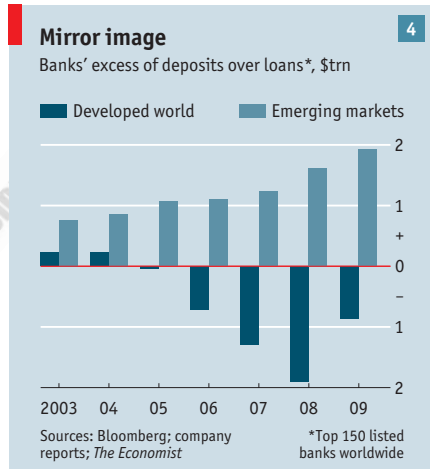
Another way of measuring the differences is to look at the absolute funding gaps. Although by and large rich and poor countries' banks are not lending to, or borrowing from, each other directly, there is a symmetry to the figures that is not entirely coincidental. In 2008 the surplus of customer deposits over loans (ie, excess savings) at listed emerging-markets banks was about $1.6 trillion, compared with a deficit of about $1.9 trillion at rich-world banks (see chart 4). The imbalances of the world's economies are reflected by their banks.

A Western bank with masses of excess funding would be deemed to have a huge competitive advantage. Surely the same applies to entire countries' banking systems? Emerging-market banks could use their surplus funds beyond their borders, for example by lending directly to foreigners and taking market share from rich-country firms. By doing so they would be bypassing central banks and sovereign-wealth funds, recycling excess savings directly themselves. But this is not what happens. For a start, the funding position of emerging-market banks is less impressive if China is excluded. And even in markets with excess savings these are not always evenly distributed, with a lot of them stuck in sleepy state banks. Some firms are doing their best to change that: ICICI's Ms Kochhar, for example, is setting up lots of new branches to boost its deposits.

Banks that do gather excess deposits may find the government wants to get its hands on them. This could be for prudential reasons. For example, China's regulator requires banks to keep 17% of their deposits with the central bank and tinkers with this ratio to control the economy. Or it could be because the government needs the cash. In India banks are obliged to use about a quarter of their deposits to buy government debt, which helps the government fund its budget deficit. Mr Bhatt of State Bank of India says there is little chance that this will change soon: "It is the model in this country," and allows the government to spend on development.

So complementary and yet so far

But suppose that when everything is said and done banks still have piles of excess deposits? This is broadly true of China's lenders. Can they find a way to marry their savings-rich firms with the indebted equivalents of the West? There is already a real-life case study: HSBC. It has always gathered more deposits in Hong Kong than it lends out. In 2002 it bought a mirror image of itself, Household, an American consumer-finance firm with $106 billion of loans and no deposits. It announced at the time that it was "bringing together one of the world's top asset-generators with one of the world's top deposit-gatherers". Those labels could be applied respectively to America's and greater China's entire banking systems.



The acquisition failed because of bad debts at Household, but the original premise was wrong too. HSBC's regulators, like most around the world, did not want deposits in one country to be used to finance a subsidiary overseas, exposing the bank to foreign-exchange and counterparty risk. Michael Geoghegan, HSBC's chief executive, says it might have found fiddly ways of getting Asian customers to fund Household, perhaps by securitising Household's loans and selling them to HSBC's Hong Kong subsidiary; but the bank chose not to do so because it felt that would disadvantage its Hong Kong depositors. He says the regulatory climate has got more difficult since the crisis, and "it's getting harder to move liquidity around" among subsidiaries.

For the moment China's banks show little appetite for taking positions in risky Western assets. Bank of China did boost its foreign-currency lending in 2009 by a stonking 47% to about $200 billion, or ▸▸

about a quarter of its loan book, but this was matched by $190-odd billion of foreign-currency deposits. The bank actually reduced its holdings of foreign-currency securities by an eighth, "in accordance with the global financial-market situation"—a polite way of saying in order to avoid dud Western assets. Its latest annual report notes "growing concerns" over the finances of southern European banks and governments.

Deposits don't travel

There are other ways of utilising excess deposits abroad, says Anthony Stevens, a consultant at Oliver Wyman. The most obvious ones are hedging, organising swap lines with foreign banks and encouraging domestic customers to switch their deposits into foreign currency, thereby making them take the exchange-rate risk. But none of these are large-scale options in countries with partially closed capital accounts. And in China in particular, given the undervaluation of the renminbi, the last thing policymakers want is banks whose asset bases would fall as the currency appreciated. Far better for the currency risk to be borne by the central bank and sovereign-wealth funds. In the medium term, as customers spend more and save less, the pool of excess cash in emerging-market banks may shrink. Until then it will be hard to use that strength abroad.

What about the emerging-market banks' capital positions? At the end of 2009 these banks had a weighted-average Tier-1 capital ratio of 10%, in line with rich-world banks, but this probably understates their advantage. Excluding China's banks (which have been busy raising equity since), the ratio was 12%. And the new capital rules known as "Basel 3" are likely to be much less painful for emerging-market banks, which typically have higher-quality capital and smaller investment-banking units (which will be heavily penalised by the new rules) than their rich-world peers. At the same time they are likely to be more profitable than banks in Europe and America, which will allow them to create new capital faster.

Even so, emerging-market banks will still be short of capital. That is partly because of bad debts. In most places the cycle has already turned for the better. In Brazil Bradesco has said that the worst is over. Sizwe Nxasana, chief executive of First-Rand, one of South Africa's big four banks, notes that impairments are falling off and the performance of loans to lower-income customers has been "very good" during the downturn. But in both India and China the position is less clear-cut. Indian banks have lowish levels of non-performing loans but have built up relatively small reserves against them. These reserves act as a buffer against losses before capital is eaten into. Adjusting for that could knock a percentage point or so off Indian banks' capital ratios.

China's banks seem to have lots of reserves relative to the current level of non-performing loans, but that level seems implausibly low given how much they have been lending. Bad-debt reserves relative to the size of total loans are smaller, especially compared with Western firms that have taken massive hits in anticipation of losses. For example, Bank of China has roughly the same size of loan book as JPMorgan Chase or Citigroup, but only around half the level of bad-debt reserves.

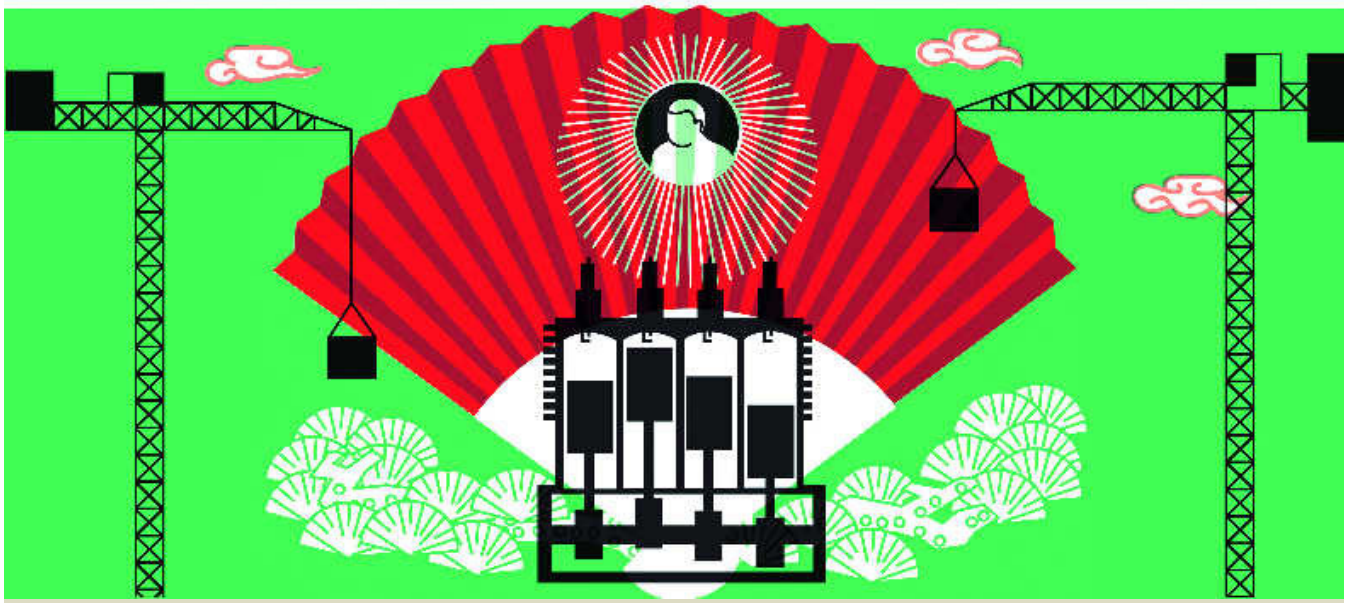
Still, assume the best: that after a lending boom of several years, bad debts at emerging-market banks are under control. Surely, then, with their high profitability, they should be throwing off plenty of excess capital? Not necessarily, for the faster they grow, the more capital they will need to set aside to support new loans. And although emerging-market banks generate decent returns on equity, in aggregate they pay out about a third of that in dividends, limiting the amount that is retained and added to their capital bases.

Less than meets the eye

The maths of this can be pretty eye-watering. Assume that emerging-market banks really increased their risk-adjusted assets at, say, 20% a year yet maintained the same return on those assets, capital ratios and dividend payout ratios as they had last year. To back new assets, such as loans, they would need $4 trillion of new capital over the next ten years, only $2.6 trillion of which would come from retained profits. They would need to raise $1.4 trillion from external sources—about one-and-a-half times the total capital America's 19 biggest banks had at the end of 2008. Even assuming growth of 15%, the shortfall would be some $400 billion. One option would be to cut dividends, but neither private nor public shareholders would like that.

At the same time Western banks are actually likely to release capital as they wind down bad assets. Royal Bank of Scotland has about $30 billion tied up in its "bad bank" but will probably have to use that to repay emergency aid from the state, its current majority owner. Still, banks that have either largely paid back the government, such as Citi, or never accepted aid, such as HSBC, could eventually have capital coming out of their ears. Vikram Pandit, Citi's boss, recently told investors that "nobody wants to talk about excess capital," but "at some point down the road we're going to have to figure out what to do with" it.

The balance-sheets of emerging-market and rich-world banks are like the coasts of America and Africa: they look like a good fit. One group of lenders is overloaded with excess deposits but in need of capital, the other is short of deposits but likely to generate capital. It would seem like a template for much closer integration, but bringing the two groups of banks together might be as difficult as melding continents. That partly reflects the problems emerging-market banks face in shifting excess funds into foreign-currency assets, or among subsidiaries in different countries. But most emerging economies now also have less appetite than they did for letting foreigners in, and much more for state involvement in banking. And far from being ready to take on the globe, most emerging-market bankers are consumed by their colossal and growing businesses at home. ■



Domestic duties

CCB, China's second-biggest bank, exemplifies the size of the task at home

IT IS something of a surprise to find that the bank boss with the best line in deadpan humour is Guo Shuqing, chairman of China Construction Bank (CCB). When it floated in Hong Kong in 2005 Mr Guo reminded the assembled ranks of slick investment bankers and analysts that during the Cultural Revolution he had been a cowboy. Five years on the bank has risen to be the world's second-largest by market value, after ICBC. Over that period its profits have more than doubled to $16 billion, more than at any of America's three most profitable banks, JPMorgan, Wells Fargo and Goldman Sachs.

CCB embodies the paradox of many emerging-market banks. It is huge and has grown phenomenally quickly, but the demands placed on it at home are also huge. Last year it expanded its loan book by 27%. The industry as a whole grew even faster, by 32%, partly thanks to the leading role the banks played in the government's economic stimulus. New loans made in China were equivalent to almost a third of GDP. Roy Ramos, an analyst at Goldman Sachs, points out that in less than ten months China added the equivalent of India's banking industry twice over.

The government is now working hard to ensure that the lending spree does not cause a bad-debt problem that infects the banks (which it had to recapitalise just under a decade ago). In April Liu Mingkang, the top banking regulator, said he had asked the banks to submit "comprehensive" reviews of their loan books by June. Of particular concern are the infrastructure projects backed by local governments, which accounted for perhaps a third of the new loans. These projects often suffer from poor cashflow, no explicit guarantee from the state and limited transparency.

Mr Guo is optimistic about bad debts in the banking system overall. "If we deal cautiously with this risk we will have a soft landing," he says. However, he also cautions that there is no blanket guarantee for local infrastructure projects: "Not all can be rescued by the central government." The key, he reckons, is to improve the flow of cash to local authorities, which itself requires further reforms. The cap on the amount of bonds the central government issues on their behalf needs to be raised. But China also needs to "open the front door" by allowing local governments to raise municipal bonds. At the same time the government can enlist the help of China's remaining fully state-owned banks, although their role needs to be defined clearly to avoid moral hazard. The same goes for the plethora of smaller local banks that can be encouraged to provide more credit to local projects but must, he says, remain "independent institutions".

Hungry for capital

China's banks are highly profitable, which gives them a buffer to absorb potential losses. Still, in response to the rapid growth in loans and the risk of bad debts, the banks are also busy raising capital. Bank of China, Bank of Communications and ICBC have indicated that between them they will issue up to $28 billion-worth of new securities, bolstering their core capital by about a seventh. CCB has yet to finalise its plans but it is likely to issue new equity too. Agricultural Bank of China, a giant fully state-owned lender, is considering floating a minority of its shares on the Shanghai and Hong Kong stockmarkets this year.

China's banks have a lot on their plates right now, thanks to the lending surge of the past two years. But even in the medium term the industry is likely to be quite a challenge to manage. Part of this relates to capital. This year, for example, the government is still aiming for lending growth of about 19%. At the same time China's banks are paying hefty dividends, limiting the amount of capital they generate internally. Mr Guo at CCB, which paid out 44% of profits last year, explains that "according to international practice the ratio should be about 30%." But an absolute dividend cut is unlikely because Huijin, the state vehicle that owns stakes in the banks, needs the income to pay interest on the funds it spent recapitalising China's banks back in 2003. Although the planned capital-raising may dilute Huijin's stake, currently at 57%, the government has "got some room", Mr Guo says, to maintain a majority shareholding.

Other banks agree that more capital will be required over time. Yang Kaisheng, the president of ICBC, said recently that the big four banks could need $70 billion of outside capital over the next five years—about double the maximum they have indicated they might raise now. This was assuming loan growth of 15% a year. At some point the state will need to inject more capital into the banks or permit them to cut their dividend payouts. The third option, ▸▸

of allowing its stake to be diluted below 50%, looks unlikely, and the fourth, of developing a shadow banking system into which the banks can offload assets, seems less attractive after the debacle in America's securitisation markets.

It is not just the capital bases of China's banks that will have to adapt to continued expansion. The system already has all the regional complexity of America, from Hainan Island, a Florida-style property-development hotspot, to pockets of conservatism such as Zhejiang Province, just south of Shanghai. And notwithstanding the heavy infrastructure lending of the past two years, the mix of the banks' lending will shift. Today only a fifth of all loans are to households. But as saving declines, consumer lending, including mortgages, will become more important. At the same time rapidly developing capital markets will offer big companies an alternative way to raise money and put pressure on banks' lending margins. Mr Guo reckons that lending to consumers and small firms could rise to 40% of CCB's loan book within five years, from about a quarter today.

If China's banking system and its capital markets develop as planned, it will be one of the biggest and fastest financial transformations ever seen. If they do not, the result may be one of the world's bigger financial headaches. There is little inclination to allow a sudden influx of foreign banks that might make the system less stable. Chinese banking has interacted with the outside world cautiously, lagging the expansion of China's big industrial firms. Bank of China last year generated 22% of its pre-tax profits outside mainland China but most of this was from Hong Kong and Macau. ICBC, which has shown the most expansionist instincts, derived only 4% of profits from abroad.

No adventures

Mr Guo, for his part, advocates caution abroad. Using domestic deposits to fund purchases of foreign assets involves too much risk: "If the currency were to appreciate, how would we pay it back?" CCB made 1% of its profits from abroad last year but the idea of boosting this by buying equity stakes in foreign banks is not enticing: "We don't want to do that very much…we want to establish a network abroad for our customers but their requirements are limited." Mr Guo says Western politicians and regulators have been "very nervous" about Chinese lenders taking big stakes in their banks, but adds that the crisis may have changed this a little. In any case, Western economies are overbanked, suggesting limited growth potential.

In mirror image, the influence of foreign firms in China is likely to be limited. Western banks, Mr Guo says, "don't have many opportunities" to build enough branches to rival the vast networks of the big domestic banks. Through their minority stakes in Chinese banks Western firms get all the exposure to China they need.

In some respects China's template for banking seems rather conservative. It envisages a stable industry structure, with limited entry for Western newcomers, a high degree of government co-ordination and a cautious view of banks going abroad. Yet at the same time it is dynamic, with vigorous competition among domestic banks, big shifts in the pattern of lending, plenty of product innovation and, most important of all, fast credit growth. This kind of "managed finance" model is no longer confined to China. Since the crisis a milder version of it has gained fans all over the emerging world. ■

Mutually assured existence

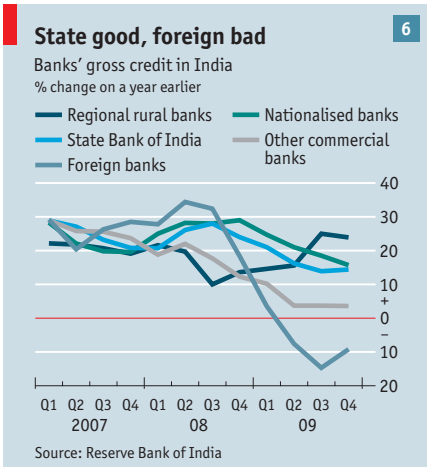
Public and private banks have reached a modus vivendi

"INDIA is where China was ten years back," says Mr Kamath, chairman of ICICI. That is certainly true by size. India's GDP amounts to about a quarter of China's today and its banking industry just a tenth. But in at least one respect India is well ahead: it has several dynamic privately owned banks that over the past decade have taken a fifth or so of the market from the state-controlled banks. Until the financial crisis in the West the private banks seemed to offer a template for the entire industry: within a decade or two, it seemed, the state would retreat significantly. Now India's mixed model of banking is likely to persist for longer.

Part of that reflects the fact that India had its own wobble during 2008. This was not a full-blown crisis; indeed, Aditya Puri, chief executive of HDFC Bank, the second-biggest (and perkiest) private firm, says to describe it that way would be an "appalling misconception". But there was a sharp spike in money-market interest rates after the collapse of Lehman Brothers, a liquidity squeeze and a notable shift in deposits. At ICICI overall deposits, as well as the stickier category of savings and current-account deposits, dropped by about a tenth between June and December 2008. Savers shifted their cash to the government-controlled banks, which were perceived to be safer. "Money was pouring out of our ears," says Mr Bhatt of State Bank of India.

That experience has helped prompt a change of strategy at ICICI, which for a long time was one of the most admired private banks in the developing world. After a decade of spectacular growth, fuelled in part by wholesale funding (including bulk deposits), the bank recently slammed on the brakes. In 2009 its loan book shrank by 17%.

Chanda Kochhar (one of several female bank bosses in India), who took over as chief executive from Mr Kamath last year, says that the bank decided to focus on changing its funding mix towards retail deposits because as interest rates rise these should be cheaper as well as stickier than wholesale funds. Current and savings deposits now make up 42% of total deposits, up from 27% before the crisis. Private banks so far lack the state banks' huge branch networks, but they are working on it. ICICI now has 2,000 branches, against only 755 ▸▸



in early 2007. That should help it suck in more deposits.

The state banks may hold on for a while yet to the market share they have taken. Between June 2007 and December 2009, after a long period of genteel decline, they saw their share of total deposits and loans rise from 73% to 77%. After years of fierce competition from the private banks, they have begun to get their act together. At State Bank of India's headquarters in Mumbai visitors may still receive a smart salute from a man in uniform, but, Mr Bhatt says, its technology and products are now "comparable to the private sector". Mr Kamath agrees that the state banks have caught up on technology.

Learning to love state banks

Yet even if the private banks do go back on the attack, attitudes towards the state-controlled banks have changed for good. After all, they were the ones that continued to supply credit to the economy during the downturn. Before the crisis all banks were expanding their loan books at an annual rate of about 25% (see chart 6). After mid-2008 there was a big divergence, with the state banks (which come in three main flavours: the nationalised banks, State Bank of India and the regional rural banks) keeping credit growing fairly steadily. The private banks more or less ground to a halt. The foreign banks went from expansion to sharp decline, with their share of loans dropping from a peak of 7% to a paltry 5.3% last December.

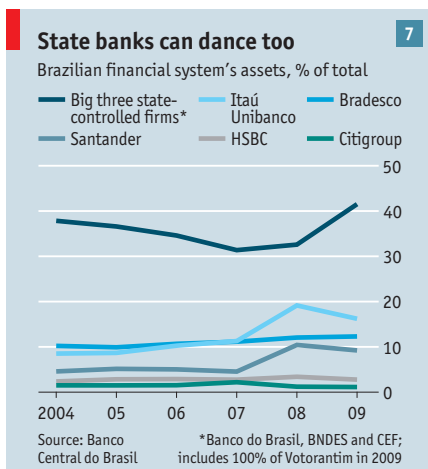
Most bank executives now also concede that old-fashioned regulation was shown to have its merits. Indian banks are required to hold a big slug of their assets (typically just under a third) in government bonds and at the central bank. Now Western regulators too are considering pushing up liquidity levels. Indian bankers joke that all the fiddly rules they face have become the envy of regulators throughout the world.

All this has led to a reappraisal of whether state banks should be fully privatised in the long term. HDFC Bank's Mr Puri says that "the world has changed and the view around here has changed." Mr Kamath takes a similar view, predicting that in the new circumstances "India's evolution will be more or less in line with China's." Mr Bhatt reckons there will be "no big-bang reform" and that over time the state-controlled banks' share will drop only gently, to 55-65% of the market.

A similar message is heard in Brazil. In the past five years Brazilian private banks have risen to global significance, helped by a frenetic 2007 and 2008 when an eighth of the system's assets changed hands. Itaú bought Unibanco and Santander bought ABN AMRO's Brazilian business.

But just as important has been the expansion of the state banks, Banco do Brasil (a listed commercial lender with a bias towards agriculture), Caixa Econômica Federal (a mortgage specialist) and BNDES (which acts more as an investment company). Together their share of the financial system's assets has reversed its earlier decline and now stands at 42% (see chart 7). Part of their increase in market share reflects acquisitions, with Banco do Brasil buying Nossa Caixa, a mid-sized state-owned firm, in 2008 and a 50% stake in Votorantim, a car-finance specialist, in 2009. But about two-thirds of the rise has come from lending more than the private firms during the downturn.

That in turn has changed people's views of a mixed financial system. Domingos Abreu, chief financial officer of Bradesco, says the state banks "had a very important role…in the government's anti-cyclical policies", adding that in a downturn "it makes a difference" to have a mixture of state, private and foreign banks. He concedes that two years ago he might have answered the question differently, but now he had to acknowledge that the state banks have their merits.



Alfredo Sáenz, chief executive of Santander, which owns the country's third-biggest private lender, quips that Brazil keeps an "artistic equilibrium" between the private and the public sectors. Persio Arida, a former governor of the central bank and president of BNDES, and now a partner at BTG Pactual, Brazil's leading independent investment bank, says that the "consensus" in the country is that the state banks played a vital role. However, he cautions that until the extent of bad debts created by their lending is known, no definitive judgment can be reached.

Russia holds the line

In Russia up to 54% of the system's assets are state-controlled, according to Andrei Vernikov, an economist, compared with 45% in 2007. Foreign banks' share stands at 18%. The balance-sheets of the three European banks that are most active in Russia, UniCredit, Raiffeisen International and Société Générale, together shrank by about a quarter in euro terms in 2009. Royal Bank of Scotland's loans to Russian corporate customers dropped by 45% in sterling terms. Net loans at state-controlled Sberbank and VTB declined by only 4% and 10% respectively in local-currency terms. Last summer the government took a larger stake in VTB to bring its holding up to 86%. Andrew Keeley, an analyst at Troika Dialog, an investment bank, says that although the government is likely to sell the additional stake in VTB again, it intends to keep majority control of both big banks.

But none of this means that a Soviet-style banking system is about to emerge in any of these countries. In China the government did take control of credit during the crisis, but for other state banks it was more of a nudge and a wink. Mr Bhatt says he was left to his own devices. Most governments also want private-sector banks to raise the level of competition. Even in China the state accepts some innovative upstarts, such as China Merchants Bank, a mid-sized bank with diffuse ownership and no direct state control. And all emerging markets want some foreign banks in order to keep local firms on their toes.

So although the ratio of ingredients varies, the objective mostly seems to be a mix with a strong state presence. This is seen as more responsive to businesses, less vulnerable to flaky foreigners and more open to "soft" control by the state as it tries to manage the economic cycle. Western bankers see its merits too: HSBC's Mr Geoghegan, a veteran of banking in Latin America, the Middle East and Asia, reckons that a healthy combination of foreign and local firms leaves foreign banks politically less exposed.

Control freaks

The problem for state banks is that they need to find a way of raising capital without diluting the government's holding. Most state-controlled banks are listed because a quotation brings market discipline to managers and provides useful information about the performance of the bank. But governments seem determined to hold on to a stake of at least 51%. For example, Banco do Brasil, now the country's largest lender by assets, announced plans to raise $5 billion earlier this year, but its objective remains the "maintenance of the government's shareholding control". Turkey is thinking about floating its largest lender, Ziraat Bank, but the state seems likely to retain control. It is the same story in China, says Bill Stacey, an analyst at Aviate Global, a brokerage firm. The government is happy to sell shares in banks but wants to keep a majority stake. Likewise, in Russia the state wants to retain control of the two biggest banks.

What happens when the state's holding gets close to that crucial 50%? State Bank of India expects to receive a capital injection from the government this year. Its chairman, Mr Bhatt, says it is still an open question whether the state might breach the 50% threshold in the medium term, but even then it would seek to have a big enough stake to remain the dominant shareholder. Many governments are in better fiscal condition than India's and have more scope to top up banks' capital.

Emerging-market banks' hunger for capital used to ensure that they would ultimately be sold off to the market—or to foreigners. Not any more. So the prospect now is of a fast-growing, innovative banking industry that remains subject to conservative regulation and only gradual shifts in control. After the West's experience with no-holds-barred banking, that may be a good idea. But for growth-starved Western banks desperate to do business in emerging markets it means they will find it even harder to get in. ■

We lucky few

For Western firms the barriers to entry into emerging-market banking are daunting

"YOU kind of needed to think about this 30 years ago," says Stuart Gulliver, who runs HSBC's investment bank, when asked about Western banks expanding in emerging markets. He has a point.

There are only two kinds of Western banks that are big in developing countries, and both have been at it for quite a while. The first are the global network banks which have a limited presence in lots of countries which they use to tap internationally minded companies and consumers: Citigroup, HSBC and Standard Chartered. The second are the lenders that have "gone native" with a deep retail presence, most notably Santander and BBVA in Latin America and UniCredit in eastern Europe.

These six firms certainly pack a punch, with nearly $30 billion of profits from developing countries in 2009 (see chart 8), about a quarter of what listed local banks made. But replicating the "gone native" banks has become next to impossible (see next article). And even the network banks have historical advantages that make it hard to emulate them. By the end of the 19th century HSBC was already big in Asia and Standard Chartered's predecessor firms were doing well in Africa and India. Citigroup's main constituent part, International Banking Corporation, was founded in 1901. A year later, with an agent installed in China, it advised shareholders that "matters are progressing favourably in Shanghai"—a message banks still intone.

The network banks have been through a few twists and turns. For its first 85 years HSBC concentrated on Asia, although it retained a presence in London. From 1949 it adjusted to the revolution in China and consolidated in India, Hong Kong and the Middle East. After 1978 it started to expand mainly in rich countries, which led to the purchase of Britain's Midland Bank in 1992 and the shift of its headquarters to London, and in 2003 to the ill-fated takeover of America's Household.

Standard Chartered had a turbulent time from the 1970s to the early 2000s, with an expansion in America, a failed attempt to buy one British bank, a hostile bid from another, then the Asian crisis and a bout of boardroom bloodletting. Citigroup has spent the past decade trying to be a financial supermarket.

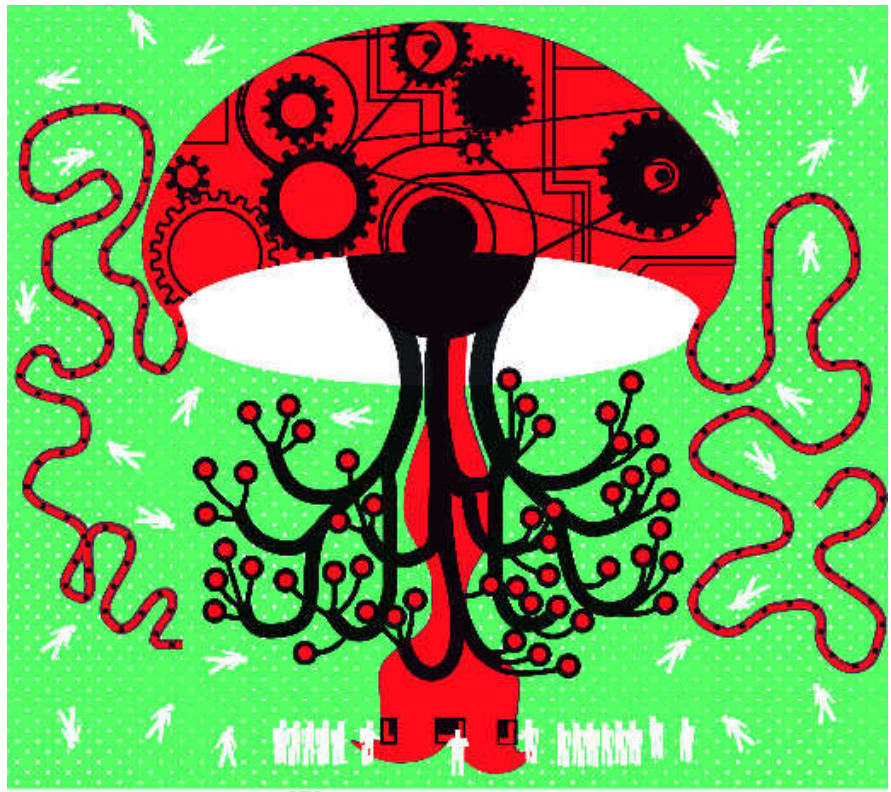
The crisis has cleared their minds. Citigroup, notes its Indian-born boss, Vikram Pandit, "is going back to the core model of what we had as a global bank". After the bail-out Citi realised that "it was the emerging markets that made us very special," he says, and that the dealmaking of the past decade had diverted a lot of energy away from the firm's strengths. Shirish Apte and

In foreign fields 8

Western banks' net income in emerging markets
2009, $bn

Bank	Emerging markets	Asia	of which: Hong Kong	of which: Stakes in China	Latin America	Central Europe & Russia	Africa & Middle East	Group profit/loss
HSBC	9	8	4	2	1	0	<1	6
Citigroup	7	4	na	na	2	na	na	-2
Santander	5	0	0	0	5	0	0	12
Standard Chartered	3	3	1	0	0	0	<1	3
BBVA	3	0	0	0	3	0	0	6
UniCredit	2	0	0	0	0	2	0	2
Total	**29**	**15**	**5**	**2**	**12**	**2**	**1**	**28**

Sources: Company reports; *The Economist* estimates



Stephen Bird, joint bosses of Citi's business in Asia, say it has been largely untouched by the turmoil in New York. One rival in the region says Citi's business is "brilliant". That resilience has echoes in history. When President Roosevelt closed America's banks in March 1933 to try to halt a meltdown, the bank's overseas deposit base shrank by just 2%.

America's other large commercial banks came late to the party. Because of regulatory quirks most did not go overseas until the 1960s, and despite the huge advantage of their customer base at home few were able to maintain the global presence they had aspired to.

HSBC's Mr Geoghegan moved to Hong Kong in early 2010. His perks include a house on a leafy lane on top of the island and a huge office in one of the city's most iconic buildings. He says emerging markets are about "volatility", something only the biggest and most experienced firms can handle. HSBC's rethink began in 2006 when it abandoned its efforts to turn its investment bank into a bulge-bracket contender and shifted its attention to developing economies. The blow-up at Household, which HSBC is now winding down, gave impetus to this move. After an $18 billion rights issue in 2009 it has landed on its feet. Its structure, with a surplus of deposits and its local operations ring-fenced as subsidiaries, is a regulator's dream. And at a time when emerging countries increasingly do business with each other, being everywhere turns out to be pretty useful.

Standard Chartered has concentrated mainly on emerging markets for two decades but has recently changed its approach. When Mervyn Davies was chief executive in 2002, he said the consumer business would be "our engine for growth". In fact the horsepower has come from wholesale banking, which now provides 80% of profits, up from 60% seven years ago. Peter Sands, who became chief executive in 2006, may have refined tastes—during an interview with your correspondent he received a note from his piano tuner—but his message to shareholders last year was anything but subtle: "Our role and position in the world of banks have changed dramatically. We did not just weather the crisis, we turned it to our advantage."

When the network banks have strayed too far from their core businesses—for example in consumer finance—their record has been patchy. Their backbone is the international presence built up over decades and their relationship with corporate customers which is based, in an oft-repeated formulation, "more local than other international banks and more international than the local banks." Although this is often mocked by rivals as a way of dressing up small market shares in many countries, the case for geographic reach is getting stronger as emerging markets trade more with each other and the number of multinational companies grows. Citigroup says clients that bank with it in 70 or more countries spend twice as much as those that bank with it in 50-60 countries. HSBC's Mr Gulliver says that to win corporate customers in emerging markets, "you have to have a substantial presence in the developed world" and the ability to lend on a substantial scale—something few other firms can offer.

In praise of plumbing

All three banks also own bits of the global financial plumbing that governments, companies and other banks need to ship funds around the world. That gets a foot in clients' door and generates a slab of stable profits and deposits. Some other banks, including Deutsche Bank, JPMorgan Chase and Royal Bank of Scotland, have big transaction-services divisions, but about half of their revenue comes from their home markets. In terms of profits from emerging markets, the three network banks' transaction-services units are much larger. Replicating Citi's operation, Mr Pandit says, would be "a very, very difficult thing to do because you've got to follow the generational process" that saw the bank expand over a century.

Have the network banks been able to translate their unique advantages into profits? After all, ABN AMRO's giant global presence became a liability when it produced too little revenue to cover its costs. That helps to explain why all three banks developed consumer-banking businesses. Citi has been trying to attract well-off retail customers since 1976, but has not always succeeded. Its Latin American credit-card business lost money last year and its credit-card loans of $18 billion in Asia generated profits of just $214m. Jonathan Larsen, who heads its consumer business in Asia, says bad debts are improving and Citi enjoys "an extraordinary brand awareness" that can be tapped. Urbanisation helps: the top 85 cities in emerging markets generate 10% of global GDP, so a small branch network can make a big difference. Mr Pandit says the business is there to stay.

HSBC is sticking with well-off customers but has gone off mass-market consumer finance. Mr Geoghegan notes that in developing countries "it is quite easy to lend and much harder to collect." Instead HSBC is bulking up, for example with a small deal in Indonesia recently that "solved our problem" of too few deposits. Critics point out that almost half the bank's $11 billion of pre-tax profits from emerging markets in 2009 came from mature Hong Kong and $1.5 billion from minority stakes in Chinese firms. Yet many banks would love to be so well placed in China. In theory HSBC has the right to increase its stake in BoCom to

40% if regulators approve, but it is far from clear that they would. Mr Geoghegan says that HSBC has "chips on a number of different opportunities" in China and had never assumed that it might be able to gain control of a Chinese bank. Bank of Communications is currently raising capital, and HSBC is planning a Shanghai listing that could raise, say, $5 billion. Whatever the sum, say Mr Geoghegan, "the money will stay in China."

The time of Sands

Both Citigroup and HSBC have tilted away from the rich world but their direction—consumer or corporate, China or the entire emerging world—remains in the balance. StanChart, for its part, has pushed the network model towards investment banking. Its success in Asia over the past three years raises big questions for the bulge-bracket firms. Mr Sands argues that the old paradigm—foreign banks with products and global reach on one side, local banks that have cosy relations with customers and regulators on the other—is no longer valid. A successful bank needs to have all of those things now. The importance of a local deposit base has also grown, partly for regulatory reasons and partly because customers want banks that can lend to them. Richard Meddings, StanChart's finance director, says the base of branches has created a "very rare and advantaged business model". All this has made the bank a perennial takeover target.

The reincarnation carries some dangers. The bank argues that on most measures, for example the extent to which its loan book is backed by collateral, it has cut risk over the past decade. It does, though, have some tricky positions, such as $10 billion of exposure to the United Arab Emirates. Trading on its own account reached an uncomfortably high 30% of the wholesale unit's revenue in the first half of last year. Yet the main warning light flashing from StanChart may be a signal to investment banks, against which it increasingly competes. They typically generate only 10-20% of their business from outside the rich world. Today most have a soft target for this to double within half a decade or so. The idea is to specialise in activities like equity-raising, derivatives and deal advice. Brady Dougan, the boss of Credit Suisse, reckons it is tough to compete on lending. He says that customers "compartmentalise", expecting credit to come from local banks and more sophisticated needs being met by global firms. Kalpana Morparia, JPMorgan's feisty boss in India, says that "we can't be a mainstream" commercial bank in India, and that success is about finding a niche.

But that may not be easy. There will be growing competition not only from the network banks but from local lenders too. Ms Kochhar at ICICI says that the bank rode the wave of consumer lending in India but that the next wave will be banking for companies. "Global banks are very competitive here," says Mr Abreu of Brazil's Bradesco, "but we have space to gain market share." At BTG Pactual, the big Brazilian investment bank, which was owned by UBS from 2006 to 2009, Mr Arida says the "ambivalent commitment" of foreign investment banks to the country has been their downfall. Unless this changes, he predicts, the business will over time "be dominated by locals".

Domestic bond and equity markets should grow quickly, with more securities sold to local investors. Today the big Western investment banks dominate the league tables in most categories in places like Asia. This is an offshore business, concentrated in a few finance centres. None has a decent grip on China's local A-share market, and in local-currency bond and loan issuance in Asia the only foreigners that get a look-in are the network banks.

Some investment banks have backtracked. During the crisis UBS foolishly sold Pactual. The best firms are trying to strengthen their local roots. Mr Dougan at Credit Suisse says he wants its emerging-market units to liaise with each other directly, rather than act as satellites of headquarters, and looks to its private bank to help establish strong links with local business people. Gary Cohn, the Cleveland-raised chief operating officer of Goldman Sachs, notes that a couple of layers down from the top his firm's demography has changed and within a generation its top brass will be less clearly Western.

Less clearly Western is what most rich-world banks these days would like their profit-and-loss accounts to look like, but it is not clear how they can achieve that. Network banking is not an option because they lack the historical connections. The riskier business of investment banking, hard enough in rich countries, may soon get much more crowded in developing countries too. And the strategy of "going native" no longer looks possible either, as the next article will show. ■

Breaking and entering

Why it is hard to copy Santander

SANTANDER, the rich world's fourth-biggest bank by market value, is a beacon of hope and a source of despair for other firms. Having started as a small regional bank, it pulled itself up by its bootstraps to become a big player in Latin America (as well as in Britain). Yet copying its strategy has become far harder now that most big emerging markets are in effect closed to large takeovers by foreign firms. Although the Spanish bank is dipping a toe into Asia, for example through a co-operation agreement with China Construction Bank, Santander's boss, Mr Sáenz, is mildly concerned about the industry's present frenzy to expand there. The region, he says, is "closed and expensive".

Santander's strategy is to build a deep retail presence with a large market share. A good example of how this works is Brazil. By assets Santander has a market share of 9% there, big enough to compete head-on with the big boys (see chart 9, next page). The network banks are one level below this: HSBC has a 3% share and Citigroup 1%. The investment banks are another step down. Credit Suisse, which has a relatively big Brazilian operation, having bought a local firm, Garantia, in 1988, accounts for only 0.6% of the financial system's assets. Santander's business is heavily skewed towards lending to individuals and small businesses rather than to big firms.

The same is true of the other "gone native" banks. BBVA has a market share of about a quarter in Mexico. In eastern Europe Italian and Austrian banks have pursued a similar strategy. UniCredit, for example, is a mass-market bank in Poland,

Bulgaria and Croatia, where it has shares of over 10% by assets. These banks argue that being big in particular countries is more profitable than being widely spread in the manner of the network banks. Ronit Ghose, an analyst at Citigroup, has benchmarked HSBC against local peers in its key regions and concluded that, outside Hong Kong, it typically has a worse cost-income ratio and return on assets, whereas Santander with its higher market shares in Latin America and Britain does better than the locals.

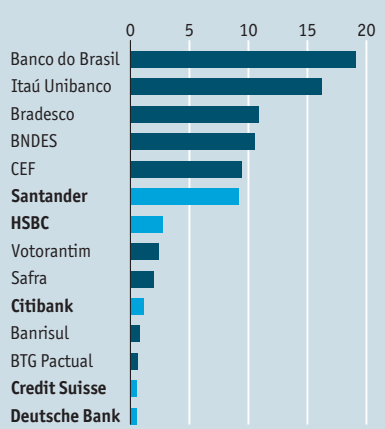
Establishing such positions of strength in depth takes time. Santander made its first round of acquisitions in Brazil in 1997 and its first game-changing one, of Banco Banespa from the Brazilian government, in 2000. Its build-up culminated in its purchase of ABN's Brazilian unit in 2007. Nor is it for the faint-hearted. BBVA bought into Brazil in 1998, but by 2003 it had concluded that it was unable to achieve critical mass and sold out to Bradesco. These days even the willing and able simply cannot find much to buy, because most developing countries will sell big banks to foreigners only from positions of weakness.

In the late 1990s and early 2000s Brazil went through a period when it needed foreign capital, investors were still skittish and there was a political commitment to privatisation. In Mexico the government nationalised the banking system in the 1980s and refused to allow foreign firms to buy control when it privatised the system in the early 1990s. The opportunity for foreign banks came after the devastating peso crisis of 1994-95 which eventually caused the rules to be relaxed. That led to BBVA's acquisition of Bancomer (2000-02), Santander's of Serfin (2000), Citigroup's of Banamex (2001) and HSBC's of Bital (2002).

Something similar happened in South Korea. Citigroup and Standard Chartered bought their banks from private-equity funds that had picked up controlling stakes in 1999 and 2000 from the wreckage left by the Asian crisis. And in eastern Europe, where Austrian and Italian banks have cleaned up over the past decade, most of the original stakes were taken as cash-strapped governments auctioned banks after the fall of communism. Federico Ghizzoni, who runs UniCredit's central and eastern European business, says the majority of its businesses were acquired through privatisations.

Spot the foreigners 9

Brazilian banks' assets, 2009, % of total



Source: Banco Central do Brasil

Slim pickings

Are there equivalent opportunities for Western banks today? Mike Smith, chief executive of Australia's ANZ and an Asia veteran, says that in some countries in the region smaller family-controlled banks may be up for sale as capital requirements become more onerous. ANZ is also rumoured to be eyeing a bank in South Korea owned by a private-equity fund. But the biggest emerging markets, China, India and Russia, are state-dominated and no big banks are likely to come on the block.

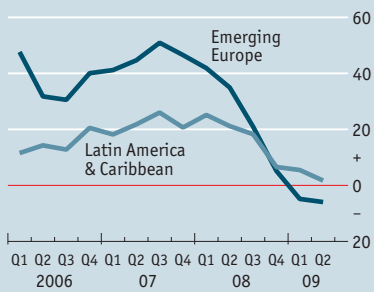
Santander, finding much of the emerging world outside Latin America closed to it, has shifted its strategy. It has expanded through the crisis in Britain, buying bits and pieces (and bidding for some of the branches Royal Bank of Scotland is selling) to add to the base it acquired with Abbey in 2004, gradually building up market share—much as it did in Brazil. Mr Sáenz says the bank has "faith in a business model more than a geography", adding that "it's more likely that in the near future we will invest in more mature economies."

That could include eastern Europe, which has changed from emerging-market darling to villain. Instead of the bullish stories three years ago, when the penetration of banking services was expected to rise to western European levels, there is now deep pessimism about the region's adverse demographic profile and its lack of a saving culture. Poland is Santander's kind of market, though: biggish and with distressed sellers. Allied Irish Bank, having been bailed out by its government, is auctioning off its operation there, which has a 5% market share.

Other western European firms active in eastern Europe suffered during the crisis and are scaling back, for example KBC and Dexia. The healthy banks are staying put and remain optimistic. Société Générale is reorganising its interests in Russia and will get a majority stake in what will become the fifth-biggest firm by loans. It says it is convinced of the long-term potential. UniCredit's Mr Ghizzoni says the "process of convergence will continue".

Two takes on the crisis 10

Foreign bank lending, % change on a year earlier



Source: IMF

Mr Sáenz believes that when countries invite in big banks from overseas it "puts lots of pressure on the competition", forcing it to raise its game and allowing economic development to move at a faster pace. Partly because of that, he thinks that in the longer term countries such as India and China might open up somewhat. "Do I think this will be the situation for the next 20 years? I believe something will happen to these economies that will make them change their mind." He points to Mexico's sudden opening up in the 1990s. "My experience is never say that it is closed for ever. Things can change a lot."

Time is what we don't have

But taking the long view is a luxury that less successful banks cannot afford. Waiting for India and China to fall to their knees is hardly a strategy. That leaves those banks with few choices. One is to build branches rather than buy a bank, which might work in some places. Standard Bank, its South African rival FirstRand and some of Nigeria's healthy banks are expanding their networks across the rest of Africa, where there is little competition.

It might also work for banks with privileged access, for example in China (see box). ANZ is building a bigger presence in Asia, having been ambivalent towards the region for years. Its boss, Mr Smith, explains that Australian businesses are now far more integrated with Asia and that this customer base gives ANZ an edge to expand its business abroad. Still, in most markets local bank bosses are pretty sceptical about Western firms building Rome branch by branch. "I don't think they will be major players" is about the politest comment your correspondent heard.

There is a traditional last resort, used, among others, by Japanese banks in California in the 1980s and more recently by desperadoes in eastern Europe. The formula is to set up a few branches, or pay astronomical prices to buy them, then use funding from your parent or from wholesale credit markets to lend through them. By some estimates half of foreign banks' loans in central and eastern Europe came from such sources. But regulators are cracking down. The new Basel 3 rules will penalise banks with too much wholesale or cross-border borrowing, and with good reason. A recent IMF briefing contrasted the sharp slowdown in foreign-bank lending in emerging Europe with the much more stable picture in Latin America (see chart 10), where foreign banks typically have bigger branch networks. It concluded that "foreign-bank lending funded by domestic deposits and denominated in local currency is likely to be more resistant to external financial shocks." The days of building up a big loan book without bothering about deposits or branches may be over. As Mr Ghizzoni puts it: "Some banks had an opportunistic approach. It's a game that is at the end."

So what are traditional banks in Europe and America to do if they want to expand abroad? They face stagnant home markets. They cannot replicate the presence of firms such as Citigroup or HSBC. They have no opportunity to buy dominant positions in attractive geographic markets, as Santander did, and no tradition of competing in sophisticated niches such as investment banking. Even the cheapskate strategy of buying a paper-thin presence is being closed off. Their only consolation is that emerging-market banks face the same dilemmas as they venture abroad. ■

Old friends only

To do well in China, Western banks need a long history

CHINA'S big banks each "have almost more branches than we have employees", says one Western bank boss. He is only half joking. The big two have over 15,000 branches each. Only a few hundred are owned by foreign firms, which on the mainland have a feeble market share of 2% of total assets. And although many Western banks have been allowed to take passive minority stakes in Chinese financial firms, being given permission to build up a biggish branch network is a privilege granted to the very few.

Only four firms have any scale, and they have been in China for a century. At the end of 2009 HSBC had 99 branches, as well as a further 38 through Hang Seng Bank, a subsidiary that is separately listed and run at arm's length. Bank of East Asia, run by Sir David Li Kwok-po, whose grandfather traded rice and silk in the late 19th century, had 76 branches and Standard Chartered 54. Citigroup, with 29 branches, is the only firm on the list that does not have lots of branches in Hong Kong, but at least it was exporting silver from San Francisco to Guangzhou in 1904. Sir David says, with wry understatement, that the Chinese authorities "look at the historical position of a bank".

By virtue of its size, China is the "holy grail" of banking, says Jonathan Larsen, who runs Citi's consumer business in Asia. But all of these firms are subject to restrictions on their branch expansion, loan-to-deposit ratios and local-currency business. Bank of East Asia's loan book is made up mainly of loans to Hong Kong companies that are active on the mainland. Getting large amounts of business from state-owned Chinese firms is more difficult. Mr Larsen reckons China might follow Singapore's model of development, gradually opening up corporate banking to outside competition first and retail banking later.

Some argue that ultimately China is likely to cede only about 15% of the market to Western banks, but even such a comparatively modest share could make a huge difference if it were concentrated among a handful of firms. HSBC made a pre-tax profit of just $111m from its fully owned operations in China in 2009, but bullish analysts reckon that could rise to over $1 billion within a few years. Mr Geoghegan, its chief executive, says China "will remember for a very long time" that some banks, including UBS and Bank of America, sold part or all of their stakes in Chinese firms during the financial crisis. What about the long tail of other firms keen to grow in China? Sir David grins: "Good luck."

All the world's a stage

But emerging-market banks are still treading cautiously abroad

FROM the rubble of Western banking it is easy to conclude that emerging-market banks are already big, getting bigger, and are coming to get us. Most emerging-market banks do have a sense that they are destined for great things. Mr Kamath at ICICI speaks for many when he says that in the medium term "we will see a clutch of Indian banks among the top 15 banks in the world." Chinese and Brazilian firms are already there and Russia's biggest bank is not far off. For all their scale and ambition, however, emerging-market banks mostly still derive only a tiny share of their profits from their foreign operations (see chart 11). How quickly might that change?

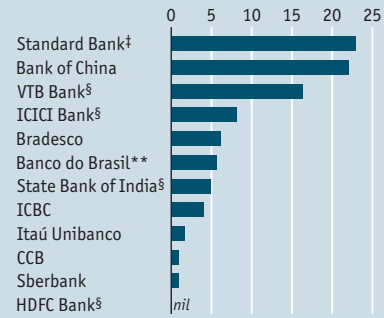
Seen from the hot seat of an emerging-market bank, the world is a dangerous place. Western finance faces an onslaught of regulation and is likely to stagnate. The few investments that emerging countries have made in Western financial firms have tended to turn out badly—think of China Investment Corporation's decision to put money into Blackstone's bubble-era flotation, or Ping An Insurance's stake in Fortis, which it was forced to write down after the Belgian bank failed. Those who declined invitations to bail out Western firms were proved right. "I did think I might do a big acquisition," says Mr Bhatt of the time when he took over as chairman of State Bank of India in 2006. "Then the sky fell in." He says he has had "a lot of offers but I have not taken them".

An emerging-market bank boss also has huge demands placed on him at home: to supply credit, to find capital and to survive the political jungle. And there are the lessons learnt since banking started to go global in the 1970s: the mediocre performance of American commercial banks overseas, the Japanese fiasco, multiple horror stories of commercial banks buying investment banks, and, as the boom peaked, a ruinous hostile acquisition in the form of the RBS-led takeover of ABN AMRO. Most emerging-market banks have plenty of humility. Mr Guo of China Construction Bank says that in rich countries "we cannot compete with local banks" for local corporate and retail business.

Instead most banks in the developing world are establishing a "string of pearls" abroad to service domestic customers as they expand internationally. At its most basic level this involves setting up branches. Often this expansion is aimed at other emerging economies, not just Western financial centres. Sberbank is opening a branch in Delhi and Itaú has a presence in Shanghai and Dubai as well as the usual offices in London and New York. In India the local banks find it hard to compete on cross-border deals these days. In Bharti Airtel's recent $9 billion acquisition the African assets of Zain, a Gulf-based mobile-telecoms firm, Standard Chartered and Barclays led a syndicate of financing banks that included only one local firm, State Bank of India. This is something the locals hope to change. ICICI's Ms Kochhar says her bank wants to set up an infrastructure abroad to service Indian firms. Mr Bhatt ▸▸

Homebodies 11

Foreign business as % of total*, 2009†



Source: Company reports

*Based on pre-tax profit †Or latest ‡Based on net income §Based on revenue **Based on loans

notes that India's banks need to expand with their corporate customers, or "sooner or later you will be irrelevant."

Forming alliances with local firms is one way of strengthening a string of pearls. In South Africa FirstRand has a pact with China Construction Bank. Sizwe Nxasana, FirstRand's chief executive, says his bank was working with them on a number of ad hoc transactions, so a formal agreement "became a very natural step". In one case this has blossomed into an even closer relationship, with China's ICBC taking a stake in Standard Bank (see box). Emerging-market banks hope that such co-operation will hone their skills. One consultant who has led workshops for Chinese bankers in international corporate banking says they soak up knowledge "like a sponge".

A complementary strategy is to provide "diaspora banking". Emerging-market banks have a competitive advantage among compatriots who live in Western countries. ICICI, for example, has small retail operations in Britain and Canada, and Banco do Brasil plans to open 15 new branches in America to target Brazilians living there. The deposits these operations gather are also handy as a foreign funding base. Still, even diaspora banking is not risk-free. In 2007 China Minsheng Bank bought a 10% stake in UCBH Holdings, a San Francisco-based bank that served Chinese-Americans. The bank failed and Minsheng wrote off its investment. Its chairman recently said: "We'd like to focus on matters at home now."

Yet the rules of banking overseas do not change just because a firm comes from a developing country. String-of-pearls strategies do not have a great track record. The experience of the Western network banks, most notably ABN, is that relying on expatriate customers to cover your costs does not work. In 1959 First National City Bank (Citigroup's predecessor firm) was aiming, in the words of one executive, to put a branch into "every commercially important country in the world". Yet by the late 1960s the strategy had run into trouble. John Reed, who eventually became head

A door to Africa

Standard Bank reaps the benefit of bold thinking

TO UNDERSTAND where Standard Bank is today, says its boss, Jacko Maree, you have to go back to South Africa in early 1987, when Standard Chartered, its original parent, sold out completely. Most South African firms were not welcome in the rest of Africa, he says, and "it wasn't entirely obvious" that Standard Bank's priority should be there or indeed in emerging markets at all. When South Africa moved to majority rule in the 1990s, plenty of South African firms shifted their domicile to London and tried to diversify into developed markets, but Standard Bank stuck to its guns. Something of this determination is reflected in its choice to keep its headquarters in downtown Johannesburg even though most financial firms moved to Sandton, a safe but dull suburb where adventure is a bar named the Bull Run.

Mr Maree, at the cuddly end of the spectrum of South African bankers, has been pretty astute. He became chief executive in 1999 after a failed takeover bid for his bank, which he says "was a big kick up the backside". That meant making more of its main activities abroad: an African presence built from branches bought from Australia's ANZ in 1992; an investment-banking unit in London (originally put there because of foreign-exchange controls in South Africa); and small operations elsewhere, including Russia, where natural-resources banking, an obvious specialism for African firms, is important.

The result has been solid, with compound annual growth in profits per share of 8% since 2003 and only a small dent in earnings from the financial crisis. In 2009 almost a quarter of profits came from abroad, either the rest of Africa or indirectly linked to the continent—for example, currency trades executed in London.

South Africa has had two lending booms since the end of apartheid. The first was driven by the opening of the economy to foreign capital, the second by lending to the rising black elite over the past decade. As a market it is fairly mature. But Africa as a whole is set for a "tectonic shift", says Goolam Ballim, Standard Bank's chief economist. The proportion of Africa's trade with China, Brazil, India and Russia rose from 5% in 1993 to 19% in 2008. Much of this, inevitably, is in resources, but governments are getting better at saving the proceeds of the good times for the less good ones, reckons Mr Ballim.

Old Africa hands who used to roll their eyes at this kind of analysis got a surprise in 2007 when ICBC, now the world's largest bank, spent $5.5 billion on a 20% stake in Standard Bank in what was then China's largest ever corporate foreign investment. Mr Maree and Mr Jiang, ICBC's chairman, stitched the deal together after spending a day in Cape Town together. There is still a wow factor about it, says Mr Maree. Although the revenues generated from working with ICBC are modest—some $78m in 2009—co-operation is being stepped up. Standard Bank has 30 bankers in Beijing now, as well as a main board director in an office close to ICBC's, who help clients of the Chinese bank interested in expanding in Africa.

For China's banks the deal is a test case of whether "treading softly" overseas will work. The combination ticks every box, bringing a presence in key markets for Chinese clients and exposure to a sophisticated foreign firm with skills in areas like investment banking and foreign-currency funding. Yet ICBC has limited influence with Standard Bank, with only a couple of directors on its board. A full takeover looks unlikely. ICBC would need permission from Standard Bank's board to buy more shares, and South Africa's government would probably not approve.

For Standard Bank the merits of the deal are clear: more capital, and kudos, to build a bigger presence in Africa and elsewhere. It is mulling buying a bank in Nigeria (where the government is opening up more to foreigners). And it is eyeing India, which Mr Maree says is "the missing link", given that Standard Bank already has an operation in Brazil and a stake in a Russian investment bank, Troika Dialog. With Standard Bank's complex history and relatively isolated position, explains Mr Maree, "we've had to think in a much more out-of-the-box way."

of Citi, once said of its overseas branches that they "didn't really know how much they earned". The network banks eventually succeeded because they widened their customer base to include locals as well as expatriates.

There are sceptics even among banks in developing markets. Aditya Puri of HDFC Bank doubts that the number of Indian firms going abroad is big enough yet to make it worth following them: "We will move when we see a migration of ducks rather than just a single swallow." He is of the Santander school of overseas expansion: "Unless you are a big player in a market, it is not of much use." At Santander itself Mr Sáenz says he is not planning to expand his network abroad to service Brazilian corporate clients there. That is a small part of the profit pool in Brazil, he says. "It is not our core business at all."

Two ways in

The spreading of emerging-market banks' branches across the world is simply a catching-up process that in itself has little significance. After all, even third-rate European banks have offices in New York and Hong Kong. In the longer term there are two possible approaches that could prove more important.

One is to try to find a competitive advantage. For India's banks this could be their low-cost technology—"the edge", as Mr Kamath puts it. A big test of this will be State Bank of India's expansion in retail banking in Singapore. Mr Bhatt says the bank is catering to the whole population, not just Indians, and will keep the back office in low-cost India. Many bankers in Mumbai speculate that this might produce a new twist on Western firms outsourcing to India: Indian banks will buy rich-country banks to get a shop front, then move the back office to India. Brazil's banks, meanwhile, are betting on investment banking. Bradesco's Mr Abreu says: "Brazil is still where we have the best opportunities. But what we are really focusing on abroad is to expand our investment bank."

The other possibility is to make acquisitions. There are very few, if any, examples of Western banks building a big presence abroad branch by branch. The way all commercial banks, even the network banks, went global is through deals. But acquisitions in banking are harder than in most industries. The politics are controversial. The financial risks are high because of leverage. And because banks have no physical plant beyond their branches, their value rests in their staff, who might wander off. To do this well, you need practice.

China's banks have been practising in their "near abroad". ICBC has bought small banks in Indonesia, Thailand and Macau. China Construction Bank has acquired bits of Bank of America and American International Group in Hong Kong. These are small deals by value but, says CCB's Mr Guo, "very significant" because they will help improve the bank's capabilities. Sberbank has bought small operations in Belarus, Ukraine and Kazakhstan. Banco do Brasil has just bought a controlling stake in a mid-size Argentine bank, and Itaú already has a presence in neighbouring countries. Even Bradesco, less expansive by instinct, recently bought a small bank in Mexico. Mr Abreu says it is a very cautious first step.

Will such first steps lead to greater leaps abroad? Certainly stories of giant deals make the rounds: your correspondent heard a yarn about a Chinese bank board discussing whether to bid for Merrill Lynch. And if the crisis had turned out differently, some emerging-market banks might have taken the plunge. During its darkest hours Citigroup considered selling Banamex, Mexico's second-biggest bank. Had it done so, the new owner might have been one of Brazil's banks.

Yet the expansion of emerging-market banks into the rest of the world depends on two things. One is that they grow even bigger and accumulate more capital and more skills. This seems all but inevitable. The second condition is that the globalisation of banking, a trend that has governed the industry for two decades, continues. And that is far from certain. ■

Cross your fingers

Emerging-market banks have done remarkably well, but they need all the luck they can get

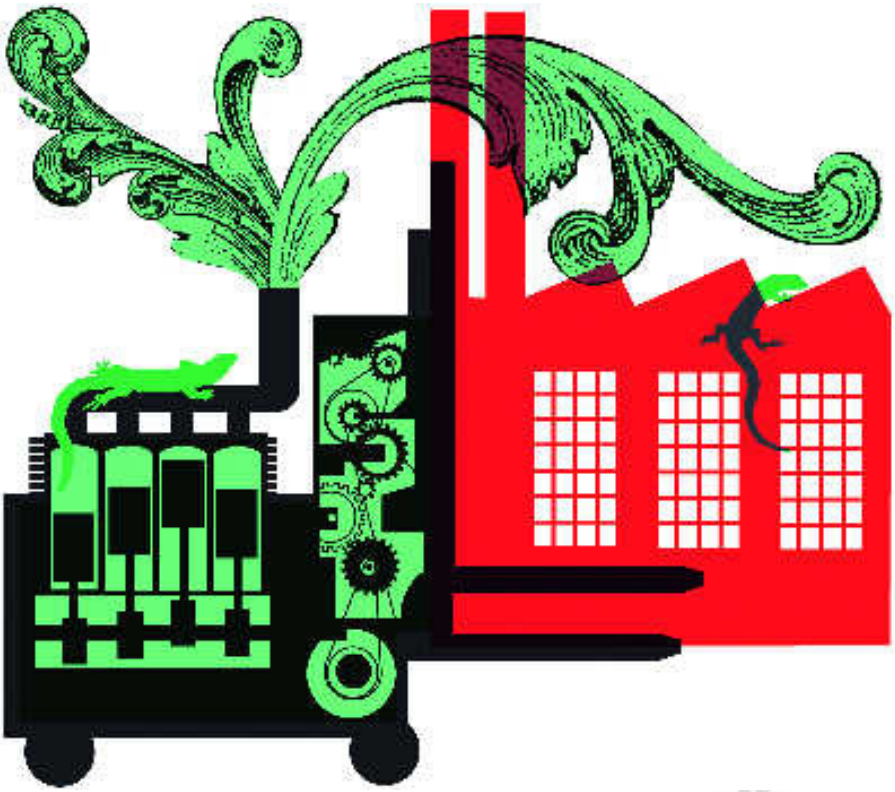
BANKERS in many rich countries failed two tests over the past decade. The first was the test of the marketplace, which exposed many banks that proved unable to command the confidence of their investors and counterparties or even to make a profit during a downturn. In the end they required government help to fund themselves and get hold of capital.

The bigger test was that of being "socially useful", in which the whole system got poor grades. Too much energy was put into speculation and complexity. Rather than being a source of stability, banks intensified the economic cycle, with firms showing little discipline during the boom and no humility afterwards.

Compared with their Western peers, emerging-market banks are mostly A-grade pupils. As businesses they are in good fettle, partly because of their youth and their natural advantages. They have plenty of funds because the societies they operate in have high saving rates. Their profits are stable, not least because their capital markets are small and volatile investment banking is not a big business yet. Yet much of their success reflects good management and good regulation. Supervisors learnt from the many crises in emerging markets over the years and made sure that banks had decent capital ratios and plenty of liquid assets. These firms tend to keep a good balance between old-fashioned banking values and innovation in customer products and technology.

On the wider test of performing a useful economic role, emerging-market banks have come out of the crisis well. Most of them genuinely believe in the importance of providing more people with access to financial services. The banking system as a whole continued to extend credit throughout the crisis. State-controlled banks did the heavy lifting, lending freely through 2008 and 2009, but private firms too performed reasonably well, whereas some Western firms in emerging markets proved unreliable, cutting credit or even shutting down or selling out.

This special report has argued that the experience of emerging-market banks will have a lasting impact. A fairly traditional banking business model has worked. That means Western firms without big local deposit bases and serious intentions to grow deep local roots will be less welcome. The



few American and European firms that already have solid emerging-market businesses have been very fortunate, and there is little chance that others will be able to replicate their model.

It also means that a mixed banking sector—with state-owned and private firms, as well as some foreign ones—will stay in place. This balance is now seen as a good thing in its own right rather than just a stage on the road to full market ownership. Big privatisation programmes are not on the cards. That will make it hard for Western firms without emerging-markets exposure to get established.

Big and getting even bigger, well run and well regulated: the emerging-market banks seem to have a lot going for them. At the same time their Western peers are dazed, under attack and shrinking. Yet for all their success, emerging-market banks face two big challenges.

The ifs and buts

The first is coping with exceptionally rapid growth without blowing up. The absolute volume of loans many banks are adding in a year now is often bigger than the entire bank was a decade ago. Growing at a rate of 20% a year will impose colossal pressures on everything from staffing levels to risk control. And to sustain it, these firms will have to plunge headlong into products they know little about, such as mortgages. Yet if their economies keep roaring ahead, the stodgy business of lending to companies will suffer as alternative means of finance for businesses open up. Emerging-market banks say this activity is not very profitable anyway, but they are bound to miss it if it goes.

The second challenge is the greater involvement of the state in the past few years. Although this has served emerging economies well, it brings its own problems. There is ample historical evidence that government control over banks' lending can breed cronyism and misallocation of funds. China will be a test case after its big lending spree of the past 18 months. At least in other developing countries the government's role in bank lending has been much less overt. Still, state-controlled banks, which hold the majority of assets in the financial system in China, Russia and India and over 40% in Brazil, will have to juggle their dual personalities as independent agents (often with minority stock-market listings) and public servants.

Most emerging-market banks are pursuing a cautious string-of-pearls strategy abroad, but the lesson from Western banks is that this is a quick way to lose money. To succeed in expanding abroad, banks need scale and a local deposit and customer base. New regulations will make this even more important.

As emerging-market banks begin to consider bigger acquisitions, they will find that being state-controlled will be a serious disadvantage. This is partly because banking in the rich world has become more politicised. But it is also because the conservative culture of many state banks is ill-suited to foreign takeovers, and because many customers would prefer to deal with a privately owned bank. That means India's and Brazil's private banks, although smaller than China's, may have an easier time expanding abroad.

Emerging-market banks are not about to take over the world. They have far too much to do at home: double the size of their business every five years or so, avoid bad debts, find more capital, cope with rapidly shifting patterns of corporate lending, bring banking to millions of poor people and deal with the politicians. Can they really do all this? Most have already performed miracles over the past few decades, from surviving political earthquakes to coping with hyperinflation, and prospered throughout a crisis that felled Western banks. But if the strength of emerging-market banks today is impressive, the task they face is also huge. ■

Fonte: The Economist, May 15th 2010. Disponível em: www.economist.com. Acesso em: 19 maio 2010.