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Banks **Western Europe**

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European Banks in Latin America

El Dorado or 'Hell' Dorado?

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- Latin America has not been the promised 'El Dorado' and we doubt its growth potential
- Santander's franchise is the most diversified, but the biggest beneficiary of a recovery in Brazil should be ABN Amro[ace]
- BBVA offers the most attractive franchise in the long term, while HSBC needs to improve profitability

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Cover image: View From Corcovado in Rio de Janeiro, Brazil
(courtesy of gettyimages)

Summary

In this report, we have analysed the situation of the Latin American region as a whole and individually for five countries: Argentina, Brazil, Chile, Mexico and Venezuela.

Latin America's large population, low GDP per capita and low bancarisation ratios should imply huge growth potential. However, this is not the economic reality. Looking at historical data the region has neither outperformed Europe nor the US in the last 20 years but, in fact, on a GDP per capita basis growth has been almost zero. Recovery should be seen in 2004F, after the region suffered one of its worst crisis in 2002, with strong currency depreciations and two countries (Argentina and Venezuela) in a deep recession.

The region has never been homogeneous and performances between countries are different. Choosing the right places to invest in is key for getting long-term returns. Figure 1 summarises each country's main characteristics. Our conclusion is that Mexico offers the best risk/return equation because margins have already been affected by convergence in interest rates while volume growth potential is huge.

Fig 1 Financial sector aggregates for selected countries (2002)

	Total loans (US$bn)	Total deposits (US$bn)	Loans/GDP (%)	Deposits/GDP (%)
Argentina	16.1	17.6	15.7	17.6
Brazil	108.6	82.5	22.4	17.0
Chile	42.6	24.9	65.3	38.3
Mexico	68.7	70.5	11.2	13.7
Venezuela	7.7	10.2	8.0	10.7
Eurozone	6,251	5,956	104	99

Source: Central banks and Supervisoras

Brazil: This is the largest banking market in Latin America with over US$100bn in loans and an aggregated 2002 net profit of US$7.0bn. Foreign presence is relevant with almost one fourth of assets and c50% of total profit. We believe the main threat in 2004 is the impact of falling rates on net interest margins. The Selic rate is expected to fall from 26.5% to 17.0% at the year-end. Asset and liability management and a change in regulation regarding cash coefficients should reduce the impact. Furthermore, the spread on assets is much larger than on liabilities, which should smooth the impact of falling rates. We forecast lending to grow by 13% in 2004F and 2005F (from 6% in 2002).

Mexico: We consider this to be the most underdeveloped banking market of any of the relevant emerging economies. It has a loan/GDP ratio of 11% and lending growth has been sluggish since the Tequila crisis took place in 1994. After cleaning the banking system, the sector is recovering its growth rates. Currently, consumer lending is growing above 40% YoY, corporate lending at 17% and mortgages at c4%. The sector is experiencing strong competition on the lending side from non-banking financial institutions (Sofoles, arrendadoras, etc), which are experiencing fast growth rates in mortgages and consumer lending, however when lending growth picks up in any sector banks usually start to recover market share. We forecast household lending growth of 23% in 2004F and 2005F (from 14% in 2002).

Chile: Its banking market is the third-largest market in the region with US$43bn in loans and aggregate net profit of US$1bn, representing 9% of the region. The most relevant

Summary

characteristic of this market is its high level of financial development; with the highest ratios in the region (2002 loans/GDP was 67%). It is the most stable market and, despite its financial development, we forecast lending growth of c10% in the next couple of years (8.3% in 2002).

Argentina: Before the default in 2001, Argentina was a model of growth potential, with high GDP per capita and low bancarisation rates, however in 2001 everything changed. The default made Argentina a bottomless pit where foreign banks had to provision the whole investment in the country. Although there has been some improvements in the country, there are still a number of pending issues like the full compensation to the banks after the asymmetric pesification and the impact of the 'amparos'. In fact, should the banks' mark to market their government bond portfolios, their equity would be negative. The size and attractiveness of the banking market is very limited and we believe further investments in the country are not justified.

Venezuela: This is one of the smallest banking markets in the region with only cUS$7bn in loans. However, profitability is especially high given the size of the market at US$1bn in 2002. We fear that this high profitability is maintained by an overvalued currency and interest rates. The political situation is also risky with an expected referendum to oust Mr Chavez in March or April, which could generate further instability in the country.

After analysing each country, we identify two countries where profitability is too high given the size of the banking market: Brazil and Venezuela. Both present risks in terms of currency and the impact of falling rates, although these are much bigger in Venezuela.

European banks in the region

The number of European banks that ventured into the region makes a long list although the ones in the following table are those with significant exposure. Many others (Lloyds TSB, Intesa and Credit Agricole) have exited the region and a few others maintain small offices (for wholesale banking activities or representative offices).

Only four large European banks remain in Latin America: ABN Amro, Banco Santander BBVA and HSBC. As shown in Figure 2, HSBC suffered losses during 2002 (due to restructuring charges at Bital), ABN had a ROI of c10% and the two Spanish banks made a ROI of only 8%. These sorts of returns (especially given that most investments are older than three years and some date back from the early 1990s) can be considered poor and do not cover the required return of investing in the region. The required return calculation depends on the time of investment, but we think it should have been at least 14-15% bearing in mind the bond yield, plus country risk premium, plus equity risk premium.

Fig 2 Investment of main European banks in LatAm

	Investment (US$bn)	Countries of presence	Net profit 02* (US$bn)	% group profit
Banco Santander	17.2	All except Peru	1.303	62
BBVA	9.2	All except Brazil	0.69	43
HSBC	4.7*	Brazil, Mexico, Argentina & Panamá	-0.75	N/M
ABN Amro	3.7	Brazil and local branches	0.39	18

* Includes capital increase at Bital

Source: Company data

Summary

Regarding the presence of the Spanish banks in the region, our conclusion is that although in the short term Santander looks to be in a better position with a diversified and profitable franchise, BBVA should benefit from the growth potential of Mexico. Both banks face a challenging 2004 due to falling interest rates and, especially, because the political situation in Venezuela can deteriorate. Venezuela represents c3% of the group profit for BBVA and 4% for Santander (as of 1H03).

ABN Amro[ace] has benefited from profitability in the Brazilian market, where it is represented through ABN Banco Real. Besides the Netherlands and the US, Brazil is one of the focus markets for ABN Amro, where the division is growing organically and through acquisitions. The focus on lending (where spreads are larger) and an improvement in the cash coefficients should reduce the impact of falling interest rates on margins. Furthermore, IT system improvements should have an impact on costs and ABN hopes to improve its cost/income ratio to 55-57% (last available was 60.3%). Long term, however, we have doubts about the sustainability of profitability in the Brazilian market as a whole.

Banco Santander looks to have a clearer strategy, leading position in core markets and a strong management team (with Francisco Luzón and his team). Mexico and Brazil represent c80% of the net profit it gets from the region, while Chile represents 12% and Venezuela 9% (as of 2002). We expect Latin America to contribute €1.28bn to Santander's P&L in 2003F and €1.34bn in 2004F. Short term, it should benefit from the recovery in the Real.

BBVA has had a buying spree without a clear strategy or targets. However, after the appointment of new management in 2001 it looks as if its strategy is clearer with focus on countries in which it has critical mass or can achieve it. We have doubts regarding the position in Chile, although the group intends to grow organically. A sale of BHIF could be an option if profitability is not improved. We think that in the long term, Mexico offers huge potential and BBVA is the leader in this market through Bancomer. The appointment of Vitalino Nafría as managing director of BBVA America division is also a signal that BBVA's main focus remains Mexico.

HSBC's Latin American operations have been a source of great pain and minimal profits over the past few years, but a revamp of the group's strategy bodes quite well for the future viability of the business. HSBC's LatAm operations have lost a collective US$708m since their inception in 1996 by our calculations on over US$3.7bn of investment – clearly a dismal record. Nevertheless, we think that HSBC's repositioning as a mass consumer bank in LatAm is a winning strategy, especially when the group will now be able to bring to bear the expertise of both Household and Losango. The group's focus on Mexico and Brazil, which together with China and India, are the markets where it is concentrating its efforts.

All in all, we conclude that **Banco Santander's** franchise is the strongest and most diversified, but the largest beneficiary of a recovery in Brazil is more likely to be **ABN Amro**. **BBVA** offers the most attractive franchise in the long term if it focuses its strategy on developing its Mexican business, while **HSBC** has a weak track record and needs to improve profitability in Mexico and Brazil, although management looks to be moving in the right direction.

Latin America: A risky region

Latin America's large population, low GDP per capita and low bancarisation ratios imply that growth potential here should be huge. However, looking at historical data, the region has not grown faster than Europe or the US and loan/GDP ratios have not improved since 1994.

The region is prepared for a period of growth after suffering its worst year (in the last 25) in 2002 due to currency depreciation, the Argentinian and Venezuelan crises and weak economic growth.

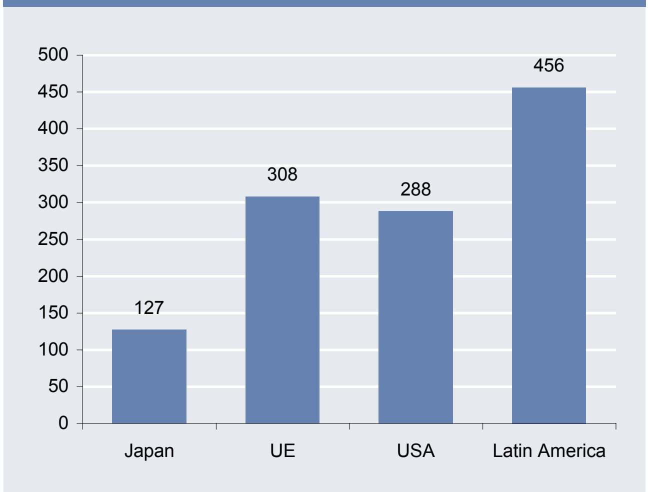
The region has never been homogeneous and performances between countries are different. Choosing the right places to invest is key for getting long-term returns. We think Mexico offers the best risk/return equation.

The rationale behind Latin American expansion

Latin America has been the main region of expansion for Spanish banks but also for other European operators

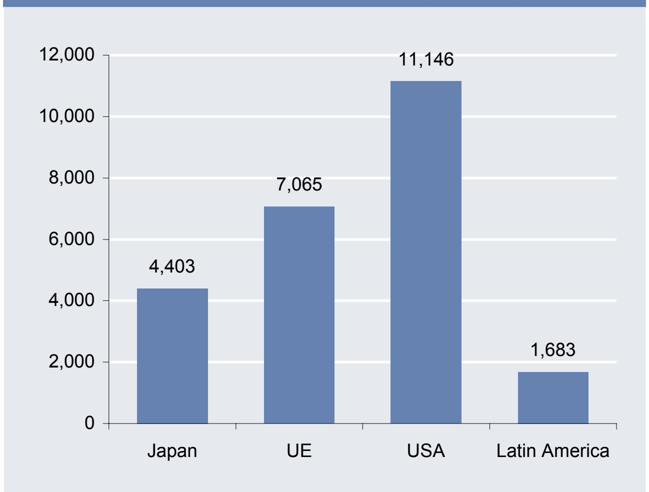
Latin America has been the main expansion region for Spanish banks, but also for many European operators such as HSBC, ABN Amro, IntesaBCI and Lloyds TSB, which have carried out relevant investments in the regions. Supposedly, the region offered significant room for growth. Latin America is a region with a larger population than the whole Eurozone or the US, with a very low GDP per capita and with ratios of financial development substantially lower than those in Europe or the US.

Fig 3 Population of main regions (m)



Source: National statistical institutes

Fig 4 2002 GDP in main regions (US$bn)



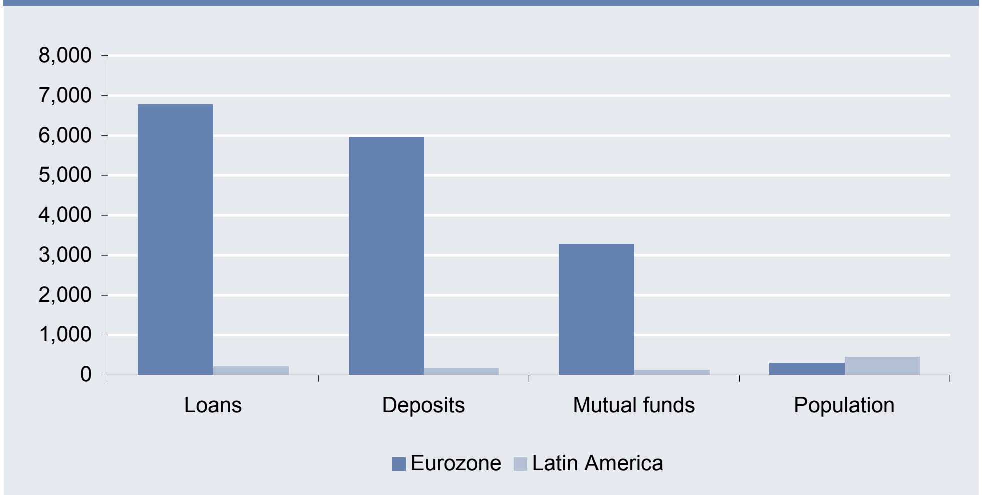
Source: National accounts, CEPAL for Latin America, ING estimates

The assumption of banks investing in Latin America was that GDP per capita growth would prompt growth in financial development ratios (loans/GDP and deposits/GDP) and, consequently, the region offered a double source of growth: per capita GDP growth and faster development of financial services. These two sources of growth and a young and growing population implied that the region was a potential 'El Dorado'.

Despite having 50% more inhabitants than the Eurozone, its banking market is only 1/30th loans and deposit markets are small

In fact, the low GDP per capita combined with low loans and deposits over GDP ratios creates the paradox that despite Latin America has almost 50% more inhabitants than the Eurozone, the loans, deposits and mutual funds markets in the Eurozone are c30x the size of Latin American markets.

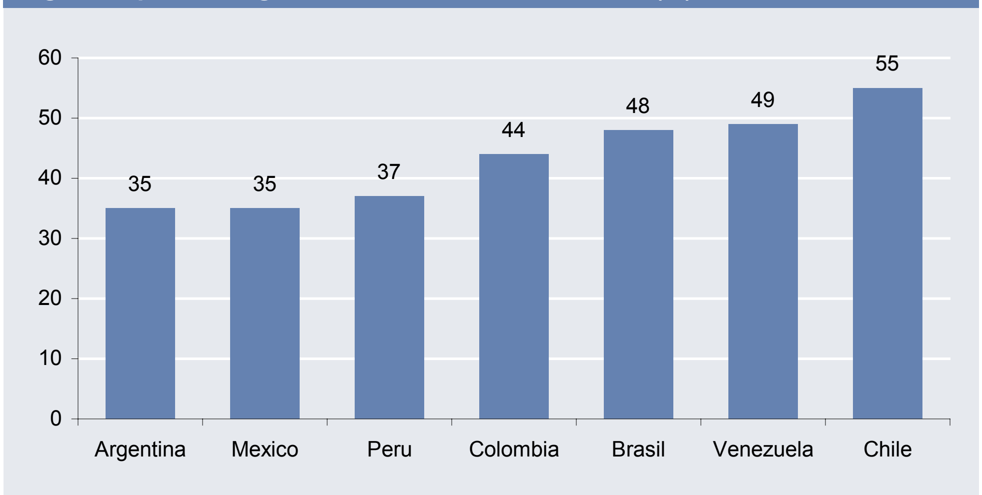
Fig 5 Comparison of the Eurozone versus Latin America (US$m)



Source: Central banks, association of mutual funds and national statistical institutes

Furthermore, the low bancarisation of the population implied that there was huge potential for development of financial services across the region. In most countries more than 50% of the population does not even have a bank account.

Fig 6 Population aged over 18 with a bank account (%)



Source: Banco Santander

GDP growth and financial development: a reality check

As we have explained, GDP growth should imply financial development and bancarisation, which would stimulate lending and savings activity increasing loans/GDP and deposits/GDP ratios.

History demonstrates that Latin America is not a growth region

Although the basis for growth seemed sound, history tells a different story. Despite the low GDP per capita and liberalisation and democratisation process in most countries, the region has not outperformed the US or the Eurozone in terms of GDP growth. Since 1980, the US has outperformed the Eurozone and both have outperformed the

Latin America. Furthermore, if we take into account that Latin America has experienced strong population growth of almost 2% pa in the last 20 years, we can easily reach the conclusion that GDP per capita growth has been much smaller than in developed countries like the US or Spain (the second-largest investor in the region after the US).

Fig 7 A comparison of growth (%)

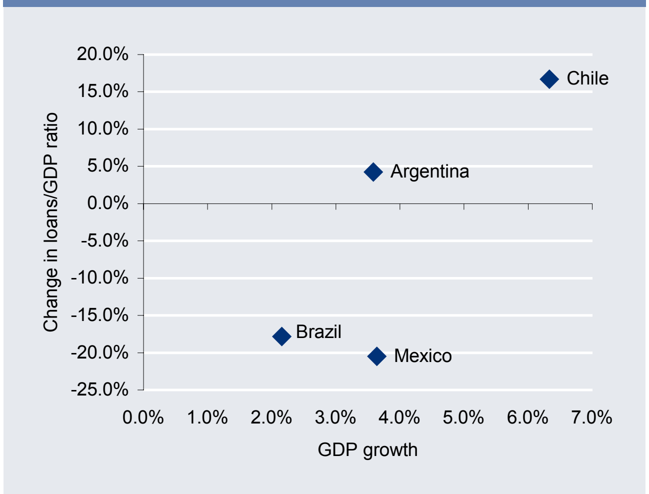
	CAGR 1980-02 (22yrs)	CAGR 1990-00 (10yrs)
GDP		
Eurozone	2.2	2.4
US	3.1	3.2
Spain	2.8	2.7
Latin America	2.1	3.0
GDP per capita		
Eurozone	1.9	2.0
US	2.3	2.1
Spain	2.4	2.4
Latin America	0.3	1.9

Source: ING calculation based on Institute for International Finance, IMF, CEPAL, INE and Bloomberg data

GDP growth and financial development are not totally correlated

Regarding GDP growth and financial development, the relationship is not as straight forward as it would seem. Although we can correctly say that a relation exists, other conditions are necessary for it to work as expected, such as a sound financial system, economic stability, etc. For example, Argentina's and Mexico's financial development ratios moved in opposite directions in 1994-99 despite similar GDP growth. In that period, both countries experienced similar real GDP growth (3.6% per annum), but Argentina's loan/GDP ratio rose from 20.0% to 24.2%, while in Mexico the ratio fell from 35% to 14.4%. Deposits/GDP performed similarly.

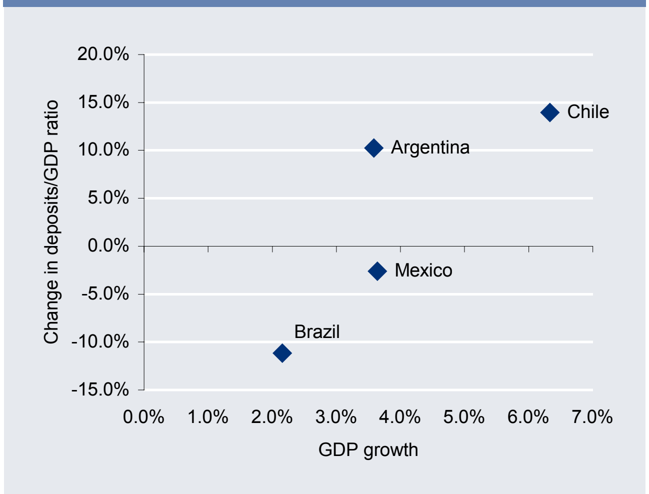
Fig 8 GDP growth vs growth of loans/GDP



Note: Period is 1994-99

Source: ING estimates

Fig 9 GDP growth vs growth of deposits/GDP



Note: Period is 1994-99

Source: ING estimates

Latin America: not a uniform region

Latin America is not uniform

Although Latin America is not a growth region (as we tried to demonstrate in the previous section), certain countries have a track record of sustained growth. The explanation for this is that Latin America is not a uniform region. Mexico is very different in terms of trading patterns and economic fundamentals to countries in the southern region. Chile's GDP per capita is double that of its neighbours' (Peru and Colombia) and Puerto Rico is most similar to the US with a GDP per capita 2.5x bigger than that of the rest of the region.

In terms of GDP, two countries are by far the most important: Brazil and Mexico. Following these two is a group of relatively similar-sized countries but with nominal GDPs in the region of US$50-100bn: Argentina, Chile, Colombia, Peru and Venezuela. The combined GDP of Brazil and Mexico represent two thirds of the region, while the following five represent 25% of the region's GDP.

Fig 10 Comparison of main Latin American countries

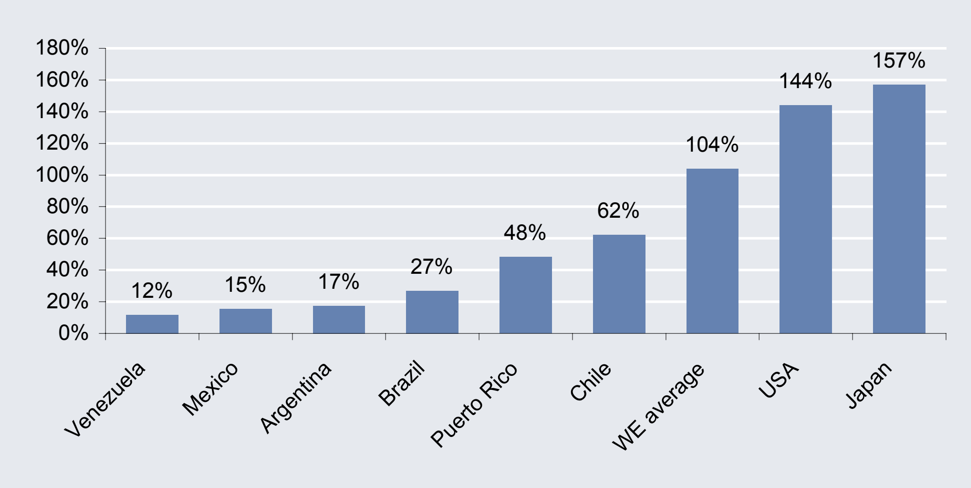
	Population (m)	Contribution (%)	GDP (US$bn) 2001	2002	% of total
Mexico	99	22	617	643	38
Brazil	175	38	504	484	29
Argentina	37	8	268	100	6
Venezuela	24	5	126	95	6
Colombia	44	10	83	82	5
Chile	16	3	66	65	4
Peru	27	6	53	54	3
Puerto Rico	4	1	71	73	4
Uruguay	3	1	17	11	1
Paraguay	6	1	7	7	0
Bolivia	9	2	8	8	0
Ecuador	13	3	17	17	1
Total	**456**		**1,886**	**1,683**	

Source: IMF, Cepal

Growth potential is different across the region. Mexico has the highest potential, in our opinion

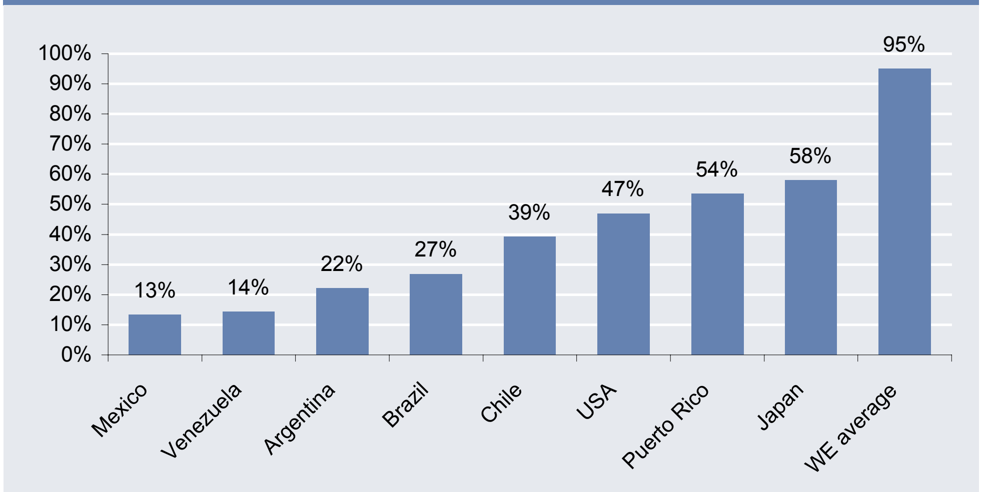
The level of financial development is also different between the various countries and, consequently, so is growth potential. Mexico is an especially notable example, where the Tequila crisis (1994) resulted in very low lending growth for the last seven years (negative in real terms) and the inability of SME and individuals to access banking loans. As a consequence, the loan/GDP ratio fell from 35% in 1994 to 15% in 2002. Excluding Chile, all of the countries have very low loans/GDP and deposits/GDP ratios (below 30% in most countries). This ratios compares with more than 100% in most European countries and almost 90% in Southeast Asia, the other large Emerging market region.

Fig 11 Loans to private sector/GDP 2001



Source: Central Banks, Datastream, ING estimates

Fig 12 Deposits/GDP 2001

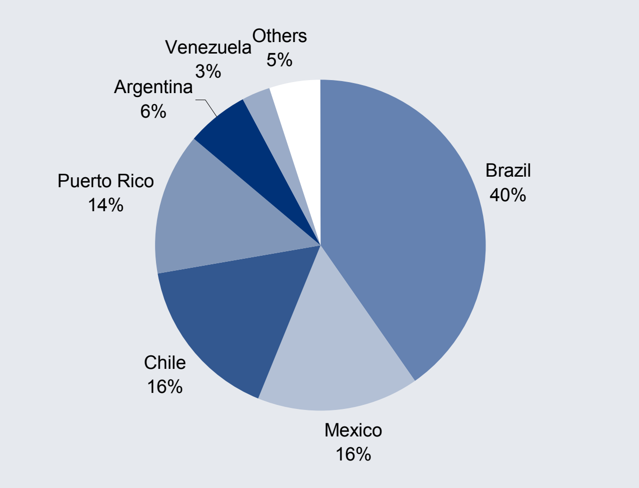


Source: Central Banks, Datastream, ING estimates

Five countries are the most important in every financial product

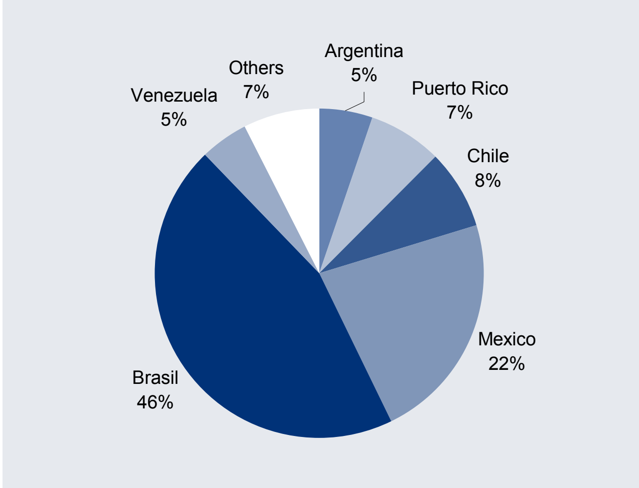
As Figure 10 shows, two countries represent almost 70% of the region's GDP and in almost every line of business (loans, deposits, mutual funds, pension funds), three or four countries represent more than 80% of the market. Those countries are the two largest (Mexico and Brazil) plus Chile, Venezuela and Puerto Rico. In terms of assets (loans and deposits), these five countries represent 92% of the regional total. In mutual funds Brazil and Mexico represent almost 90% of the business in the whole region.

Fig 13 Loan distribution by country (2002)



Source: Central banks

Fig 14 Savings* distribution by country (Jun 03)



*Savings = deposits & mutual funds

Source: Banco Santander

Chile, Mexico and Colombia outperformed the rest of the region

In terms of growth, Latin America is not a uniform region. Chile, Mexico and Colombia have outperformed Brazil, Argentina or Peru. In 1980-02, Chile experienced 7.8% GDP growth, Colombia 2.9%, Mexico 2.4%, Brazil 1.9% and Argentina a sluggish 0.6%.

Although the differences in these growth rates would not seem relevant, over a 20-year period the implied real GDP differences are huge.

Fig 15 GDP growth rates in last two decades and 1980-02 (%)

	1980-89	1990-99	1980-02
Chile	2.9	13.0	7.8
Colombia	3.4	2.8	2.9
Mexico	1.9	3.6	2.4
Brazil	1.6	2.1	2.1
Peru	-0.8	3.6	1.9
Venezuela	0.6	2.5	0.9
Argentina	-1.1	3.6	0.6

Source: IMF, Cepal

Banking in Latin America: a risky business

Investing in emerging markets has obvious risks and Latin America is not exempt from them. In the last few years, we have seen huge volatility in currencies, interest rates and recessions in several countries for different reasons (natural causes in Peru, instability in Colombia, political reasons in Venezuela and default of foreign debt in Argentina). Some of these crises have led to a complete loss of investment in the country (Argentina), others have reduced the profitability of the banks to a minimum (Peru and Colombia) and some have had a minimal impact due to the positive impact on revenues from larger spreads (Venezuela).

For more details on Argentina see page 27 for information about the country's situation and pages 50 and 62 for more details on Santander's and BBVA's exposure (which we estimate to have been €2.6bn and €1.9bn, respectively). The examples of Peru and Colombia are also a lesson in how the €2.0bn invested by the two large Spanish banks over the last decade failed to reap any rewards. In 2002, those two countries did not make a contribution to the net profit of the either group.

Fig 16 BBVA's and Banco Santander's exposure in Colombia and Peru (€m)

2002	Colombia	Peru
Investment		
Santander	444	215
BBVA	1,120	290
Net profit 2002		
Santander	(30)	N/M
BBVA	(11)	8
ROI (%)		
Santander	N/M	N/M
BBVA	N/M	2.8

Source: Company data and supervisors

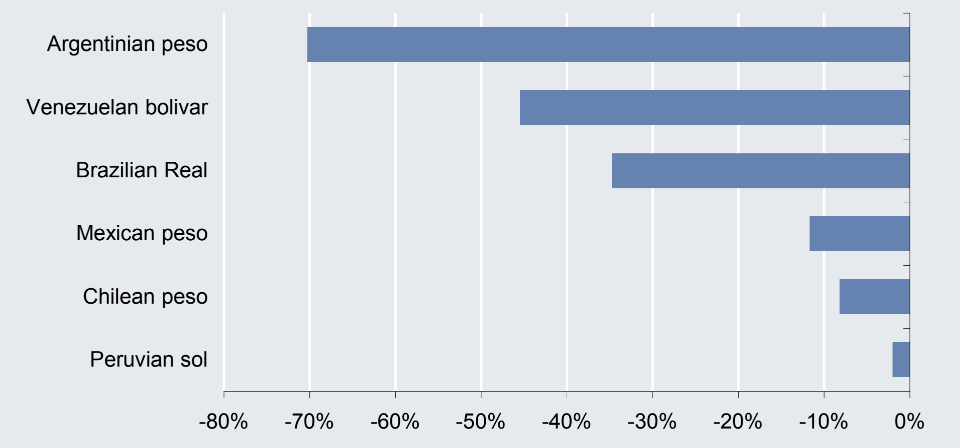
Instability in the region is likely to continue, and we would not be surprised if the next country to experience problems is Venezuela. Before the year-end, Venezuela could probably devalue its currency and political instability is likely to continue if no referendum is called to confirm the president in his position (for more details see page 25 of this report).

2002: The toughest year in a decade

Uncertainty in Argentina, because of the default, and Brazil, due to election, has had a pernicious effect. This, together with the depreciation of the most important currencies in the region and the impact of the US slowdown on Mexico, made 2002 a really tough year in the region.

In recent history, 2002 was one of the toughest years for Latin America, only comparable with the difficult situations in 1983 and 1994. Two of the most important countries (Venezuela and Argentina) entered into deep recession (more than an 8% fall in GDP for both countries), while Mexico suffered from the slowdown in the US and Brazil suffered from election uncertainty that eventually led to the Lula mandate. Simultaneously, the currencies experienced depreciations of up to 70% (in Argentina).

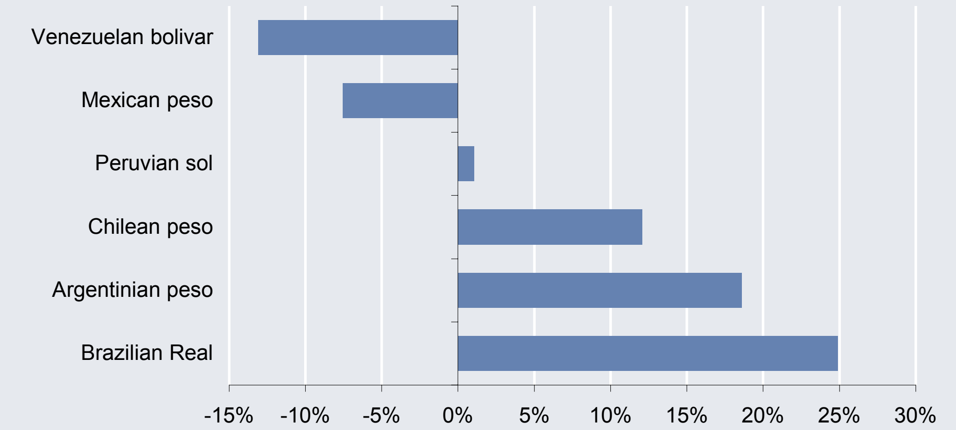
Fig 17 Currency depreciation versus the US dollar (2002)



Source: Bloomberg

However, in 2003 there has been a recovery of most currencies versus the US dollar, except for the Venezuelan bolivar and the Mexican peso.

Fig 18 Ranking of performance 2003 (YTD until 10 October)



Source: Bloomberg

The correlation between currencies rose during crisis times in 2002

In our report, "*BBVA, the three myths of Latin America*", September 2001, we argued that currency risk was not such an issue because the correlation between Latin American currencies had been historically low. So when, for example, the Mexican peso depreciated the Real could appreciate (which is what has been happening now). However, in 2002 the correlation between currencies rose substantially and they all depreciated against the US dollar at the same time.

Consequently, although the correlation between local currencies is generally low, in times of crisis they increase and, consequently, there are no diversification benefits from investing in different countries (at least in terms of currency exposure reduction). That was the case in 2002.

Fig 19 Correlation among currencies in 2002

	MXN	BRL	CLP	ARP	COP	VEB	EUR
MXN	1	0.92	0.79	0.79	0.91	0.90	0.95
BRL	0.92	1	0.89	0.66	0.97	0.86	0.86
CLP	0.79	0.89	1	0.55	0.90	0.85	0.73
ARP	0.79	0.66	0.55	1	0.66	0.83	0.79
COP	0.91	0.97	0.90	0.66	1	0.89	0.87
VEB	0.90	0.86	0.85	0.83	0.89	1	0.9
EUR	0.95	0.86	0.73	0.79	0.87	0.9	1

Source: Bloomberg

Apart from local currency impact, it is quite relevant for the Eurozone banks the performance of the US$/€ exchange rate. Given that Latin American currencies are traded against the US dollar and then converted into euro, the US$/€ exchange rate is very relevant because it affects the whole region. Of the banks we cover in this report, the most exposed is Santander for which a 10% depreciation of the US dollar implies a 6% impact on group profit.

A comparison of sensitivity:

Fig 20 Impact of a 10% depreciation in the US dollar on group profit (%)

Bank	Impact on group profit
BBVA	4.3
Santander	6.2
ABN Amro	1.7
HSBC	N/M

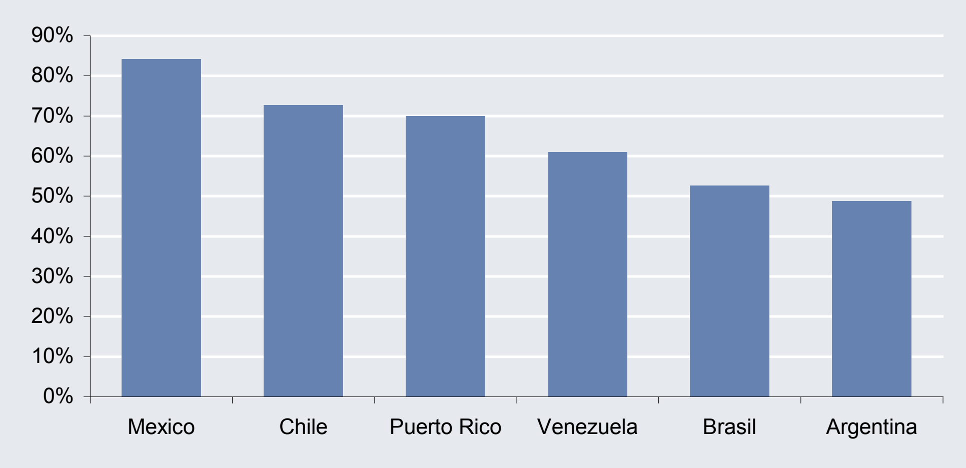
Before impact of currency hedge
Source: ING estimates

Consolidation potential

The main countries have financial institutions with high levels of concentration

At first glance, because of the undeveloped banking market, it could appear that Latin American countries have fragmented banking markets. However, that is not the case and most of them present concentration ratios comparable with those in the maturest European markets (like the Netherlands or Switzerland). For example, in Mexico five institutions control 84% of the assets.

Fig 21 % of assets controlled by the five largest financial institutions (2002)



Note: Argentina's data is from 2001
Source: Central banks, ABA, Comisionado inst fin Pto Rico, CNBV

In our opinion, apart from the specific situation in Argentina where public banks have a large presence, there is consolidation potential in Brazil and Venezuela. In Brazil, the market has witnessed a consolidation process in recent years with many acquisitions. However, the ongoing privatisation process is expected to continue, although there is no timeframe for it. Let's remember that Banco do Brasil[c], Caixa Economica Federal and Caixa Nossa control c30% of the country's banking assets.

On the contrary, we think there is no room for further consolidation in Mexico and little scope for it in Chile. However, there is the possibility that Banco Chile, the third institution in the country, being privatised at some point and that would create an opportunity for further consolidation.

Brazil

The Brazilian banking market is the largest in Latin America with over US$100bn in loans and an aggregated net profit of US$7.0bn in 2002.

The foreign presence is significant with almost one fourth of assets and c50% of total profit. Domestic banks are quite competitive while public banks are large in size but inefficient.

The main threat in 2004 is the impact of falling rates on the net interest margin. The Selic rate is expected to fall from 26.5% to 17% at the year-end. Asset and liability management and the change in regulation regarding cash coefficients should reduce the impact.

Economic view

The Lula government is taking the right steps to reduce inflation and improve government solvency

We maintain a constructive outlook for Brazil over the medium term. Over the first nine months of President Lula's mandate, he implemented an austere fiscal and monetary policy, which ultimately reigned back inflation and erased concerns about government insolvency. Besides gains on the macroeconomic side, political advances were also considerable, specifically the swift approval of the social security reform in the Lower House. Although the Senate's approval of the bill is still to come, we believe that markets have priced in such event and should hereafter be anticipating the government's new political agenda, which in our view should be focused on economic development, or in other words economic growth with social inclusion.

Economic recovery should resume in the latter part of 2003, mainly driven by a decompression of personal consumption. Declining interest rates coupled with a stable exchange rate and low inflation is setting the stage for improving expectations with respect to the Brazilian economic outlook. This, in turn, should provide space for the consumption of durable and semi-durable goods to pick up some steam at the margins. However, in order to guarantee a sustainable path of growth throughout the next few years (in the absence of any external financial turmoil), such consumption recovery has to be backed by a pick-up in capital expenditure. While we believe the spark for that should come with the pick-up in infrastructure investment, private investment will also remain key.

In terms of macroeconomic variables, we believe the exchange rate will reach R3.15/US$ by the year-end, and should remain in depreciated territory for at least a couple more years. This should guarantee the necessary inflow of hard currency through robust levels of trade surpluses, and keep the country's external vulnerability low. Growth should still remain modest (1.3% in 2003F, 3.0% in 2004F and 4.0% in 2005F) and dependent on the level domestic investment.

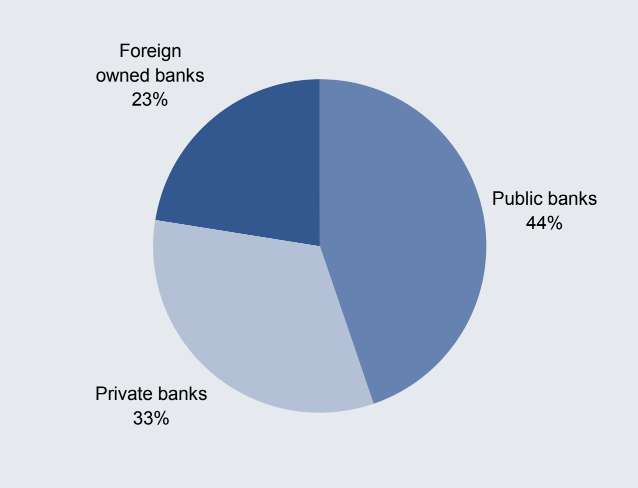
Author: Marcelo Salomon

The banking market

It is the largest banking market by far with significant presence of foreign institutions

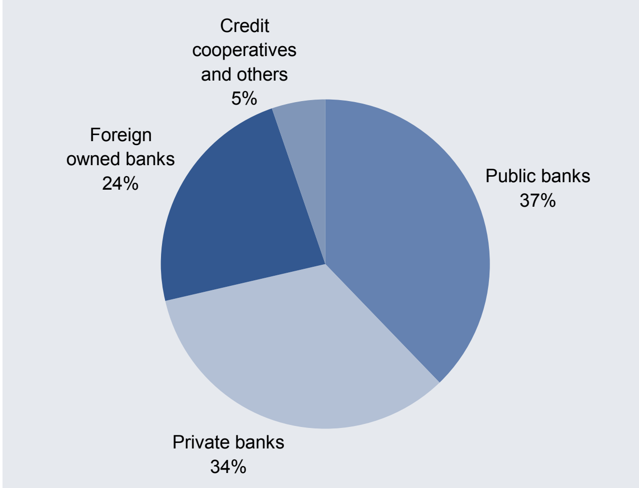
Although Brazil is the second-largest economy in the region, it has larger financial development ratios than Mexico and is, consequently, the largest banking market by far. It currently has slightly more than US$100bn in loans and US$83bn in deposits with a large presence of public and foreign institutions but also strong local banks. Foreign-owned banks represent one third of the assets of the financial system and c25% of the loans. In 2H02, and as a consequence of reduced exposure by foreign-owned banks, both private banks and public banks gained market share. Total assets grew by 7.5% in 2H02, with public banks growing at 17.6% and private banks at 10.1% while foreign-owned banks' assets fell by 4.4%.

Fig 22 Market share by assets (December 2002)



Source: Brazil Central Bank

Fig 23 Market share in loans (December 2002)

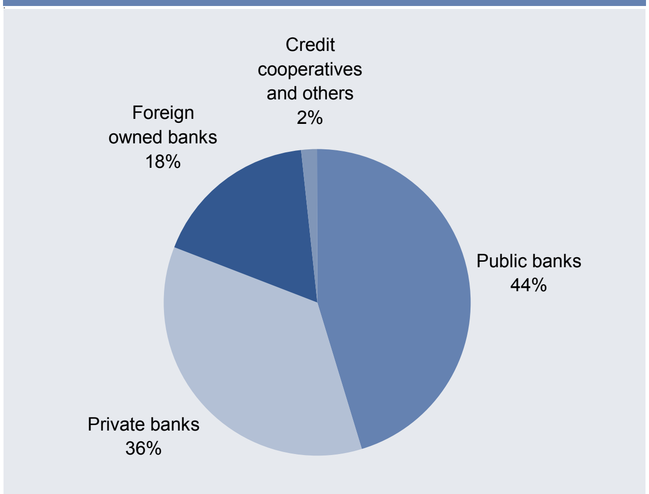


Source: BCB

Foreign banks are the most profitable institutions

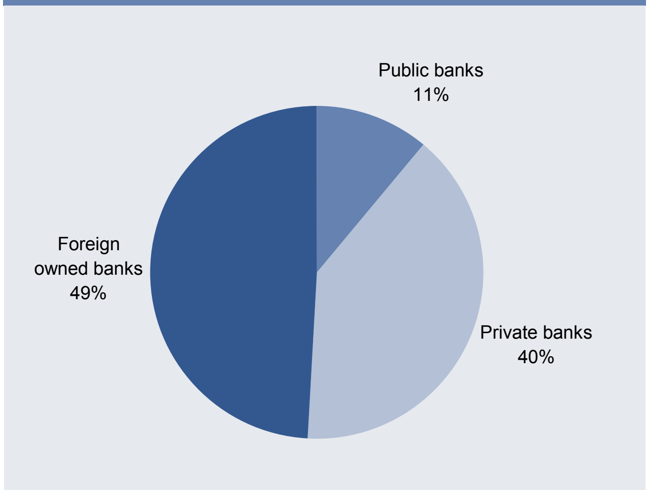
Although public banks' market share is even larger for deposits, the profitability of those banks is quite poor and the smaller foreign-owned banks are the most profitable institutions in the country. With 23% of the assets, they gain almost 50% of the Brazilian banking system's net profit.

Fig 24 Market share in deposits (Dec-02)



Source: BCB

Fig 25 Net profit contribution to the sector (2002)



Source: BCB

In terms of size, public banks are the largest in the country (Banco do Brasil and Caixa Economica rank first and third). In terms of importance, the three largest private listed banks (Bradesco, Itau and Unibanco) follow in importance while the largest private bank by assets is Banco Santander Banespa closely followed by ABN Amro Banco Real.

Fig 26 Ranking of Brazilian banks in 2002 (US$bn)

	Assets	Market share (%)	Equity	Deposits	Branches
Banco do Brasil	57.9	17	2.6	27.5	3,164
Bradesco	38.5	11	1.3	21.7	2,961
Caixa Econômica Federal	36.3	10	3.1	16.0	1,701
Banco Itau	30.5	9	3.0	11.2	2,231
Unibanco	20.1	6	1.9	7.4	906
Banco Santander	15.5	4	1.7	5.5	1,022
Abn Amro Real	14.9	4	2.0	6.1	1,381
Nossa Caixa	8.1	2	0.4	5.1	497
Citibank	8.0	2	1.0	0.4	51
HSBC	7.0	2	0.4	3.6	943
Total	**348**		**30.3**	**129.1**	**17,514**

Source: BCB

In terms of balance sheet structure, as with other developed countries, there is an important weight of claims on the central bank (due to the cash reserves that banks need to keep) and claims on central and local government. Brazilian banks in general are well -capitalised institutions with an average BIS ratio of over 16%.

Fig 27 Balance sheet structure of Brazilian banks 2002

Assets	(%)	Liabilities	(%)
Cash and central bank	18	Private sector deposits	38
Loans to private sector	38	Money market instruments	2
Claims on government, regions and municipalities	21	Foreign liabilities	14
Foreign assets	11	Other liabilities	4
Inter-bank	8	Inter-bank liabilities	14
Other	4	Capital accounts	27

Source: BCB

Margins: the threat of falling rates

There is a worry in the market that a fall in interest rates could harm the net interest margin of Brazilian banks. The SELIC rate (discount rate at central bank) has fallen from 26.5% to 20% and is expected to fall to 17% by the year-end according to our economists.

Fig 28 Selic rate (%)

Source: Bloomberg

Our view is that the impact will not be that large for three reasons:

1) Margins on the asset side are much larger than on the liability side. For example, according to Santander, the average margin on loans is 15% while the average spread on deposits is much smaller at 3% due to the compulsory cash kept at central banks. On demand deposits, the cash required to be kept at central banks is 60% of the amount.

2) The reduction in the cash coefficient will improve margins and partially offset the effect of falling rates. For example, the demand deposits' cash requirement is reduced from 60% to 45% (as of August 2003).

3) Banks are actively managing assets and liabilities to smooth the impact of rates.

Consequently, we are not as worried as the market about the performance of net interest income for Brazilian banks.

Regarding volume growth, we forecast a recovery in volumes from 2004 onwards as GDP growth accelerates. Based on current figures (July 2003) published by Brazil's central bank, we foresee a 6% growth in loans to the private sector during 2003. However, we expect higher growth in 2004F and 2005F at 13%, mainly driven by lending to private individuals, which we forecast to grow at 11% in 2004F and 15% in 2005F. We expect the big players to focus their commercial efforts on the asset side, especially in mortgages and consumer lending.

Fig 29 Brazilian financial system forecasts (R$m)

	1999	2000	2001	2002	2003F	2004F	2005F
Loans to private sector	**268,324**	**307,460**	**322,539**	**364,826**	**387,821**	**438,667**	**496,179**
% growth	*6*	*15*	*5*	*13*	*6*	*13*	*13*
Lending accelerator	0.9	1.1	0.6	1.3	0.5	1.3	1.2
Lending to private individuals	**92,742**	**116,691**	**101,294**	**105,803**	**116,624**	**129,890**	**149,935**
% growth	*5*	*26*	*-13*	*4*	*10*	*11*	*15*
Mortgages	52,991	55,966	23,948	24,081	26,730	31,007	37,208
% growth	*-2*	*6*	*-57*	*1*	*11*	*16*	*20*
Other lending	39,751	60,725	77,346	81,722	89,894	98,884	112,727
% growth	*15*	*53*	*27*	*6*	*10*	*10*	*14*
Lending to companies	**175,582**	**190,769**	**221,245**	**259,023**	**271,197**	**298,317**	**334,115**
% growth	*6*	*9*	*16*	*17*	*5*	*10*	*12*
Deposits and mutual funds							
Private sector deposits	**205,454**	**201,680**	**226,310**	**277,201**	**297,702**	**320,917**	**349,029**
% growth	*4.6*	*-1.8*	*12.2*	*22.5*	*7.4*	*7.8*	*8.8*
% of client resources	*37*	*32*	*33*	*44*	*43*	*41*	*41*
Mutual funds	**353,108**	**432,434**	**454,124**	**359,318**	**395,250**	**454,537**	**499,991**
% growth	*25.3*	*22.5*	*5.0*	*-20.9*	*10.0*	*15.0*	*10.0*
% of client resources	*63*	*68*	*67*	*56*	*57*	*59*	*59*
Private sector deposits + mutual funds	**558,562**	**634,114**	**680,434**	**636,519**	**692,951**	**775,454**	**849,020**

Source: Brazil Central Bank, ING estimates

Chile

The Chilean banking market is the third-largest market in Latin America with loans of US$43bn and aggregate net profits of US$1bn, representing 9% of the region.

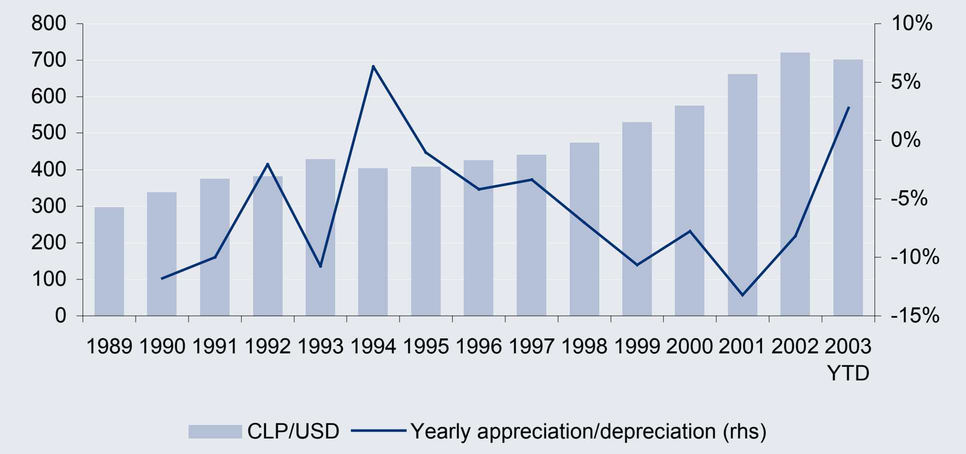
The most relevant characteristic of this market is its high level of financial development, with the highest ratios in the region (loans/GDP of 67% in 2002). Banco Santander holds the leading position (with 23% market share over total assets) after the merger of Banco Santander and Banco de Santiago.

We do not expect political or economic instability in the country during the coming years, something remarkable for LatAm. To that extent, we see this country as a safe haven with good growth prospects within the region.

The third-largest economy but also the most stable

Chile is the third most important economy in Latin American, but contrary to Brazil or Mexico, one of the most important characteristics of the Chilean economy is the relative stability of its currency.

Fig 30 Chilean peso versus US dollar evolution (1989-YTD)

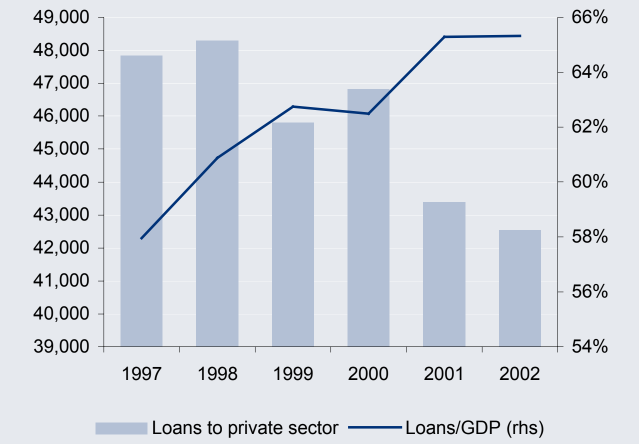


Source: Bloomberg

A US$43bn loans market that has experienced steady growth

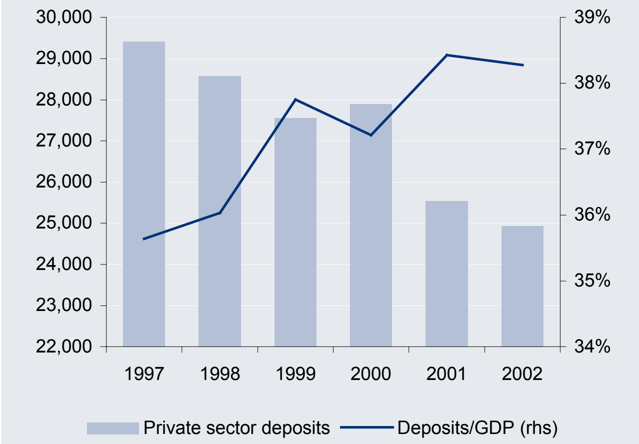
Although the size of the banking system is not very import – 2002 total system loans amounted to just US$43bn and deposits to US$25bn – in terms of development, Chile ranks alongside Puerto Rico as one of the most advanced countries in the region. A high degree of development is Chile's most important characteristic, especially if we compare it with the regional average. To that extent, the banking system is quite stable, showing, in local currency, stable growth rates for loans and deposits in the past five years.

Fig 31 Total loans (US$m) – Loans/GDP ratio (%)



Source: Central bank of Chile

Fig 32 Total deposits (US$m) – Deposit/GDP (%)



Source: Central bank of Chile

In terms of foreign banking presence in Chile, Banco Santander, BBVA and Citigroup are the most relevant. In terms of profitability, the whole sector reached a total net profit of US$728m during 2002, of which private banks represent 94% of the sector. In terms of market share of deposits, the split between private and public banks has been stable for the past five years at 85% and 15%, respectively.

Santander and the public banks are the leaders

Among the private banks, in leading position is Banco Santander Chile, which after the merger has a strong franchise in the country with market shares in loans and deposits of 24% and 21%, respectively. Although public bank Banco Estado de Chile is not very efficient or profitable, in terms of market share its presence is more relevant with a 13% market share of loans and 16% of deposits.

Fig 33 Ranking of Chilean banks (US$m)

	Total loans	% total	Total deposits	% total	Net worth	% total	Pre-tax profit	% total	Net profit	% total	ROE (%)
Santander-Chile	7,722	23.6	5,186	21.1	819	22.4	119	26.6	106	28.5	6.1
Banco De Chile	5,980	18.3	4,299	17.5	569	15.5	87	19.3	80	21.6	12.8
Banco Estado de Chile*	4,258	13.0	3,956	16.1	356	9.7	47	10.5	18	4.8	18.1
Banco De Crédito e Inversiones	3,508	10.7	2,530	10.3	288	7.9	58	12.9	46	12.3	26.3
BBVA Chile	2,277	7.0	1,861	7.6	238	6.5	20	4.5	18	4.8	16.7
Corpbanca	1,940	5.9	1,293	5.3	289	7.9	28	6.3	28	7.6	24.2
Del Desarrollo	1,259	3.9	768	3.1	118	3.2	5	1.1	5	1.4	27.3
Scotiabank Sud Americano	1,182	3.6	838	3.4	105	2.9	9	1.9	7	1.9	7.4
Citibank N.A.	988	3.0	967	3.9	227	6.2	25	5.7	21	5.7	22.1
Security	932	2.9	671	2.7	81	2.2	9	2.1	7	2.0	7.9
Total	**32,667**		**24,614**		**3,659**		**449**		**371**		**17.3**

* Public bank

Source: Superintendencia bancos e instituciones financieras

Regarding volume forecasts, we expect steady growth for total loans as we foresee an improvement in the economic scenario of the region. We estimate single-digit growth for total loans at 8% in 2003F, 9% for 2004F and in 2005F we expect total loans to grow by 10%. On the deposit side, we expect a small contraction in terms of relative growth versus GDP and forecast 6% for 2003F and 2004F, and 7% for 2005F.

Fig 34 Chilean financial system forecasts (Pm)

	2000	2001	2002	2003F	2004F	2005F
Loans to private sector	**26,874,000**	**28,691,000**	**30,650,000**	**33,193,558**	**36,306,211**	**40,055,625**
% growth	*11*	*7*	*7*	*8.3*	*9.4*	*10.3*
Deposits and mutual funds						
Private sector deposits	**16,005,410**	**16,885,820**	**17,959,580**	**19,021,997**	**20,225,328**	**21,629,775**
% growth	*10*	*6*	*6*	*5.9*	*6.3*	*6.9*
% of client resources	*87*	*83*	*79*	*77*	*75*	*75*
Mutual funds	**2,445,780**	**3,364,212**	**4,829,106**	**5,794,927**	**6,664,166**	**7,330,583**
% growth	*4*	*38*	*44*	*20*	*15*	*10*
% of client resources	*13*	*17*	*21*	*23*	*25*	*25*
Private sector deposits + mutual funds	**18,451,190**	**20,250,032**	**22,788,686**	**24,816,924**	**26,889,495**	**28,960,358**
Main ratios (%)						
Loans/GDP	66.5	66.2	67.0	67.8	69.1	70.7
Deposits/GDP	39.6	39.0	39.2	38.9	38.5	38.2
Mutual funds/GDP	6.1	7.8	10.6	11.8	12.7	12.9

Source: Central Banks, ING estimates

Mexico

Mexico is the most underdeveloped banking market of any of the relevant emerging economies. It has a loan/GDP ratio of 15% and lending growth has been sluggish since the Tequila crisis of 1994.

The sector is recovering its growth rates. Currently, consumer lending is growing above 40% YoY, corporate lending at 17% and mortgages at c4%. We expect high 23% growth in household lending in 2004F and 2005F.

The sector is finding strong competition on the lending side from the non-banking financial institutions, which are experiencing fast growth rates in mortgages and consumer lending.

Over the past five years, Mexico should be considered an example for the rest of the economies in the region. After the Tequila crisis in 1994, the economy has been able to grow well above the regional average at 5.3% pa. However, for the past two years it has been suffering an economic recession due to the deterioration in the US economy, which is Mexico's most important trading partner.

The least-developed banking market in the region

Albeit the relevance of Mexico in Latin America, the financial market is not so relevant, total loans over GDP represent only 15% being the second lowest ratio among their peers, below Venezuela, whilst total deposits amount to US$70m.

Fig 35 Market share of top Mexican banks (2002)

	Assets (Pbn)	Market share (%)	Deposits (Pm)	Market share (%)	Net profit (Pm)
Banamex	427	25.4	374	25.1	(110)
BBVA Bancomer	416	24.8	372	24.9	5,400
Santander Serfin	218	13.0	198	13.3	5,625
Banorte	193	11.5	185	12.4	1,470
Bital	159	9.5	150	10.1	(6,702)
Scotiabank	83	5.0	78	5.2	1,104
Inbursa	58	3.5	35	2.4	2,158
TOTAL	**1,677**		**1,490**		**11,289**

Source: CNBV

The IPAB helps to ensure confidence in the banking system …

The IPAB is Mexico's public institution in charge of providing deposit insurance for commercial banking institutions and is also responsible for the detection and resolution of insolvent commercial banking institutions in co-ordination with other Mexican financial authorities. If necessary, the IPAB will pay guaranteed obligations and liquidate the assets of insolvent banks. IPAB loans have been falling since after the Tequila crisis in 1994, although they already represent 31% of total lending to the private sector at P263bn.

Banks that were bailed out after the Tequila crisis were subject to two different outcomes: they were either nationalised or kept private by receiving IPAB notes in exchange for bad loans. In general, the nationalised banks were privatised later but the responsibility of cleaning the balance sheet did not transfer to the new shareholders. However, those banks that remained private, like Bancomer or Banamex, have been subject to an auditing process to determine whether some of the loans that were transferred to the IPAB had been improperly exchanged (ie, the loans had already been long defunct or were made to bankers' friends who had no intention of repaying them). These cases could mean huge, although not quantified, payments from banks to the government (as much as P45bn (€3.5bn)) may be requested by state lawyers.

BBVA and HSBC could have a small liability because of the IPAB bail out

On 14 September, the Federal Court ruled that the federal deposit insurance agency had no right to perform audits or revisions not previously ordered by congress. The ruling affects the four largest banks (Bancomer, BBVA subsidiary, Banamex, which is a Citigroup subsidiary, Bital, a subsidiary of HSBC and Grupo Financiero Banorte). However, there has been an appeal by the government, and we would not be surprised if banks have to pay an amount to settle finally this issue. We do not expect a substantial impact for BBVA Bancomer and HSBC Bital although it could imply a small charge, which we expect to happen at the end of 2003 or in 2004 at the latest.

Because of the large amount of deposits on their balance sheets, Mexican institutions are more sensitive to interest rate movements than other Latin American banks. Its lending business is relatively small in size (almost one third of its loans are restructured or loans currently under Fobaproa administration) and the spreads on loans and deposits are quite similar (c2%). Consequently, they can be considered deposit-taking institutions, which, consequently, are dependent on interest rate levels for their margins. However, most of the large banks (Bital, Serfin, Bancomer and Banamex) are owned by foreign institutions and carry out more active asset and liability management. We think that by changing the deposit mix, increasing the weight of consumer lending to total lending and by taking debt portfolios, banks will be able to smooth the impact of a falling CETE rate on their net interest income.

Fig 36 Balance sheet of Mexican banks, June 2003 (Pm)

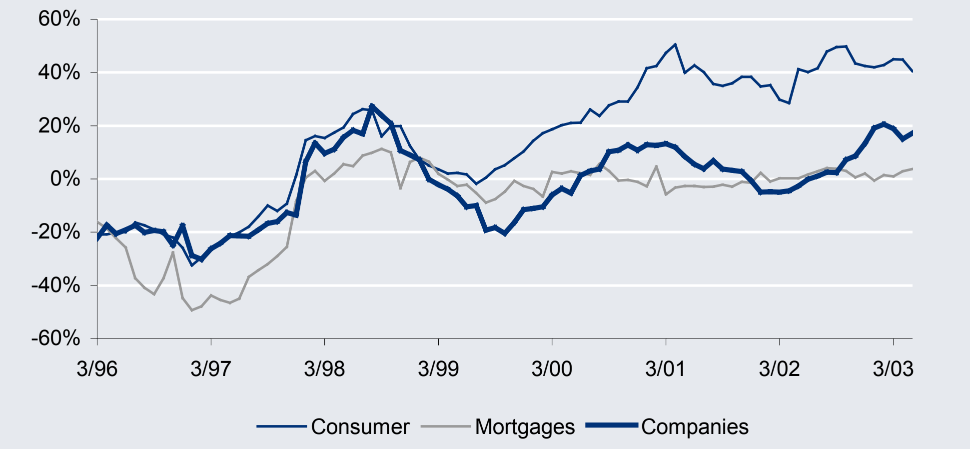
	Amount	% of total
Cash and central banks	249,804	15
Securities	311,439	19
Loans	882,608	54
Fixed assets	50,667	3
Other, deferred and intangible assets	140,202	9
Total assets	**1,634,721**	**100**
Debt	14,092	1
Deposits	1,139,651	70
Inter-bank liabilities	162,091	10
Other liabilities	126,632	8
Equity	**192,254**	**12**
Total liabilities	**1,634,721**	**100**

Source: CNBV

Growth potential

Lending in Mexico is starting to recover, although from a small starting point. As of May 2003, consumer lending was growing at 40% YoY, mortgage lending at just 3.7% and corporate lending at 17%. We believe that recent measures to improve the exchange of information on clients with doubtful loans and the improvement in the legal process to foreclose properties will push both consumer and mortgage loan growth. On our forecasts (see below), we continue to expect more aggressive growth rates in consumer lending than mortgage lending since the new legislation on property foreclosure has not been given enough time to see how effective it is.

Fig 37 Growth rates by type of lending



Source: Central bank of Mexico

A formidable competitor: the Sofoles and Arrendadoras

As banks refrained from lending, Sofoles and Arrendadoras took their position

Commercial bank liberalisation began in 1991 and led to wide-scale expansion in mortgage credit until the end of 1994. This rapid credit expansion, however, was followed by an even more abrupt halt to mortgage lending following the peso devaluation of December 1994, and commercial banks were left to reorganise their outstanding mortgage (and other) debt. These events allowed the Sociedades Financieras de Objeto Limitado (SOFOLES) to gain entry to the low-income mortgage market.

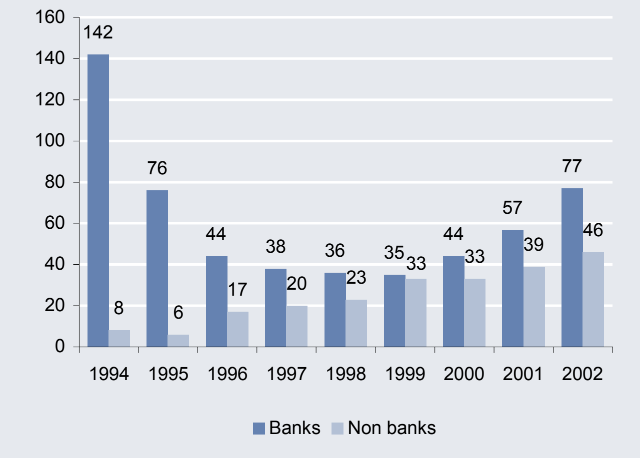
The SOFOLES are non-bank financial institutions that are allowed to lend to particular sectors or for specific types of activities such as housing, consumer and small businesses. SOFOLES are not authorised to receive deposits, so their funding comes from foreign or national investors, development bank loans or the Mexican capital markets. Most of their funds have come from a government trust for low-income (or so called 'social interest') housing, the Fondo de Operacion y Financiamiento Bancario a la Vivienda (FOVI).

Arrendadoras Financieras are another institutions that compete in this market, especially in auto financing. They are usually subsidiaries of large auto companies or of the banks and can also be independent players.

The SOFOLES target the low-income segment of the mortgage market and function essentially as mortgage companies that originate and service loans financed, until recently, at a subsidised interest rate by FOVI.

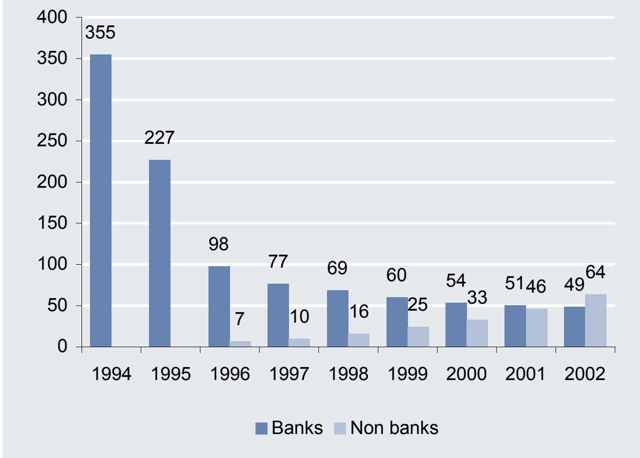
All in all, SOFOLES are growing at a higher rate than commercial banks and have a niche in mortgage lending. We consider that these institutions are well prepared for a rise in mortgage lending as this has been their prime activity in recent years.

Fig 38 Consumer lending (Pbn)



Source: Central bank of Mexico

Fig 39 Mortgage lending (Pbn)



Source: Central bank of Mexico

Deferred tax assets

Because of the large losses Mexican banks experienced after the 1994 crisis, they have accumulated huge tax shields. For those banks that were taken over by the government, most of the cleaning up was made off balance sheet and the deferred tax assets were not recognised. On the contrary, banks like Bancomer or Banamex recognised huge deferred tax assets that have 'inflated' their reported equity, which is why comparing ratios based on the balance sheet or equity (ROE) between those banks and others like Serfin and Scotia Inverlat is not entirely fair.

Fig 40 Mexican bank ROE comparison (%)

	ROE	Adj ROE
Scotiabank	25.3	25.3
Santander Serfin	**20.4**	**23.1**
HSBC Bital	**15.1**	**22.8**
BBVA Bancomer	**12.1**	**21.0**
Banamex	17.3	20.9
Sector	14.7	18.3
Banorte	10.2	11.7
Del Bajío	6.5	6.5
Inbursa	-0.1	-0.1

Source: CNBV

Mexico financial system forecasts

We think Mexico offers huge growth potential, not only because it has a low loan/GDP ratio, but also because the banking market was cleaned up after the 1994 crisis and the economy has already reached a level of interest rates comparable with those in any developed country. Consequently, margins have already suffered (or still are suffering) the effect of falling rates, while volume growth still offers huge potential. In 2002, household lending grew 23% and as of May 2003 it was still growing at rates of 23%. We believe Mexico will enjoy the largest growth in household lending of any of the Latin American economies (23% in 2004F and 2005F) on the back of strong consumer lending growth. We do not forecast an acceleration in mortgage growth rates until we see clear proof that new legislation has improved the system to foreclose on properties.

Fig 41 Mexico financial system aggregates (Pm)

	2000	2001	2002	2003F	2004F	2005F
Loans to the private sector	**560,032**	**619,871**	**712,239**	**724,544**	**759,494**	**787,816**
% growth	*6.8*	*10.7*	*14.9*	*1.7*	*4.8*	*3.7*
Lending accelerator	0.3	1.8	2.7	1.2	1.3	1.5
Of which FOBAPROA/IPAB	186,096	226,408	263,943	237,549	213,794	168,897
Lending to households	**86,840**	**100,962**	**124,645**	**142,305**	**174,819**	**216,071**
% growth	*12.1*	*16.3*	*23.5*	*14.2*	*22.8*	*23.6*
Mortgages	48,180	47,489	48,461	50,884	55,973	61,570
% growth	*-1.1*	*-1.4*	*2.0*	*5.0*	*10.0*	*10.0*
Consumer	38,660	53,473	76,184	91,421	118,847	154,501
% growth	*34.4*	*38.3*	*42.5*	*20.0*	*30.0*	*30.0*
Lending to companies	**287,096**	**292,501**	**323,651**	**344,691**	**370,881**	**402,848**
% growth	*11.7*	*1.9*	*10.6*	*6.5*	*7.6*	*8.6*
Non-financial corporates	266,750	265,244	300,568	321,608	347,336	378,597
Financial corporates	20,346	27,257	23,083	23,083	23,545	24,251
Deposits and mutual funds						
Private sector deposits	**739,000**	**773,400**	**730,600**	**756,171**	**793,980**	**841,618**
% growth	*-10.2*	*4.7*	*-5.5*	*3.5*	*5.0*	*6.0*
% of client resources	*81*	*73*	*69*	*67*	*66*	*70*
Mutual funds (no real estate funds)	**178,233**	**291,006**	**320,793**	**368,912**	**405,803**	**438,267**
% growth	*-2.4*	*63.3*	*10.2*	*15.0*	*10.0*	*8.0*
% of client resources	*19*	*27*	*31*	*33*	*34*	*36*
Private sector deposits + mutual funds	**917,233**	**1,064,406**	**1,051,393**	**1,125,083**	**1,203,571**	**1,203,571**
Main ratios (%)						
Loans/GDP	10.2	10.6	11.6	13.2	13.0	12.8
Deposits/GDP	13.4	13.3	11.9	13.8	13.6	13.7
Mutual funds/GDP	3.2	5.0	5.2	6.7	7.0	7.1

Source: Bank of Mexico, ING forecasts

Venezuela

Venezuela is one of the smallest banking markets in the region with only cUS$7bn in loans. However, the profitability of the country is especially high, given the size of the market, at US$1bn in 2002.

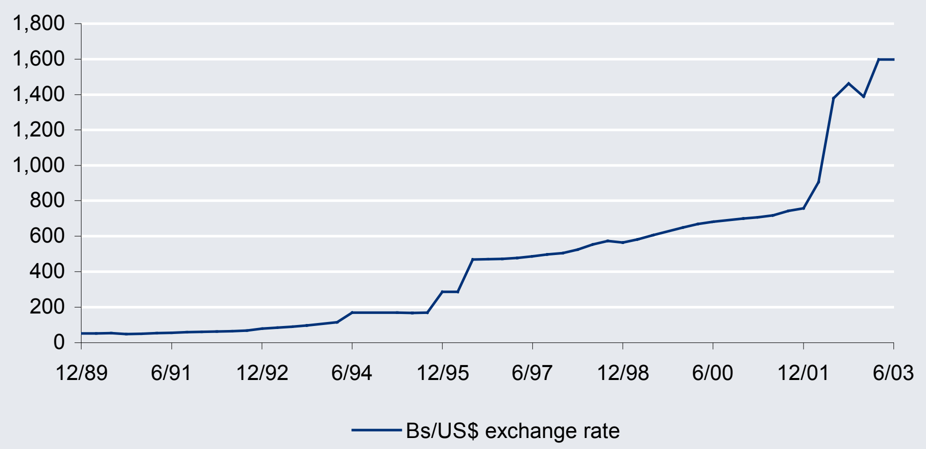
Foreign banks have a significant presence in the country as Santander and BBVA are the second and third largest banks, respectively.

Political risk is the most important issue in the country, and we expect this situation to continue in 2004.

Exchange rate and political volatility characterised Venezuela in 2002

From an economic perspective, Venezuela has been the perfect example of volatility in a growth region like Latin America. GDP bounces have been impressive and CPI in 1989-03 always has been in double digits. However, this volatility was even more remarkable during 2002 when the Venezuelan currency (bolivar) suffered a 45% depreciation. The 2003 economic situation in the country is gloomy with an expected GDP growth rate of -13.5%.

Fig 42 Bs/US$ exchange rate (1989 – June 2003)



Source: Bloomberg

The Venezuelan banking market is small with cUS$7bn in loans and US$8bn in deposits

The size of the banking system is not very relevant, although it is among the top five countries in the region, the deterioration of the currency has, undoubtedly, damaged much possible interest in the country. Total loans were US$7.3bn, representing 8% of GDP. Deposits are not very relevant, representing only 11% of GDP (US$8.4bn).

Foreign banks have a relevant presence in the country, although neither Santander nor BBVA have the leading position.

Fig 43 Major Venezuelan banks, December 2002 (Bs m)

	Total assets	Market share (%)	Total loans	Total deposits	Net profit
Banco Mercantil	3,529,385	17	1,601,076	2,756,038	74,382
Banco de Venezuela	3,487,474	17	1,441,756	2,690,191	97,168
Banco Provincial	3,319,562	16	1,510,315	2,438,381	103,827
Banesco	2,861,414	14	716,845	1,712,112	70,432
Banco Occidental de Descuento	1,619,070	8	543,747	873,445	7,006
Total	**20,960,845**		**8,349,722**	**14,143,106**	**542,617**

Source: Venezuelan banking sector regulator

Venezuela has all the characteristics of the region, volatility, instability and large social differences, with important bounces in economic activity and low rates of bank usage; there are only 2m accounts out of 24m inhabitants. This situation has been even more extreme, during 2002 the country suffered a three-month strike in the oil sector and a coup that made the country inoperable for several months.

Just as we have done for the other five countries in the region, we have forecast main aggregates for the banking system. We have used consensus forecasts for real GDP growth and for CPI. In this scenario, we forecast 8%, 11% and 12% growth in total loans to the private sector in 2003F, 2004F and 2005F, respectively, as we have taken into account high inflation rates that will impact the new loans granted. For deposits, we forecast lower growth rates at 6.7% in 2003F, 13% in 2004F and 12% 2005F, as part of the client resources mutual fund contribution will continue to be negligible.

Fig 44 Venezuelan main banking aggregates (Bs bn)

	2000	2001	2002	2003F	2004F	2005F
Loans to private sector	**9,608**	**10,564**	**10,628**	**11,422**	**13,153**	**14,662**
% growth	*24.2*	*9.9*	*0.6*	*7.5*	*15.2*	*11.5*
Deposits and mutual funds						
Private sector deposits	**12,072**	**12,952**	**14,181**	**15,128**	**18,546**	**21,025**
% growth	29.8	7.3	9.5	6.7	22.6	13.4
% of client resources	99	99	99	99	98	97
Mutual funds (no real estate funds)	**119**	**162**	**176**	**203**	**238**	**286**
% growth	*16.4*	*35.2*	*9.1*	*15.0*	*17.5*	*20.0*
% of client resources	*1*	*1*	*1*			
Private sector deposits + mutual funds	**12,175**	**13,071**	**14,343**	**15,331**	**18,784**	**21,311**

Source: Venezuelan central bank, ING estimates

Venezuelan risks are not related to the weak economic situation, high indebtedness of the public and private sectors or the lack of a competitive economic situation. It is a country with large reserves of petrol managed by a public company (PEDEVESA), which produces substantial inflows of US dollars into the country. The government had been able to keep the currency stable until 2002 when political and social tensions led to large foreign exchange fluctuations. Banks in the country have been able to keep solid franchises, with high BIS ratios, high liquidity and limited exposure to individuals or SMEs. However, we do not feel comfortable with this situation because the risks are purely political and not economic. We expect a softening of the 'control de cambios' regime before the year-end. The real currency value could be above Bs2,500/US$ (versus the current Bs1,598/US$) and the social tension produced by the referendum to oust Mr Chavez could continue affecting the economy.

Argentina

Update on the situation

Before the default in 2001, Argentina was a model of growth potential, with high GDP per capita and low bancarisation rates. The default made Argentina a bottomless pit where foreign banks had to provision their whole investment in the country.

Although there have been some improvements in the country, there are still a number of pending issues such as full compensation to banks after the asymmetric pesification and the impact of the 'amparos'.

However, so long as banks are not injecting capital into their subsidiaries the situation should be controlled, and their current strategy is to maintain a franchise in the country in case further improvements take place.

After Argentina defaulted, a number of restrictions on banking activity were imposed …

By the end of 2001, and following a period of social and economic instability, Argentina defaulted on its external debt. In reaction to these events, Argentina has imposed severe economic restrictions including: (1) suspending payments on external debt; (2) abrogating the convertibility of the peso; (3) converting US-dollar-denominated bank deposits into peso-denominated deposits at an exchange rate of P1.40/US$; (4) converting US-dollar-denominated debts into peso-denominated debts at an exchange rate of P1/US$ (except internal federal and provincial government debt, which is converted at P1.40/US$1); (5) restricting bank withdrawals and transfers abroad; (6) closing down the Argentinian banking system for extended periods; (7) enacting changes in bankruptcy laws to protect debtors; (8) amending the charter of the Argentinian central bank to provide for increased money supply; and (9) requiring the sale by all banks of all their foreign currency within Argentina to the central bank at an exchange rate of P1.40/US$ (this requirement is currently suspended). The resultant shock of these events has caused increased inflation, a volatile exchange rate and reduced economic activity.

… the situation has improved although there are some underlying risks unanswered …

As we already know, banks responded to these events by creating large provisions to cover their investments. For example, we estimate that Santander had €2.6bn in charges relating to the Argentinian situation and BBVA had c€1.9bn.

There see three pending issues for the banks:

- The application of a different exchange rate to loans and deposits at the time of the 'pesification' has created a mismatch in the banking system, which we estimate to be over US$13bn. The government has compensated banks with US$9bn in bonds of two different classes. Firstly, the government issued guaranteed loans that paid 4% plus inflation and then it issued BODEN, which pays LIBOR six months and currently trades at 63% of nominal value. The problem is that the market value of the bonds received by banks is below their face value and a mark to market would imply that the financial system would have negative equity.
- The application of different inflation coefficients to loans and deposits has also created a balance sheet mismatch, which has been compensated by P2.8bn (US$930m) in government bonds, a decision taken by parliament in early September.

- The judicial decisions ('amparos') allowing individuals to withdraw their US dollar deposits at the market rate instead of the officially used P1.4/US$ has created an additional hole in the banks' accounts. The Association of Argentinian Banks estimated the size of that gap at P8bn. However, after comments made by the economic minister in Dubai, it looks less likely that banks will receive compensation for these events.

The government has committed to issue P17bn of new bonds to be given to financial institutions as additional compensation for the asymmetric pesification and the impact of the 'amparos'.

As a result, government bonds represent c48% of Argentinian banks' balance sheets and this is rising (as private sector lending continues to fall).

Fig 45 Balance sheets of Argentinian financial institutions (€bn)

	2002*	% of total
Cash and due from banks	4.4	8
Foreign currency operations	3.0	5
Loans to public sector	**26.9**	**48**
Loans to private sector	13.4	24
Other assets	8.5	15
Total assets	**56**	**100**
Foreign liabilities	12.2	22
Deposits to the public sector	3.1	5
Deposits to the private sector	20.4	36
BCRA bonds	8.0	14
Other liabilities	5.2	9
Shareholders equity	7.4	13
Total liabilities	**56**	**100**

*As of December 2002
Source: Banco Central Argentina

Up until September, foreclosing on properties to recover unpaid loans was not possible. The uncertainty of the regulatory framework has limited the capacity of banks to continue providing loans. Banks extended the period of non-foreclosing one more month and it is not clear what amount of assets will be foreclosed and loans recovered, given the political impact that a massive foreclosure of property would have.

What is the risk right now?

… a haircut in foreign debt would not be enough …

On 2 September, changes in bankruptcy law that limited the ability of banks to repossess assets were revoked. In the following week, banks were granted P2.8bn compensation for the application of different actualisation rates to loans. An agreement with the IMF is expected sooner or later.

However, there is still a big risk for the banks: negotiations for external debt restructuring. Argentina has defaulted on US$74bn of external debt that needs to be refinanced. A study by the association of public and private banks reached the conclusion that in order to make the system viable, it would be necessary to write off 84% of the debt. (For more details see the document in Spanish on www.abappra.com/documentos/cartamonetaria/03_07_11_carta_monetaria.pdf.)

The study was made under certain assumptions of economic growth, fiscal superavit (3.3% below the IMF target but in line with the government's intention) and assuming that debts held by AFJPs are also included in the renegotiations. The only possible solution for the government is to either increase the fiscal superavit or to include the loans and bonds held by the banks on the restructuring process. This would imply that some sort of renegotiation of internal debt could also be needed, which would additionally hit banks' balance sheets. In that event, the banking system would probably disappear and although it is a low probability scenario, the AFJPs are also pressing the government to reduce the haircut on the bonds held by them as it would impact their ability to provide for future Argentinian pensions.

Why Argentina is no longer relevant

… however Argentina's contribution to banks' net profit is marginal …

The good news is that Argentina is no longer a particularly relevant market and we do not expect foreign banks to invest more money here in the short term. Comparing the relative size of Spain to Argentina, Argentina currently represents only c2.0-3.5% of the size of the Spanish market. Consequently, owning 10% of the Argentinian market is similar to owning a 0.2-0.3% market share in Spain and the total lending market represents roughly 0.2% of the Eurozone market.

Fig 46 A comparison of market size (€bn)

Data as of June 2003, except GDP	Argentina	Argentina as a % of Spain	Argentina as a % of Eurozone
Total assets	56	4	0.7
Lending to private sectors	13	1.8	0.2
Private sector deposits	20	3.4	0.3
Equity	N/M	N/M	N/M

Note: Argentinian data is converted at market rates
Source: Central banks

… and the market's appeal is small

Put differently, the current stock of lending in Argentina is similar to the growth experienced by the Spanish market in one single month (for example, in April 2003 lending in Spain grew by €14bn, in July 2003 it grew by €12bn).

Fig 47 Main financial institutions in Argentina, 2001 (Pm)

	Total assets	Market share
Banco de la Nacion	17,921	14.7
Banco de la Provincia Buenos Aires	12,898	10.6
Banco de Galicia	10,798	8.9
Banco Rio (Santander)	9,329	7.7
BBVA Banco Frances	8,443	6.9
BankBoston	7,411	6.1
Citibank	7,192	5.9
HSBC	4,716	3.9

Source: ABRAPPA

Profitability of each country

The next step after analysing each country individually is to compare them. We have already spoken about growth potential and financial development. We think that looking at the profitability of each country is a 'sanity check' of whether there is something unusual in any of them.

We have compared the whole region with Spain and have made some interesting conclusions: the region has a GDP that is twice the size of Spain's but Spain has a banking market that is three times bigger than Latin America's. However, the aggregated net profit of the banks in Latin America is US$11bn, 20% larger than in Spain. When we analyse the region, we find large differences between the different countries. The profitability of the Venezuelan banking system is extremely large (US$1.0bn for a banking system that has cUS$7bn in loans and US$8bn in deposits). An overvalued currency and large spreads explain this high profitability. In Brazil, we are also afraid that the current level of profitability is hardly sustainable because it has the second-largest ratio in terms of profits to GDP or profits to the size of the banking market.

On the contrary, Mexican profits were depressed in 2002 because of restructuring charges at Bital and Banamex, and in 1H03 the net profit of the financial system had already reached cUS$1.3bn. However, in the medium term, we would expect a convergence between the profitability of both Mexico and Brazil given that their size and banking markets are similar (Mexico's GDP is c20% larger than Brazil's, but Brazil's banking market is c20% larger than Mexico's). We are afraid that the convergence process could imply falling profits in Brazil (due to margin squeeze) and rising profits in Mexico (boosted by volume growth). That explains why our long-term view is more positive for Mexico than it is for Brazil.

Fig 48 Net profit of financial system 2002 (US$bn)

	Net profit	% GDP	% loans + savings
Brazil	7.0	1.4	**2.4**
Venezuela	1.0	1.0	**5.5**
Chile	1.0	1.5	1.3
Mexico*	1.2	0.2	0.7
Argentina	N/M	N/M	N/M
Puerto Rico	0.9	1.2	1.1
Total LatAm	**11.0**	**0.8**	**1.9**
Spain	**9.3**	**1.3**	**0.6**

*Mexico is distorted by losses at Bital and Banamex following their acquisition by HSBC and Citigroup

Source: Data from central banks

European & US exposure in the region

After Argentina defaulted, banks like Intesa, BNL and Credit Agricole withdrew from the region

A number of banks tried to leverage their profit by investing in the region, which they did during the late 1990s. But after Argentina defaulted in 2001 and the tough environment followed during 2002, a number of banks reconsidered their retail operations.

European banks made a number of divestitures during 2002 and 2003, especially active have been Italian and French banks.

- Last year, Banca Intesa sold its subsidiary in Argentina, although it still has a 20% stake in Banca de Patagonia, and this year it sold Banco Sudameris, its Brazilian subsidiary, to ABN Amro.

- Banca Nazionale di Lavoro has announced the sale of its operations in Uruguay and Brazil.

- Credit Agricole sold its activities in Argentina after the country defaulted in 2001 and sold its Brazilian activities afterwards to Bradesco. It has maintained its operations in Uruguay.

Fig 49 European banks' investment in Latin America (€m)

European peers	Presence in the region	Divestitures	Activities	Net profit 2002	% total	Equity
Banca Intesa	Argentina/Peru/ Brazil/Chile	Brazil/Chile	Retail	(708)	N/M	N/A
Credit Agricole	Argentina/Uruguay/Brazil	Argentina/Brazil	Retail	(324)	N/M	N/A
BES	Brazil	None	Investment banking	N/A		N/A
BNL	Argentina/Uruguay/ Brazil	Brazil/Uruguay	Retail			74

Source: BNL, Credit Agricole, Banca Intesa, BES websites

As with European banks, North American banks had also made significant investments in the region. But contrary to their European peers, US banks have maintained their operations there, although cross-border risks has been steadily reduced, for example Fleet Boston reduced is cross-border risks (Argentina and Brazil) by 35% between December 2001 and December 2002, from US$13.2bn to US$8.6bn.

Fig 50 Main US banks in Latin America (US$m)

Other players	Presence in the region	Divestitures	Activities	Net profit 2002	% total
Scotia	Argentina/Mexico/Caribbean	Argentina	Retail	(540)	
Citigroup	All regions including Mexico and Puerto Rico	None	Retail/ Investment banking	1.139	7
Bank of America	Mexico/Puerto Rico/Venezuela/Argentina/Chile	None	Retail/Investment banking	225	1

Source: Company data

However, there have been several European banks that retained their rank during 2002 and 2003, and even increasing their exposure, such as ABN Amro after the acquisition of Banca Sudameris from Banca Intesa.

The largest European players in the region

In this report, we analyse the performance of the three largest European players in the region plus HSBC (which can probably be better considered a global bank) but is also included in our Western European universe.

Fig 51 Investment of main European banks in LatAm

	Investment (US$bn)	Countries present	Net profit 2002* (US$bn)	% of total
Banco Santander	17.2	All except Peru	1.303	62
BBVA	9.2	All except Brazil	0.69	43
HSBC	4.7*	Brazil, Mexico, Argentina & Panamá	(0.75)	N/M
ABN Amro	4.0	Brazil and local branches	0.391	

* Includes capital increase at Bital

Source: Company data

Hedging policies

Hedging policies vary amongst the banks. Our view is that the decision on whether to hedge or not is more a question of financial management and its impacts are short term. Long term, it is impossible to avoid the impact of a depreciating currency. It is difficult to find hedging instruments for long maturities, and uncertainty regarding the contribution of subsidiaries could also create a substantial mismatch in the hedged position.

Individual bank policies

Santander has had a hedge in place for US$1.3bn since the beginning of the year. The amount hedged is the expected contribution of the Latin American subsidiaries in US dollars. That hedge is producing profits, which are accounted on the P&L as trading profits (€117m in 1H03).

BBVA and ABN Amro have also hedged their expected profit for the year by taking a short €/US$ position.

Hedging of book value

The parent bank can hedge the book value of its subsidiary by receiving a loan from that subsidiary in local currency and converting it into a structural position in US dollars or by taking debt in local markets and investing it in a US dollar position. If the amount invested were equivalent to the equity of the subsidiary there would be a 100% hedge. In the case of Santander, 35% of the Brazilian equity is covered, 100% of Mexican equity, 40% of Chilean equity and the whole equity of Venezuela and Colombia. The position in Venezuela is hedged thanks to an offshore subsidiary.

According to BBVA, 70% of the book value of Latin America is hedged, although the only country in which there is a local currency hedge is Mexico. For the rest, the risk hedge is the €/US$ impact. In Venezuela, the bank has kept the maximum amount allowed of US dollar positions to hedge against depreciation (15% of equity or c€50m).

Financial sector summary & macroeconomic forecasts

Fig 52 Macroeconomic forecasts (%)

	2003F		2004F		2005F	
	GDP growth	CPI	GDP growth	CPI	GDP growth	CPI
Argentina	5.3	5.9	3.6	8.9	N/A	N/A
Brazil	1.9	10.3	3.0	6.6	4.0	6.5
Chile	3.4	3.4	4.2	3.0	4.8	3.0
Mexico	1.8	3.6	3.7	3.7	4.0	3.7
Venezuela	-13.5	37.2	5.1	31.2	3.1	24.8

Note: Consensus is used for Chile, Argentina and Venezuela
Source: Consensus estimates, ING estimates

Fig 53 Financial sector aggregates for selected countries, 2002 (US$bn)

	Total loans	Total deposits	Loans/GDP (%)	Deposits/GDP (%)
Argentina	16.1	17.6	15.7	17.6
Brazil	108.6	82.5	22.4	17.0
Chile	42.6	24.9	65.3	38.3
Mexico	68.7	70.5	11.2	13.7
Venezuela	7.7	10.2	8.0	10.7

Source: Central banks, Supervisoras

Netherlands

ABN Amro[ace]

'Home market Brazil'

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Maintained

Buy

17 October 2003

Target price: 12 month

€20.0

Reuters

AAH.AS

Banks

13/10/03

€16.98

Brazil is one of the three countries ABN Amro considers to be its 'home' retail banking market. Market positions are good and profitability is high. Exposure to other Latin American countries such as Argentina was reduced.

ABN Amro's presence in Latin America is concentrated in Brazil. In Brazil, the group has strong market positions. In terms of total assets, it has a market share of 4%, the fifth-largest privately owned bank in Brazil. ABN Amro is market leader in car financing. Brazil generated some 9% of the group's pre-tax profit in 2002.

ABN Amro has a particularly strong focus on lending. Its loans-to-asset ratio is above average at 47% (2002). Brazilian lending margins are high (20% for ABN Amro) and are set to come down, as we expect interest rates to drop. However, we expect better volumes and lower reserve requirements to offset margin pressure.

ABN Amro has set up a tax construction on the Cayman Islands, which has protected the group from a depreciation of the Real.

Profitability in Brazil is quite strong. ABN Amro generated an ROE of 25.2% in 2002. We expect earnings to show good growth going forward, stimulated by the acquisition of Sudameris and better cost control. With 18% upside potential to our LEFAC-derived FV our rating is Buy.

Forecasts and ratios

Yr to	Total income (€m)	Net op income (€m)	Net income (€m)	Adj EPS (€)	EPS (€)	DPS (€)	PER (x)	Adj PER (x)	P/BV (x)
2002	17,910	5,087	2,366	1.52	1.52	0.90	11.2	11.2	2.5
2003F	17,594	5,529	2,753	1.72	1.72	0.90	9.9	9.9	2.3
2004F	17,700	5,516	2,864	1.75	1.75	0.90	9.7	9.7	2.1
2005F	18,431	5,836	3,110	1.84	1.84	0.92	9.2	9.2	1.9

Source: Company data, ING estimates

Key ratios (%)

	2002	2003F
Net interest margin	2.0	1.9
NPLs	1.9	2.2
Cost/income	4.2	4.0
ROA	0.4	0.5
ROE	22.7	26.3

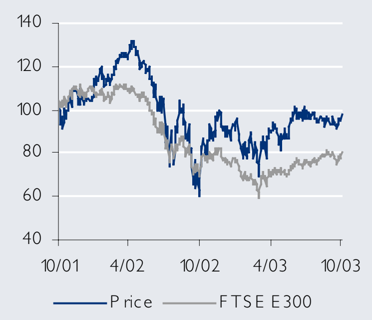
Performance (%)

	12m	3m	Target
Absolute (%)	32.7	0.2	17.8
FTSE E300	848.7	877.7	930.0
AEX All Share	316.1	309.1	340.0
Relative to (%)			
FTSE E300	22.8	(4.1)	16.14
AEX All Share	27.6	(5.8)	13.86

Share data

No. of shares (m)	1,598
Volume	10,240,600
Free float (%)	86.9
Market cap (€m)	26,256
Enterprise value (€m)	26,256
BVPS(€)	6.9

Share price performance (rebased)



Source: ING

ABN Amro in Latin America

ABN Amro's Latin America exposure is concentrated in Brazil

ABN Amro's presence in Latin America in fact is concentrated in Brazil. In recent years, the bank has sold most of its retail operations in other Latin American countries as part of its strategy to focus on its core client segments around the world and directing capital and resources towards businesses earning higher returns. In 2001 for instance, it sold its consumer banking business in Chile and Venezuela and the retail banking activities in Argentina. ABN Amro is still active in these countries but mainly in wholesale banking. However, the size of these operations is relatively small and hence we will not discuss them in this report. The focus of this chapter will be the Brazilian operations, which generated 9% of the group's pre-tax profit in 2002.

History in Brazil

Long history in Brazil

ABN Amro's presence in Brazil dates back from as early as 1917, when the bank set up its first offices in Rio de Janeiro and Santos. In 1963, the bank acquired 50% of Aymoré de Crédito Financiamento e Investimento, which would become a leader in the segment of car loans. The remaining 50% was acquired in 1970. In 1993, it moved its headquarters from Rio de Janeiro to Sao Paulo. In 1998, ABN Amro acquired Banco Real for an estimated total of US$3bn, the fourth-largest private bank of Brazil at the time, and Bandepe. In 2001 and 2003, the acquisitions of Paraiban and Sudameris (€688m) followed respectively. The total invested capital in Brazil is cR$5.8bn.

Business mix and market positions

Strong market positions in six business areas in Brazil

At present, ABN Amro holds strong market positions in Brazil. The group's market share in terms of assets, including Sudameris, is around 4%, which makes it the seventh-largest bank in Brazil, or the fifth-largest privately owned bank.

ABN Amro is active in six main business areas:

- **Retail banking:** According to the bank, ABN Amro is the largest foreign institution in Brazil. In terms of number of branches, the group is in third position (1,995 branches, including mini-branches), after Bradesco (3,847 branches) and Banco Itau (3,192 branches). Its presence is concentrated in the Southeast of Brazil, a region that represents around 58% of Brazil's GDP.

- **Consumer finance:** ABN Amro is the number one car financier in Brazil. Its market share is around 22%, compared with around 14% for Bradesco and 10% for Itau, number two and three in the market. In recent years, ABN Amro has managed to increase its market share, which was just above 15% in 2H01 through strong customer service. It has a particular niche in the financing of second- and third-hand cars, where margins are typically higher and which is typically less cyclical.

- **Commercial banking:** This unit maintains relationships with customers who are not part of ABN Amro's wholesale clients business unit and who have annual sales above R$20m. The bank has seen some good growth in this segment, with revenues growing from R$160m in 2001 to R$284m in 2002. The client base enhanced from 2,304 clients at the end of 2000 to 3,231 in April of this year.

- **Insurance:** ABN Amro is growing its insurance business in Brazil fast, especially in pensions. At present, the overall position of the bank is ninth, with markets shares between 2.2% in life insurance and 4.1% in property and casualty in terms of premiums. Total insurance revenues were R$1,268m in 2002. In pensions, it is the fifth-largest player in terms of reserves.

- **Wholesale banking**: The group serves some 400 wholesale clients in Brazil, of which some 80% are subsidiaries of large multinational companies. By far the most important product it sells to these clients is the GTS (or as it is called today – working capital) product, accounting for 46% of revenues. Other important products are global financial markets (30%) and loan products (20%).
- **Asset management:** Following the acquisition of Sudameris, ABN Amro has become the fifth-largest asset manager in Brazil in terms of assets under management. Its market share is 4.75%. Its distance from the top players is rather large though, as the top three players (Banco do Brasil, Bradesco and Itau) all have market shares of between 12% and 19%.

Fig 54 Market positions in Brazil

	US$bn	Market share (%)	Market position
Total assets	14	3.9	7
Total loans	6	5.3	7
Total deposits	6	4.3	6
Car Financing	NA	22	1
Asset management (R$bn)	19	4.8	5
Insurance (R$bn)	1	2.5	9

Source: Company data, BCB, ING estimates

Brazil's contribution to the group

Brazil: around 18% of group earnings

The Brazilian operations have gained in importance for ABN Amro as a whole during the past few years. In 1995, South and Central America contributed some 6% to the group's pre-tax profit. In 2002, for the consumer and commercial clients' Brazilian unit alone, this percentage was 9%. For 2003, we expect a lower percentage on the back of the increased importance of US operations following heavy mortgage origination results and as a result of the drop in Brazilian earnings in euro due to a higher tax rate (see paragraph on currency risk) as well as a lower currency rate.

Fig 55 Contribution of C&CC Brazil to ABN Amro (€m)

	2002			1H03		
	Brazil	Total	% of total	Brazil	Total	% of total
Risk-weighted assets (€bn)	6	230	3	7	228	3
Loans (€bn)	3.7	311	2	4.5	339	N/A
Revenues	1,736	18,280	9	784	9,105	9
Operating profit before tax	344	3,713	9	173	2,390	7
Net profit	391	2,207	18	57	1,472	4
Staff	21,954	105,557	21	21,687	103,632	21

Source: Company data, ING estimates

Strategy in Brazil

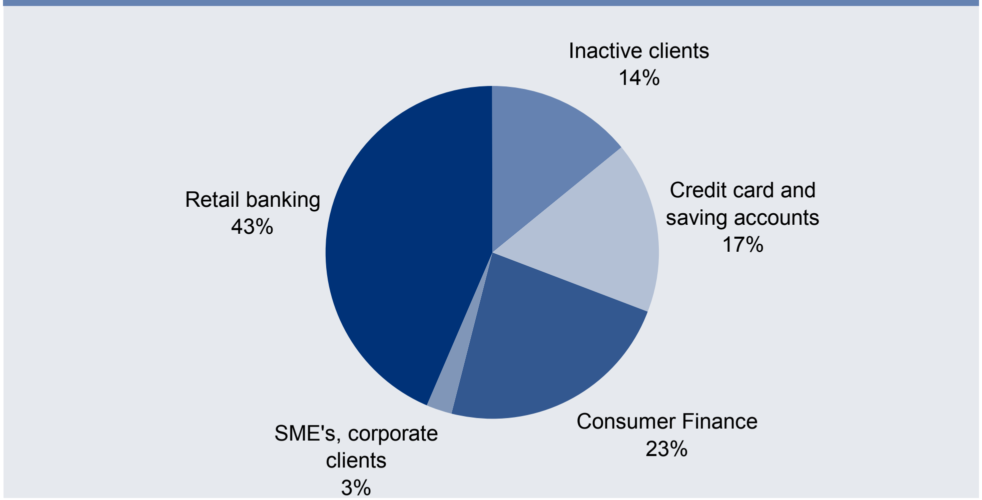
ABN Amro's strategy in Brazil consists of the following elements:

- Focus on client satisfaction
- Positioning among the top players in the Brazilian banking market
- Taking advantage of its position as an international bank with a large retail distribution network
- Integration – wholesale and retail.

Customer focus

ABN Amro has successfully focused specifically on clients and customer satisfaction in recent years. Its client base in Brazil has grown from 5.6m at the end of 1999 to 7.8m in April 2003, excluding Sudameris, which has some 500,000 clients. The percentage of active clients grew from 77% to 86% during the same period.

Fig 56 ABN Amro's client base in Brazil (7.8m)



Source: Company data

Customer satisfaction has received a lot of attention from the group. It has improved significantly over the past few years. In March 2001, only 18% of the client base was totally satisfied with Banco Real. In November 2002, this percentage had risen to 34% (Source Gallup, 2002). We believe there are two important reasons behind this improvement: (1) ABN Amro Real employees have become happier after the integration was completed; (2) systems at ABN Amro Real have become more reliable (see paragraph on cost efficiency).

Top position among foreign banks in Brazil

Acquisition of Sudameris in2003

We have already highlighted ABN Amro's market position in Brazil, which shows that it does rank among the top foreign banks there. In 2002, the bank strengthened its position through the acquisition of Sudameris. This move was motivated by a desire to improve its competitive position, to strengthen its presence in interesting market segments and because of the cost synergies (€90m) that could be achieved. As a consequence of consolidation among the other banks, ABN Amro's relative position had weakened. Since December 2001, Bradesco acquired Banco Mercantil de Sao Paulo, Banco Cidade, Banco do Estado do Amazonas, Banco Ford and BBVA Brazil, while Itau acquired Banco Fiat and Banco BBA. Sudameris was interesting for ABN Amro, because of its strong position in the state of Sao Paulo, where Banco Real historically had low market shares. To illustrate, its market share in Sao Paulo was 3% (ex Sudameris), compared with for instance 8% in Rio de Janeiro. Furthermore, Sudameris had a specific focus on SMEs and upscale retail clients, which are exactly those business segments ABN Amro finds attractive.

Take advantage of its position as an international bank with a large retail distribution network

The fact that the Brazilian operations are part of a larger well capitalised bank are an advantage as is the fact that synergies could be achieved in, amongst others, marketing expertise, database development and management, product development and, probably most importantly, IT systems.

Integrated approach

In Brazil, ABN Amro has an integrated approach to wholesale and retail banking. Through its corporate relations, ABN Amro has access to its employees. The bank has some 6,240 payroll relationships, which relates to some 920,000 individual clients. Examples of where this has led to successes are GE, Fiat and Telefonica. In 2002, 48% of the new client base was approached through corporate relationship with the employer. The remaining 52% were realised through the branch network.

Cost efficiency

Cost efficiency should improve going forward

ABN Amro is less efficient than some of its main competitors, although it has improved efficiency during the past three years and is still improving. After the acquisition of Banco Real, it turned out that the infrastructure of the Brazilian bank was not up to standard. Systems were down 15-20% of the time. ABN Amro has invested significantly to upgrade the branch network and IT systems, and today the systems are up and running more than 99% of the time. During the same time, mainframe capacity was upped from 1,603 MIPS in early 2000 to 5,715 in April of this year. As the upgrading process is now finalised, the efficiency ratio should improve further. The group's aim is to rank among the top three of its peer group in Brazil in terms of efficiency and hence is striving for an efficiency ratio of 55-57% compared with 60.5% at the end of 1H03. The target for YE03 is 60%. The acquisition of Sudameris should help in this respect, as it brings more scale to the group, which should lead to synergies. Finally, the increased use of non-traditional distribution channels should improve efficiency.

Fig 57 Efficiency ratio (%)

	2001	2002
ABN Amro	64.0	61.4
Bradesco	52.4	55.7
Itau	56.3	54.4
Unibanco	56.1	56.6
Banco Santander	73.2	63.5
HSBC	83.3	77.8

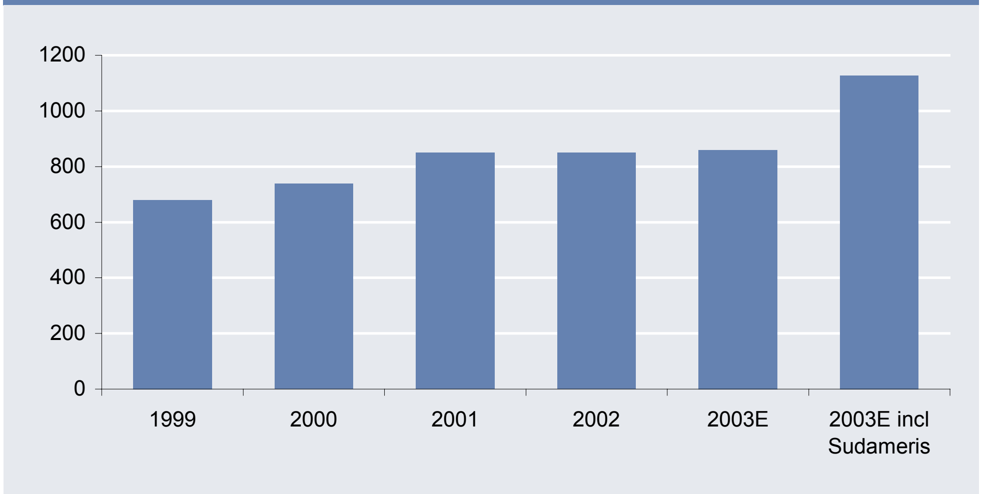
Note: Figures are based on Brazilian GAAP, adjusted for non-recurring results.
Source: ABN Amro

Distribution

Traditional branch network

As mentioned before, ABN Amro has been investing in its distribution capacity and IT systems in order to bring these up to standard. Over the years, ABN Amro has been expanding its branch network in Brazil, from 680 in 1999 to an expected 1,127 in 2003F, including 293 offices from Sudameris. We expect that in 2003, almost 40% of the branches will be located in Sao Paulo, the wealthiest part of Brazil.

Fig 58 ABN Amro's branch network in Brazil

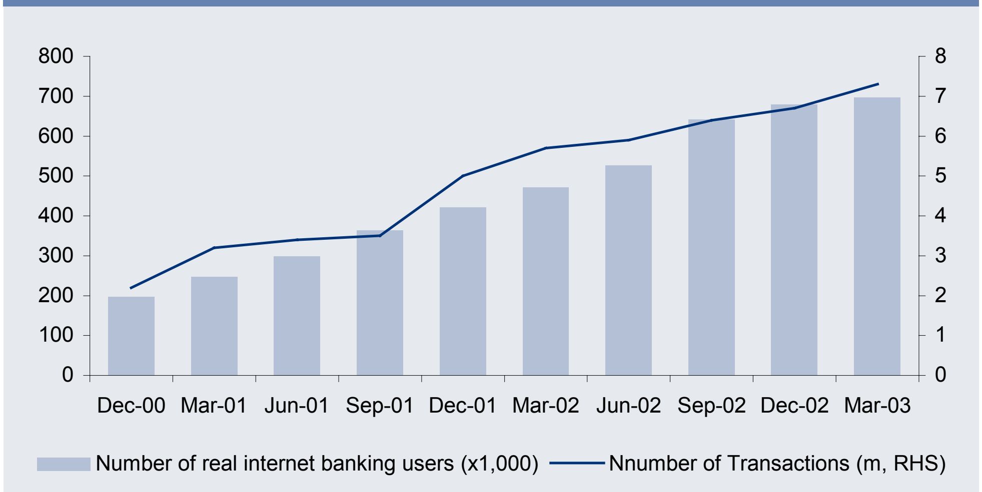


Note: Numbers include mini branches
Source: Company data

Non-traditional distribution channels

In addition to the traditional branch network, non-traditional channels account for an important part of transactions. This percentage has risen from 65% in 1999 to 81% in April 2003. Among the non-traditional channels are 6,730 ATMs (up from 3,992 in December 1999), call centres (implemented in 1985 and now taking care of 14m calls per month) and internet banking, which has also experienced rapid growth.

Fig 59 Internet banking in Brazil



Source: Company data

Interest rate risk

Strong focus on lending

ABN Amro's strategy to focus on clients has an impact on the balance sheet structure: lending, which typically carries bigger margins than, for instance, government securities, makes up a relatively large part of its assets. In 2002, lending was some 47% of total assets, compared with ratios of around 35% for Bradesco and Unibanco, and even lower than that for Itau, Banco Santander and HSBC.

Lending margins are high

Lending margins in Brazil are high (around 20% for ABN Amro), with the exception of spreads on large companies lending (0.5-1.0%). So far, ABN Amro is benefiting from these high margins maybe more than its competitors, given its strong focus on lending and the fact that its business is geared towards consumer and retail banking. A few important reasons can be mentioned to explain for the high spreads:

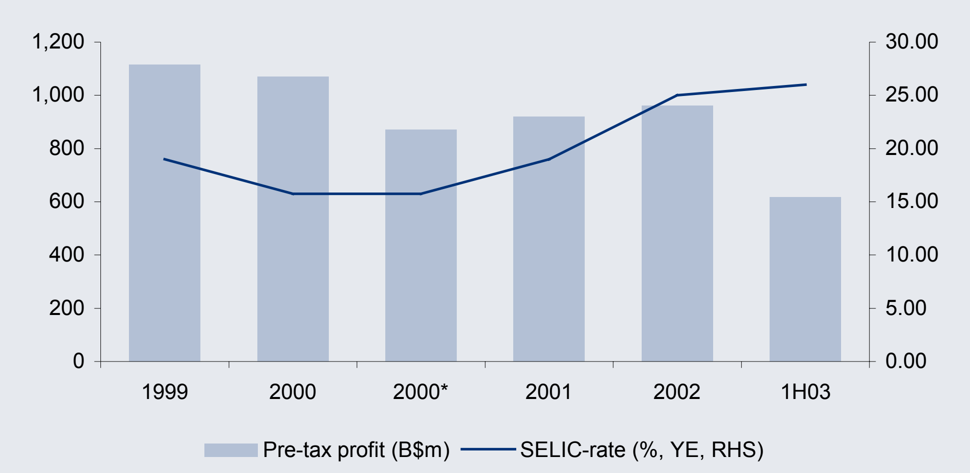
- Reserve requirements are too high. An example is on the deposit side: on-demand deposits required to be kept at central banks were reduced from 60% to 45%, which will help improve deposit margins.

- Bankruptcy law is unfavourable for banks. Often, such as in the case of mortgages, it is very hard for banks to exercise the collateral in the case of defaults. Homeowners, government and employees have a higher position than banks, despite the guarantees that they may have agreed. Car finance is an exception. Here, it is very easy for banks to gain access to the car in question and as a consequence margins in this business are much lower (0.6-0.7% per month) than for other lending products.

- Interest rate levels are high. This is probably the most important reason for high margins and, with interest rates falling, we expect lending margins to decrease too. As shown before, the SELIC rate (the discount rate at the central bank) has recently dropped from 26.5% to 20.0% and our economists expect a further drop to 17% by the end of the year. We do not fear this as much as the market seems to do. With interest rates falling, we expect an offsetting effect from volumes. In fact, we expect private lending volumes to enhance by 6% in 2003, and 13% in 2004F and 2005F.

Historically, ABN Amro has been able to maintain its profits rather well in times of interest rates falls. In our view, lower interest rates, combined with a healthier economic environment, should in the end be positive for banks, as volumes pick up and risks go down, compensating for lower margins.

Fig 60 Interest rate sensitivity



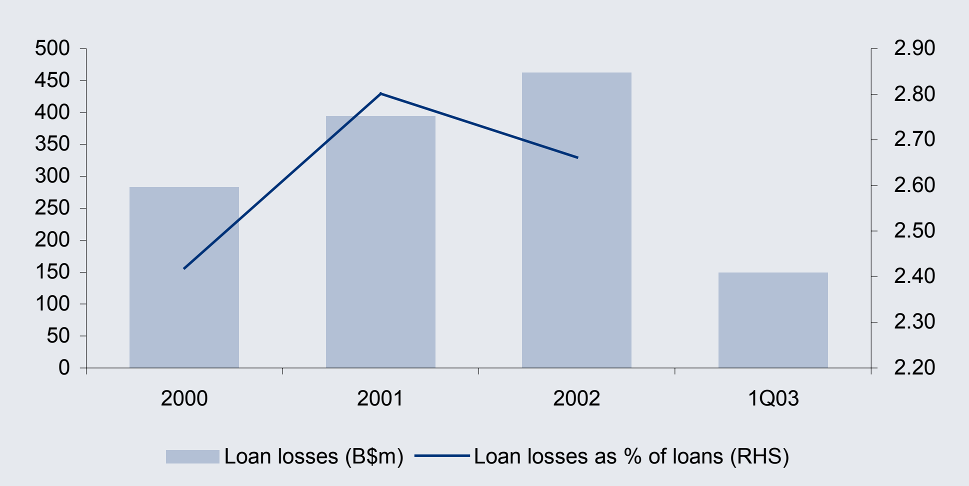
* 1999-00 South and Central America division, from 2000 Brazil consumer and commercial clients

Source: ABN Amro, Datastream, ING estimates

Default risk

The overdue loans ratio was only 4.7% in 2002, which compares favourably with, for instance, Unibanco (6.1%), Itau (8.6%) and Bradesco (6.4%). Loan losses as a percentage of total loans in 2002 were lower than in 2001 at 2.66%.

Fig 61 ABN Amro Brazil: loan losses

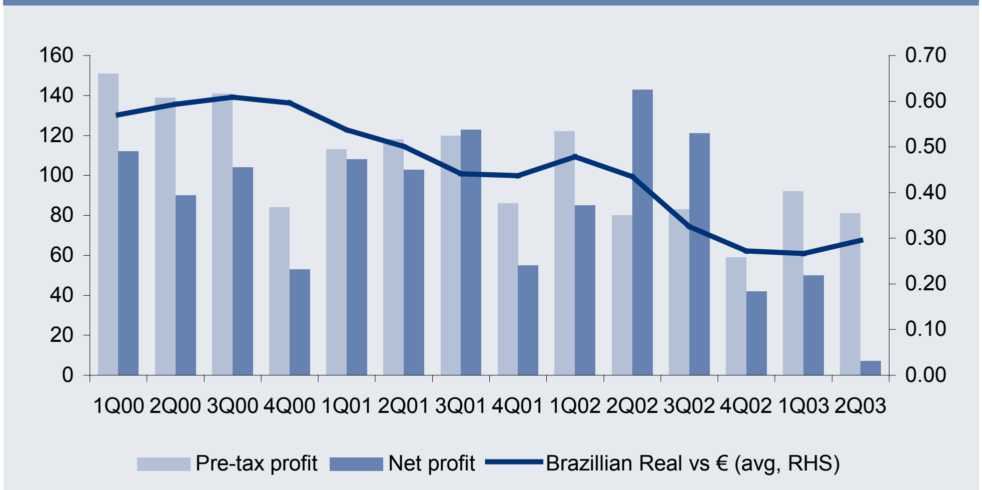


Source: Company data, ING estimates

Currency risk

One of the risks related to doing business in Brazil is, of course, the currency risk. The Brazilian Real has shown quite some volatility in recent years. As ABN Amro does not hedge its currency exposure through markets, obviously its earnings in euro are subject to exchange rate movements.

Fig 62 Exchange rate sensitivity



Source: ABN Amro, Datastream

Tax benefits in case of negative currency movements

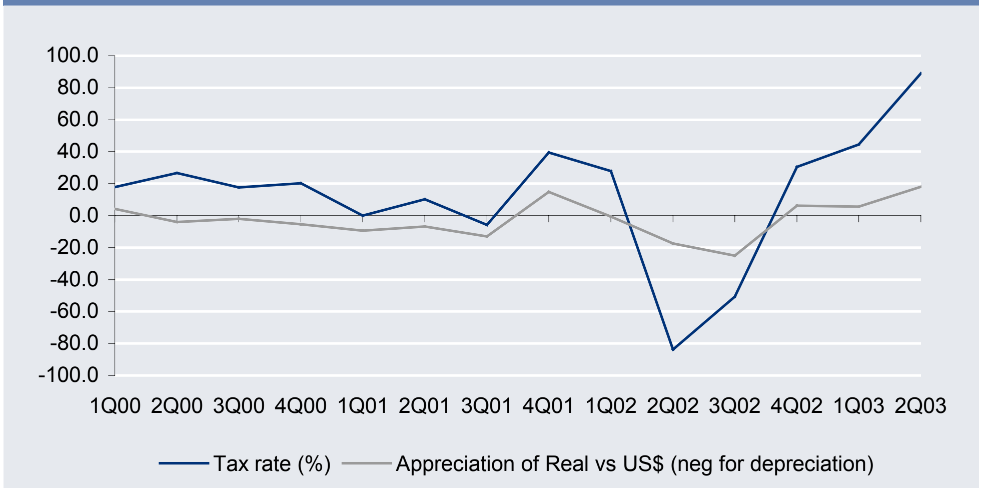
However, Banco Real has set up a tax vehicle that covers for lower currencies. In 2002, for instance, the Real devaluated heavily (45%) against the euro. Despite this negative currency impact, the net profit of the Brazilian banking operations of ABN Amro remained roughly flat at €391m. The reason for this was a tax benefit that the bank realised in case of adverse currency movements. ABN Amro Real has set up an office on the Cayman Islands, which it has capitalised with a certain amount in US dollars. The funding of this investment comes from a US dollar note that the bank has issued and which the office on the Cayman Islands has taken on. Thus, ABN Amro Real has a US dollar asset (the investment) and for an equal amount a US dollar debt (the US dollar note) on its balance sheet. Under Brazilian tax law, in case of a devaluation of the Real, the value increase in Reals of the asset is tax-free, while the currency loss on the liability is tax deductible. In the situation in 2002, this resulted in a tax benefit of €57m. In 1H03, the opposite was true: because of an appreciation of the real versus the US dollar, taxes were unusually high at 65.3%.

Fig 63 Cayman Islands tax construction

@ BRL/USD: 3	**Balance sheet ABN Amro Real (start of year 1, in Reals)**			
	Assets: Cayman investment	300	Liabilities: USD note issued	300
@ BRL/USD: 4	**Balance sheet ABN Amro Real (end of year 1, in Reals)**			
	Assets: Cayman investment	400	Liabilities: USD note issued	400
	P&L ABN Amro Real (year 1, in Reals)			
Increase in assets, tax free	Forex gain on asset, after tax	100		
Increase in liabilities, tax deductible at 34%	Forex loss on liability, after tax	-66		
	Total forex gain	34		

Note: Figures are imaginary and used just to make clear the effects
Source: Company data, ING estimates

Fig 64 Tax rate and currency movements



Source: Company data, Datastream, ING estimates

Outlook for ABN Amro in Brazil

Good profitability

We believe the position and outlook for ABN Amro in Brazil is rather good. The bank has solid market positions and has a good profitability (ROE of 25.2% and ROA of 3.2% in 2002). Especially the ROA ratio compares favourably with those of its peers (2.0-2.3% for Bradesco and Itau and even lower returns for Unibanco, Banco Santander and HSBC), which is the result of the relatively high loans-to-assets ratio. The profitability of Sudameris is lower at 16.6% (ROE). However, we believe that profitability was hurt as a consequence of uncertainty about the future of the bank. Intesa had put Sudameris up for sale already in 2001 and an agreement was reached with Itau in December of that year. However, negotiations broke down in November 2002, after which ABN Amro was able to close a deal. We expect profitability of Sudameris to improve now that the acquisition turmoil is over (the deal is expected to close at the end of October 2003) and synergies can be achieved between ABN Amro Real and Sudameris.

Positive outlook

The forecasts for Brazil are prejudiced by the acquisition of Sudameris. We expect lower interest rates to lead to margin pressure. However, this should be more than offset by volume growth, lower cash reserve requirements and the inclusion of Sudameris. We expect the Brazilian operations to show good cost control going forward, where synergies from the inclusion of Sudameris will also play a role. Risk provisioning will be relatively high in 2003, partly because of a one-off adjustment. Hence, we expect a slight improvement in 2004 (excluding Sudameris). As we expect less volatility in currencies going forward, the tax rate should move to the normal level of 35% in 2004, after a very high level of 54% in 2003. In all, we expect net profit to move from €391m in 2002 to €170m in 2003F and €358m in 2004F.

Fig 65 Forecast P&L C&CC Brazil (€m)

	2000	2001	2002	2003F	2004F
Net interest income	1,594	1,520	1,385	1,375	1,809
Net commissions	362	226	175	193	258
Results from financial transactions	35	44	30	11	21
Other revenue	122	130	146	109	112
Total revenue	2,113	1,920	1,736	1,688	2,200
Operating expenses	1,427	1,290	1,199	1,034	1,288
Pre-tax profit before loan losses	686	630	537	654	911
Provision for loan losses	171	193	193	257	310
Pre-tax profit	515	437	344	397	602
Taxes	106	39	-57	214	211
Minorities	50	9	10	12	33
Net profit	359	389	391	170	358

Source: Company data, ING estimates

Fig 66 Forecast P&L group (€m)

	2000	2001	2002	2003F	2004F	2005F
Net interest income	9,404	10,090	9,845	9,467	9,805	10,177
Income from securities	451	455	369	387	407	427
Net commission income	5,880	5,214	4,639	4,259	4,508	4,778
Results on financial transactions	1,569	1,552	1,477	1,820	1,785	1,750
Other income	1,165	1,523	1,950	2,059	1,634	1,715
Total income	18,469	18,834	18,280	17,994	18,138	18,848
Staff costs	7,460	7,653	7,250	7,208	7,313	7,547
Depreciation	941	957	1,006	1,050	1,075	1,100
Other administration expenses	4,801	5,161	4,567	3,807	3,827	3,980
Operating expenses	13,202	13,771	12,823	12,064	12,215	12,627
Provision for loan losses	585	1,426	1,697	1,335	1,334	1,241
Value adj to financial fixed assets	(43)	24	47	20	15	15
Operating result before tax	4,725	3,613	3,713	4,574	4,574	4,965
Taxes	1,324	998	1,093	1,541	1,427	1,589
Third party interests	304	252	208	234	240	247
Net profit	3,097	2,363	2,412	2,799	2,907	3,129
Net attributable profit	3,018	2,317	2,366	2,753	2,861	3,083
EPS (€)	2.04	1.53	1.52	1.72	1.75	1.84
DPS (€)	0.90	0.90	0.90	0.90	0.90	0.92

Source: Company data, ING estimates

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Spain

Banco Santander

Banking on growth

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Maintained

BUY

17 October 2003

Est fair value

€8.7

Bloomberg /Reuters

SAN SM/SAN.MC

Banks

13/10/03

€7.86

Banco Santander has a leading franchise within the region, although some risks could apply in the short term, especially in Venezuela. We believe Banco Santander has a clear strategy that should bear fruit in the medium term.

Banco Santander has a leading position in the region, with critical mass in five countries (Brazil, Venezuela, Chile, Mexico and Puerto Rico). This strategy has borne fruit in recent year, even in the last decade's toughest year the bank was able to obtain €1.383bn from the region, which represented 63% of total net profit (before goodwill amortisation and financial costs).

Even though the strategy is widespread and there is a balance in terms of contribution, two countries, Brazil and Mexico, contribute 80% of net profit within the region.

Santander Banespa is the most important contributor to net profits in the region with €803m and, after the merger with Banespa, the group has a leading position in the country. However, this net profit was distorted because net interest income has a high degree of reliability on wholesale inflation and during 2002 it was especially high but turned negative in 2003, harming 1H03 net profit.

Santander Serfin is the other relevant contributor to net profit within the region, even if it is not the Mexican market leader, the bank has a high profitability and contributes €681m to consolidated net profit. However, contributions are not limited to these countries, a leading position in Chile (a quasi-mature country with stable fundamentals) and the ability to extract value in Venezuela complete the picture.

We believe that Banco Santander's strategy has a clear focus, which should have an effect on net profit from the region; we expect €1.34bn in 2004F (+5%) and €1.48bn (+10%) in 2005F. Our estimated fair value of €8.7 (11% upside potential) is based on LEFAC.

Key ratios (%)

	2002	2003F
NII margin	2.7	2.4
NPLs	2.2	2.4
Cost/income	52.3	52.6
ROA	0.8	1.0
ROE	14.7	16.6

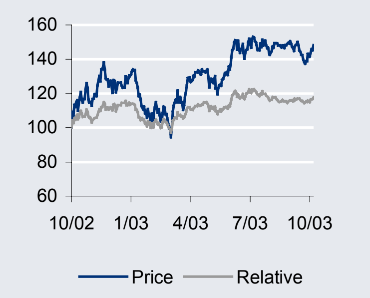
Relative performance

	12m	3m
Absolute(%)	48.3	-3.0
FTSE 300	8.1	5.2
IBEX 35	26.1	0.9
Relative to (%)		
FTSE 300	37.2	48.8
IBEX 35	17.7	22.3

Share data

No. of shares (m)	4,768
Daily t/o (€m)	347.9
Free float (%)	91.2
Market cap (€m)	37,289.1
BVPS (€m)	3.03
Price/NAV (x)	3.01

Share price performance (rebased)



Source: Bloomberg

The leading franchise in LatAm

Banco Santander made US$17bn investments …

Banco Santander has invested over US$17bn in Latin America to create the leading franchise in the region. This investment process ended in 2002 when it sold stakes in Grupo Serfin, Grupo Bital and insurance subsidiaries in Chile for cUS$2bn.

Fig 67 Historical investments of Grupo Santander in Latin America

	US$bn
Argentina	2.3
Bolivia	0.2
Brasil	7.4
Colombia	0.4
Chile	2.6
México	2.4
Perú	0.2
Puerto Rico	0.3
Uruguay	0.0
Venezuela	0.7
Others	0.5
Total investment	**17.2**

Note: Does not include divestments

Source: ING estimates based on company reports.

… the result is that Santander has a leading position in the region ...

Unlike its European competitors in the region (ABN and BBVA), Santander's franchise is widespread with leading positions in Brazil, Chile, Venezuela, Puerto Rico and Mexico.

Fig 68 Market position in main LatAm countries

Country	Total assets (€m)	% market share	Ranking	Deposits (€m)
Argentina	2,646	7.7	4th	2,742
Brazil	14,732	4.4	6th	5,242
Chile	15,631	23.6	1st	5,186
Colombia	1,085	3.4	15th	N/A
Mexico	20,025	13.0	3rd	18,208
Puerto Rico	6,734	11.0	3rd	5,256
Venezuela	2,393	16.6	1st	1,846

Source: Central banks, company data

… with a clear strategy: focus in G-5 (Brazil, Chile Mexico, Puerto Rico and Venezuela

Santander's strategy in the region has been to focus on larger countries (in terms of GDP or banking assets), with growth potential and a minimum critical mass. As a consequence, Santander has selected five markets, the G-5, which have been defined as core for the group: Brazil, Mexico, Chile, Venezuela and Puerto Rico. These five countries represent 87% of assets in the region and 91% of revenues.

Consequently, the contribution from the Latin American business has become substantial to Banco Santander's balance sheet and P&L account. Roughly one fifth of the assets, loans and deposits of the group are in Latin America while in terms of net profit it represented 28% of the group in 2002 (including financing costs but excluding goodwill amortisation). Excluding financing costs, Latin American net profit represents over 50% of group profit, which, as a result, has become quite dependent on the evolution of the region.

Fig 69 Contribution of Latin America to Banco Santander (€m)

		2002			1H03	
	Total	Latin America	% of total	Total	Latin America	% of total
Assets*	**324,208**	**83,910**	**26**	**341,998**	**78,742**	**23**
Loans	162,972	32,567	20	169,040	30,115	18
Deposits	211,555	39,740	19	216,850	38,411	18
Equity	17,594	3,628	21	19,032	3,733	20
Net interest income	9,359	4,678	50	3,928	1,509	38
Operating profit	**5,566**	**2,609**	**47**	**2,899**	**948**	**33**
Net attributable profit**	**2,247**	**1,383**	**62**	**1,293**	**697**	**54**
Net attributable profit***	**2,247**	**627**	**28**	**N/A**	**N/A**	**N/A**

* Only includes retail banking not wholesale banking assets in Latin America ** Before financing costs and goodwill amortisation ***After financial costs
Source: Company data

Within Latin America there are obvious differences in terms of contribution to net profit. The two largest countries represent c80% of total net profit in the region, followed by Chile and Venezuela. Venezuela's contribution continues to be substantial (despite is relatively small banking market) due to high margins and an overvalued currency.

Fig 70 Contribution to net profit by country

	2002 (€m)	Contribution* (%)
Brazil	802	43
Mexico	681	36
Chile	229	12
Venezuela	166	9
Puerto Rico	12	1
Argentina	0	0
Rest of countries	(16)	N/M
Rest	(493)	N/M
Total	**1,381**	

Source: Company data

Under 'rest' there are a wide variety of costs that basically include the attributable costs of preferred shares, charges coming from central services and provisions.

Fig 71 Composition of 'rest' in Latin America P&L

	2002 (€m)
Charges assigned (central services, Altair)	(160)
Capital adjustment	(133)
Provisions	(194)
Of which Uruguay	(103)
Of which Venezuelan debt	(63)
Of which Mexico	(28)
Other	(6)

Source: Company data

Of those amounts, the charges assigned and the capital adjustment are recurrent, whilst the provision line is not recurrent and should not be repeated in 2003.

Group strategy

Strategy focused on cost cutting, risk management improvement and gaining market share …

Santander's growth strategy in the region has been based on three pillars: cost cutting, improvement in risk management and gaining market share. The first two have already produced results; the Latin American operations had a 52% cost-income ratio in 2002 and in 1H03 the risk premium for the region ex-Argentina was c70bp (not far from that applied in Spain). In our opinion, there is no substantial potential left for improvement in these areas.

… once costs are under control it is time to focus on growth

Now the strategy has shifted from cost cutting and better risk management to focus on revenue growth. When we visited Banco Santander to discuss its Latin American operations on 22 September 2003 our impression was that the bank's focus was to reduce the contribution of non-client assets to net interest income (according to Santander c49% of 2002 NIR in Brazil, 56% of NIR in Mexico and 40% of NIR in Venezuela is obtained from non-client business) and offsetting margin pressure due to falling margins with accelerated volume growth.

Brazil

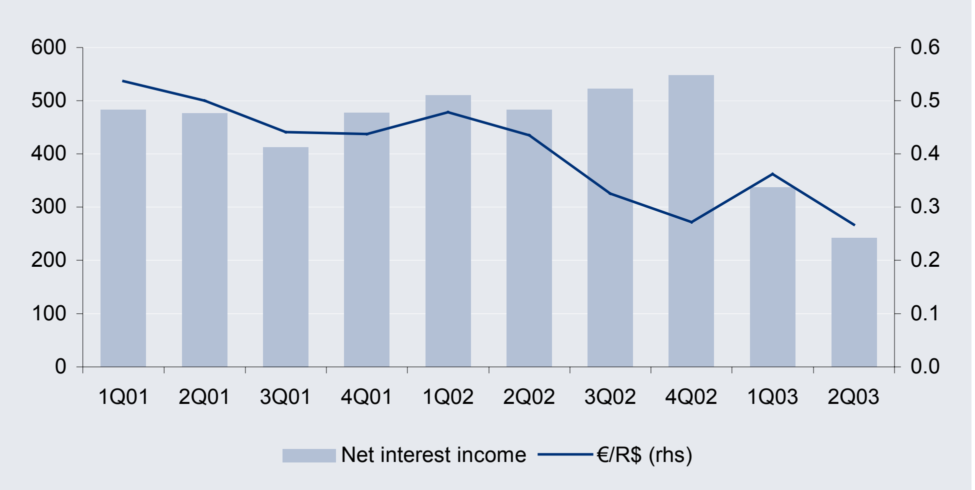
Leading position in the country after several acquisitions

Banco Santander has been in Brazil since the early 1990s with an investment banking subsidiary. It acquired several small banks (Geral, Noroeste, Meridional) and in 2000 it acquired a controlling stake in Banespa from the government. It increased its market share to 4.2% in loans and 4.5% in deposits and mutual funds. Banespa was an inefficient institution at the time of purchase with a cost-income ratio of 72.6% and 22,600 employees. But by 2002, Banespa had a cost-income ratio of 42.5% after reducing the number of employees by 8,000.

Net profit has been volatile …

Banco Santander's Brazilian operations have suffered from volatility of part of its revenue stream. In 2002, and despite an 18.3% depreciation of the Real in 2H02, net interest income reached record levels. On the other hand, in 2003, with the currency recovering, Santander's NIR fell substantially. In fact, in 2Q03 the level of NIR was less than half of what it was in 4Q02.

Fig 72 Quarterly net interest income versus €/R$ exchange rate



Source: Company data, Bloomberg

… due to the high percentage of securities linked to inflation

The reason for this performance is that there are a large amount of securities on the balance sheet (38% of its assets, almost double the amount of loans). Of those securities, cR$7bn are indexed to inflation plus 12% and general inflation had an abnormal performance in 2H02 and 1H03. Should inflation recover to its long-term trend, Banespa will recover more sustainable levels of net interest income. We estimate that normalised inflation could add c€60m a quarter to net interest income when compared with 2Q03. However, there has also been an effect on margins from the sales of government debt.

Fig 73 Structure of Banespa balance sheet (R$m)

Assets	2002	(%)	Liabilities	2002	(%)
Central banks and cash	861	2	Deposits	19,158	35
Inter-bank deposits	7,310	13	Open market funding	5,802	10
Securities	21,835	39	Loan liabilities	5,060	9
Loans	12,082	22	Other liabilities	19,308	35
Other assets	13,374	24	Equity	6,133	11
Total assets	**55,462**	**100**	**Total liabilities**	**55,462**	**100**

Source: Company data

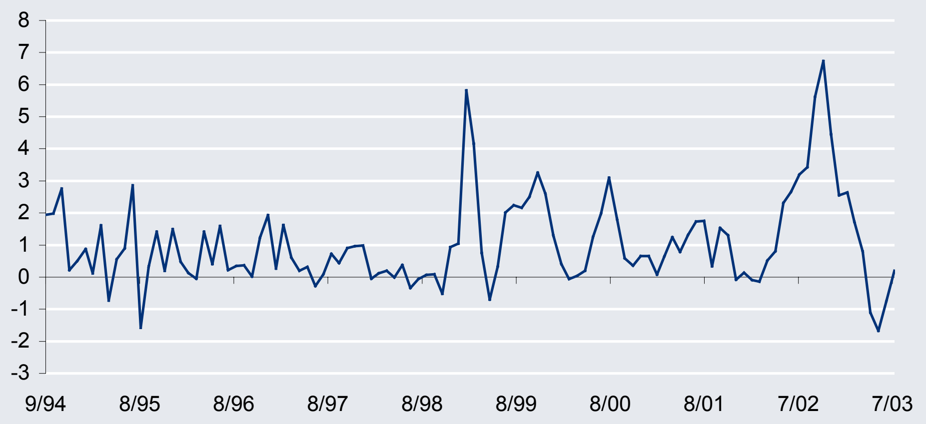
Fig 74 Securities portfolio of Banco Santander in Brazil (€m)

	Dec 2001	Dec 2002	Jun 2003
For sale and trading portfolio	8,544	3,573	2,368
Held to maturity portfolio	2,027	1,626	1,891

Source: Company data

Our economists expect a pick-up in inflation to levels of 9% (annualised) by the year-end.

Fig 75 IGPM, wholesale general inflation (%ch MoM)



Source: Banco Central Brasil

Although deposits are relevant for Banespa, the contribution to net interest income is not so relevant

Banespa's balance sheet is different to its Brazilian peers' because it has a higher weight of deposits to the private sector and a high volume of securities in its balance sheet. Supposedly, a structure of this type would be very sensitive to interest rate levels because the spread on deposits should be the largest contributor to the net interest income. However, in Banespa's case the spread on deposits only represents one fifth of net interest income, while the spread on assets is the bulk of the NIR. According to Santander, the spread on deposits is c300bp and the spread on loans is c1,500bp. As a consequence, Banespa is only slightly sensitive to interest rates and a 100bp reduction in rates has a negative impact on NII of only 0.82% (according to Banespa's annual report). In fact, falling rates may help stimulate growth and, consequently, inflation, which would be positive for Banespa's NII as it has inflation-linked bonds.

The reason for this low sensitivity to margins is the large amounts that banks are obliged to keep at the central bank (for example, on current accounts 45% is kept at the central bank and not remunerated). In September 2003, the BCB reduced the compulsory cash reserves and that should offset part of the effect of falling rates on margins.

The situation in Argentina

By the end of 2001, and following a period of social and economic instability, Argentina defaulted on its external debt. In reaction to these events, Argentina has imposed severe economic restrictions, which are explained in detail in page 27.

Santander reacted to Argentinian default, with €2.6bn in provisions and charges

As we already know, Santander responded to this events by creating a €1.287bn provision to cover equity plus goodwill of its stakes in Banco Río (at that time an 80% subsidiary of the group) and Banco Galicia (in which it holds a 10% stake). During 2002, and given the continuous instability of the country, Santander provisioned an additional €336m to cover all intra-group exposure and country risk provision as legally required. During 2003, it carried out an additional €182m provision although it used the excess provisions on its exposure for this purpose so there was no impact on the P&L .

Fig 76 Summary of exposures and provisions for Argentina (€m)

	Exposure
Equity of Banco Río	967
Goodwill	245
Option on 18.5%	395
Banco Galicia	100
Fund management companies (Previnter, Origenes)	158
Intra-group cross-border risk	322
Country risk exposure	400
Total risk	**2,587**
Charges against reserves	982
Generic provisions	1,623
Already provisioned/charged off	**2,605**

Source: Company data, ING estimates

Santander has provisioned €1.62bn to cover risk and it has recorded accumulated losses for €982m in its balance sheet because of the effect of the depreciating peso on its own accounts. Both the provision and the accumulated losses have already impacted group equity and there should be no further impact from Argentinian exposure.

Why Argentina should not present additional problems

As explained before, there are still three pending issues for the banks:

Pending issues in Argentina could make banks' equity negative

- The application of a different exchange rate to loans and deposits at the time of the 'pesification' created a mismatch in the banking system.
- The application of different inflation coefficients to loans and deposits has also created a mismatch on the profit and loss account.
- Finally, regarding the 'amparos' there is no judicial ruling yet and Santander has not received any compensation.

Government bonds already represent c48% of the balance sheets of Argentinian banks (and a similar percentage for Banco Río) and, as a result, they have become very sensitive to government decisions on bond rates, haircuts, application of inflation coefficients, etc.

Fig 77 Balance sheet of Banco Rio (Santander Argentinian subsidiary)

	June 2003 (Pm)	June 2003 (€m)
Cash and inter-bank lending	1,598	654
Government debt	2,715	1,111
Loans	6,049	2,475
Other assets	4,064	1,663
Total assets	**14,426**	**5,904**
Deposits	6,701	2,742
Debt	6,402	2,620
Other liabilities	272	111
Equity	1,052	430
Total liabilities	**14,426**	**5,904**

Source: Company data

Consequently, Banco Río has 'theoretical' equity of €430m. However, should we use the market value, or a proxy of market value of the loans and government bonds held, then its equity would probably be substantially negative. Remember that Santander has €1.6bn in loans and bonds received from the government as compensation and their market value is c60% of their face value.

The bank is following a low-risk strategy under which costs should be covered with commissions, while net interest income could be used to provision for the bad loans (that is not the case yet).

The good news is that Argentina is no longer relevant for the bank

The good news is that Argentina is no longer a relevant market and we do not expect Santander (nor BBVA) to invest more money there. Comparing the relative size of Spain with Argentina, Argentina currently represents only c2.0-3.5% of the size of the Spanish market. Consequently, owning 10% of the Argentinian market is similar to owning a 0.2-0.3% market share in Spain.

Fig 78 A comparison of market size (€bn)

Data as of June 2003 except GDP	Argentina	Spain	Argentina as a % of Spain
GDP at market prices 2002	100	693	14
Total assets	56	1,424	4
Lending to private sectors	13	754	1.8
Private sector deposits	20	604	3.4
Equity	N/A	120	N/M

Note: Argentina data converted at market rates
Source: Central banks

Put differently, the current stock of lending in Argentina is quite similar to the growth rate experienced by the Spanish market in one single month (for example, in April 2003 lending in Spain grew €14bn, in July 2003 it grew by €12bn). It would be unwise to invest more money in the country until political and economic frameworks change.

Chile: leader in the most developed market

Banco Santander leads in the most developed market

Banco Santander's franchise in Chile is very strong and is the market leader in nearly all business lines. In less mature markets this position would not be a problem given that organic growth would more than compensate for any market share losses. However, in Chile lending has not grown at double-digit rates for any of the last three years. As a result of the merger, the bank has been losing market share during the past year and management is assuming a further deterioration in market share to 22%.

Banco de Chile, its main competitor in the country, has taken advantage of the merger and increased market share in the past year from 18.4% in December 2002 to 19.1% in June 2003. BBVA BHIF has also been able to gain 1% market share a year for the last two years.

Fig 79 Banco Santander-Santiago market share (%)

Loans		Deposits + mutual funds	
June 2002	June 2003	June 2002	June 2003
27.7	24	27	21.2

Source: Company data

The strategy is to defend market share …

Therefore, Santander's strategy in the country is to focus on defending market share, through aggressive campaigns in insurance products, where the bank has no relevant presence, and in loans, with a clear focus on changing the mix geared to individuals rather than corporate lending.

… and continue to improve efficiency

On the cost side, the company said in February that the merger would imply about US$75m cost synergies. This will mean a 20% decrease in the cost base, improving the cost-income ratio to 35%. The group's commitment to the market seems achievable and to that extend Banco Santander has reduced headcount by 10% between June 2002 and June 2003.

Credit quality suffered between 3Q02-1Q03 due to the homogenisation process that Banco Santiago did to meet the credit standards of the Santander group. Credit quality should be under surveillance in the coming quarters, although the situation seems to be relatively stable and we believe that the normalised level for the bank should be in the region of US$150m, implying a 1.4% risk premium over total loans.

Mexico

After the merger, Santander achieved critical mass in Mexico

Since the merger of Santander Mexico and GF Serfin in 2000, Banco Santander achieved the number three position in Mexico and increased its focus on retail banking.

As in Brazil, management is confident of market growth potential in the private sector, especially mortgages, where the legal framework for proper execution has improved after recent reforms, and also in corporate lending. However, when looking at lending growth in Mexico there are distortions because of IPAB notes (previously FOBAPROA), which continue to decrease in size. When looking at lending, we exclude IPAB loans to see that lending is growing at high rates (45% YoY).

Fig 80 Santander loans in Mexico excluding IPAB (Pm)

	June 2002	June 2003	%ch YoY
Lending to corporates	31,259	44,512	42
Consumer lending	4,597	6,992	52
Mortgages	393	1,186	202
Total	**36,249**	**52,690**	**45**

Source: Company data

IPAB and FOBAPROA notes have recently been in the spotlight, given the fact that IPAB has asked for a new audit of BBVA Bancomer, Bital, Banamex and Banorte, as there were several irregularities in the loans exchanged in the 1995 bank rescue. However, this is not an issue for Santander Serfin as its IPAB bonds have a loss-sharing feature, implying that both Santander and IPAB share the underlying loss of the credit portfolio. Furthermore, at the point of the Banco Serfin acquisition Santander signed an agreement that reduced its responsibility over events prior to the acquisition.

CETES rates shrunk during 2003 harming Santander's P&L in Mexico

As a consequence of the dramatic fall in rates (28 CETES fell from 9.7% at the beginning of the year to 4.7% now), the main issue in Mexico remains margins. Unlike in Brazil, margins in Mexico are more dependent on the liability side. In Mexico, margins on loans are close to 2.5%, while on deposits the are c2% according to Santander.

In order to offset that effect, Santander has implemented several measures: growth in private individuals lending, charging commissions for some services and cost control (the target is to keep costs below CPI).

Venezuela

High interest rates and an overvalued currency explain high profitability for a small bank

Venezuela is in an unusual situation where a small bank (with only €1.05bn in loans and €3.5bn in client resources) can make a large profit. In 2002, it obtained a net profit of €166m. The high profitability of the whole financial system (see page 30 for a comparison a countries profitability) is explained, in our opinion, by high interest rates and an overvalued currency. The official exchange rate (Bs1,598/US$) is substantially above the exchange rate on the black market. Furthermore, political instability is creating a difficult environment for foreign direct investment. Santander has answered this by reducing its exposure to government debt, increasing liquidity in its subsidiary, tightening lending criteria and keeping a structural position in US dollars that would provide a substantial profit in case a devaluation takes place. However, in the long run, we think there is a considerable risk of Venezuela devaluing its currency and that more economic instability is a possibility.

Fig 81 Santander exposure to Venezuela December 2002 (€m)

	Exposure
Historical investment	570
Equity	402
Goodwill	332
RWA*	2,123

*June 2003
Source: Company data

Although Venezuela represents roughly the same percentage of operating profit for BBVA and Santander, Santander has a larger exposure because BBVA's stake in Provincial is less than 60%.

Fig 82 Comparison of BBVA's and Santander's exposure (€m)

	1999	2000	2001	2002	1H03
Banco Provincial					
Net profit	84	81	82	81	40
% of total	*4.8*	*3.7*	*3.5*	*4.7*	*3.4*
Operating profit	161	175	264	314	110
% of total	*4.7*	*4.0*	*4.7*	*5.6*	*4.4*
Banco Santander Venezuela + Caracas					
Net profit	113.5	115.1	144	159	52
% of total	*7.2*	*5.1*	*5.8*	*7.1*	*4.0*
Operating profit	149	138	270	343	107
% of total	*4.3*	*2.9*	*4.5*	*6.2*	*3.7*

Source: Company data

Rest

Santander provides information by country for the G-5 countries plus Argentina. The rest of the countries, which basically include Peru, Colombia, Paraguay, Uruguay and Bolivia, constitute a group of lowly profitable banks in countries where Santander either lacks critical mass or the size of the country is very small. In those countries, Santander has been reducing its size and exposure. In fact, it has already liquidated its subsidiary in Paraguay and sold its retail business in Perú. In Colombia and Bolivia Santander would consider selling if attractive offers arise.

It looks like in Colombia, Santander is redefining its strategy given that the size of the country in terms of GDP and banking market is attractive and it could earn in the range of US$10-20m a year with only 50 branches and US$427m in loans.

Fig 83 Downsizing at Bolivia, Peru, Paraguay and Uruguay (US$m)

	1998	June 2003
Total assets	3,738	965
Loans	4,167	515
Securities	365	19
Branches (no.)	280	65
Employees (no.)	5,768	1,188
Net profit	(23)	(21)

Note: Data is from parent companies
Source: Company data

Conclusions

Banco Santander has a leading franchise in LatAm after investing over US$17bn. It has top market shares in all the main countries, but is especially strong in Chile and Mexico. Its strategy is clear and has been executed with efficiency by an experienced manager (Francisco Luzón, previously chairman of Argentaria) and his team.

The Brazilian Real's recovery since 2Q03 will help Santander to improve the balance of net profit stream in the region. Management is confident of growth prospects in terms of lending in the country, however, it looks like recovery is being delayed.

Banco Santander's Mexican franchise is strong with 14% share of assets, although this is far from leaders Banamex and Bancomer. In the short term, the position in Mexico could have some risks because of margin pressure and a depreciating peso.

We remain very cautious on Venezuela as political risks seem to be in line with those that led to the coup in late 2002. Banco de Venezuela could benefit itself from further deterioration in the bolivar exchange rate because the bank will maintain a structural long position in US dollars. However, the net profit contribution should fall going forward.

Finally, its leading franchise in Chile is improving efficiency to compensate for market share losses. In the medium term, however, it should benefit from critical mass to become one of the most profitable banks in the region.

All in all, Banco Santander is has a widespread franchise in the region with relevant exposure to Mexico, Brazil and Chile. It has demonstrated that size can imply profitability and, although we feel an 8% ROI 2002 is not enough to justify the investment in the region, it is clearly much better than that achieved by most of its European competitors and HSBC. If any bank is prepared to build a profitable Latin America franchise it is likely to be Santander, although we have doubts about the region's growth prospects and Santander is unlikely to be able to exclude itself from the region's volatility.

Forecasts

Latin America

Fig 84 P&L for Latin America (€m)

	2001	2002	(%ch)	2003F	(%ch)	2004F	(%ch)	2005F	(%ch)
Net interest income	**5,805**	**4,679**	**-19**	**3,164**	**-32**	**3,450**	**9**	**3,466**	**0.5**
Commissions	2,284	1,805	-21	1,481	-18	1,577	6	1,595	1.1
Recurrent revenue	**8,089**	**6,483**	**-20**	**4,645**	**-28**	**5,028**	**8**	**5,061**	**0.7**
Trading profit	544	129	-76	350	171	265	-24	295	11.3
Total revenue	**8,633**	**6,612**	**-23**	**4,995**	**-24**	**5,292**	**6**	**5,356**	**1.2**
Personnel costs	(2,545)	(1,862)	-27	(1,417)	-24	(1,431)	1	(1,362)	-4.8
Administrative costs	(1,924)	(1,592)	-17	(1,257)	-21	(1,269)	1	(1,208)	-4.8
Depreciation	(481)	(347)	-28	(255)	-26	(263)	3	(271)	3.0
Other operating results	(169)	(201)	19	(100)	-50	(100)	0	(100)	0.0
Operating profit	**3,515**	**2,609**	**-26**	**1,966**	**-25**	**2,230**	**13**	**2,415**	**8.3**
Loan loss provisions	(980)	(1,053)	7	(283)	-73	(468)	65	(467)	-0.1
Equity method	35	33	-7	33	0	33	0	33	0.0
Extraordinaries	(567)	108	N/M	0	N/M	0	N/M	0	N/M
Pre-tax profit	**2,003**	**1,696**	**-15**	**1,716**	**1**	**1,795**	**5**	**1,980**	**10.3**
Taxes	-286	-235	-18	-223	-5	-233	5	-257	10.3
Net profit	**1,717**	**1,461**	**-15**	**1,493**	**2**	**1,562**	**5**	**1,723**	**10.3**
Minorities	-210	-78	-63	-212	170	-222	5	-245	10.3
Net attributable profit	**1,507**	**1,383**	**-8**	**1,281**	**-7**	**1,340**	**5**	**1,478**	**10.3**
Tax rate (%)	*14*	*14*		*13*		*13*		*13*	

Source: Company data, ING estimates

Group

Fig 85 P&L Banco Santander group (€m)

	2002	(%ch)	2003F	(%ch)	2004F	(%ch)	2005F	(%ch)
Net interest income	**9,359**	**-8.8**	**7,891**	**-15.7**	**8,414**	**6.6**	**8,677**	**3.1**
Commissions	4,289	-7.2	4,065	-5.2	4,316	6.2	4,498	4.2
Recurrent revenue	**13,648**	**-8.3**	**11,956**	**-12.4**	**12,729**	**6.5**	**13,175**	**3.5**
Trading profit	356	-48.0	956	168.7	764	-20.1	791	3.5
Total revenue	**14,004**	**-10.0**	**12,912**	**-7.8**	**13,493**	**4.5**	**13,966**	**3.5**
Other operating results	(226)	-1.9	(159)	-30.0	(159)	0.0	(159)	0.0
Operating costs	(7,322)	-12.8	(6,461)	-11.8	(6,577)	1.8	(6,612)	0.5
Personnel costs	(4,522)	-14.0	(4,030)	-10.9	(4,106)	1.9	(4,151)	1.1
Other administrative expenses	(2,800)	-10.9	(2,431)	-13.2	(2,471)	1.7	(2,461)	-0.4
Depreciation	(890)	-9.9	(755)	-15.1	(778)	3.0	(801)	3.0
Operating profit	**5,566**	**-6.4**	**5,538**	**-0.5**	**5,980**	**8.0**	**6,394**	**6.9**
loan loss provisions	(1,648)	3.9	(1,150)	-30.2	(1,243)	8.1	(1,313)	5.6
Net operating profit	**3,918**	**-10.1**	**4,388**	**12.0**	**4,737**	**8.0**	**5,081**	**7.3**
Associates income	280	-46.4	252	-10.0	239	-5.0	239	N/M
Goodwill amortisation	(1,359)	-27.5	(1,350)	-0.6	(600)	-55.6	(600)	N/M
Profit on group transactions	1,009	-13.7	790	N/M	0	N/M	0	N/M
Other extraordinaries	(339)	-655.5	(100)	N/M	0	N/M	0	N/M
Pre-tax profit	**3,509**	**-17.2**	**3,980**	**13.4**	**4,376**	**10.0**	**4,721**	**7.9**
Taxes	(723)	-20.5	(836)	15.6	(919)	10.0	(991)	7.9
Net profit	**2,786**	**-16.3**	**3,144**	**12.9**	**3,457**	**10.0**	**3,729**	**7.9**
Minorities	(538)	-19.9	(661)	22.8	(708)	7.1	(745)	5.1
Net attributable profit	**2,247**	**-9.6**	**2,482**	**10.5**	**2,749**	**10.7**	**2,985**	**8.6**

Source: Company data & ING estimates

Fig 86 Banco Santander Group balance sheet (€m)

	2001	2002	2003F	2004F	2005F
Central banks	9,782	6,242	5,600	5,958	6,360
% total assets	*2.7*	*1.9*	*1.7*	*1.7*	*1.7*
Inter-bank assets	42,989	40,256	40,256	40,256	40,256
%ch	*16.9*	*-6.4*	*0.0*	*5.0*	*0.0*
Securities	**82,696**	**70,841**	**75,765**	**80,609**	**86,045**
% total assets	23.1	23.0	23.0	23.0	23.0
Loans to clients	**173,822.0**	**162,973.0**	**163,894.9**	**172,089.7**	**180,694.2**
%ch	*2.6*	*5.0*	*5.0*	*5.0*	*5.0*
% total assets	*48.5*	*50.3*	*49.8*	*49.1*	*48.3*
Fixed assets	**7,228**	**5,584**	**5,584**	**5,584**	**5,584**
% loans	*4.2*	*3.4*	*3.4*	*3.2*	*3.1*
Other assets	**41,619**	**38,313**	**38,313**	**45,976**	**55,171**
Total assets	**358,137**	**324,208**	**329,413**	**350,472**	**374,110**
Inter-bank liabilities	**53,930**	**42,155**	**30,222**	**40,762**	**53,157**
%ch	*-20.7*	*-21.8*	*-28.3*	*34.9*	*30.4*
Deposits	**181,527**	**165,837**	**175,818**	**184,609**	**193,839**
%ch	*7.1*	*-8.6*	*6.0*	*5.0*	*5.0*
Debt	**54,605.1**	**54,605.1**	**57,335.4**	**57,335.4**	**57,335.4**
%ch	*21.6*	*0.0*	*5.0*	*0.0*	*0.0*
Other liabilities	**37,795**	**30,236**	**33,259**	**33,259**	**33,259**
%ch	*1.5*	*-20.0*	*10.0*	*0.0*	*0.0*
Shareholders' equity	**30,280**	**31,375**	**32,778**	**34,507**	**36,519**
%ch	*3.6*	*3.6*	*4.5*	*5.3*	*5.8*
Total liabilities	**358,137**	**324,208**	**329,413**	**350,472**	**374,110**

Source: Company data & ING estimates

Fig 87 Banco Santander ratios (%)

	2001	2002	2003F	2004F	2005F
Main ratios					
Net interest margin group	2.9	2.7	2.4	2.5	2.4
Cost/income America	51.8	52.2	53.5	51.0	48.0
Cost/income group	56.7	52.3	47.8	47.3	46.9
Profitability ratios					
EPS (€)	0.55	0.47	0.52	0.58	0.63
ROA	1.2	1.1	1.2	1.0	1.0
ROE	22.8	20.5	19.1	15.2	14.8
Yield	5.0	5.0	5.0	5.0	5.0
Risk & capital ratios					
Risk premium group	0.89	0.99	0.65	0.72	0.72
Risk premium America	1.89	3.08	0.89	1.48	1.43
NPL ratio	2.17	2.21	2.40	2.29	2.18
Core capital	5.1	5.1	6.0	6.8	7.6
Tier 1	8.4	8.0	8.7	9.4	10.2
BIS ratio	12.5	12.6	13.3	13.8	14.3

Source: Company data, ING estimates

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BBVA

The Mexican player

Maintained

BUY

17 October 2003

Est fair value:

€10.6

Reuters/Bloomberg

BBVA.MC/BBVA SM

Banks

13/10/03

€9.43

BBVA's Latin American business is highly geared towards Mexico, which we see as the most attractive country in the region. BBVA should benefit from its position there but could be hurt by its Venezuelan exposure in the short term.

BBVA is the second biggest franchise in the region, although it is less widespread. Its investments in the region reached US$9.2bn, second only to Santander. The group's strategy has also borne some fruit and Latin America contributes €735m to net profit, representing 49% of group net profit.

Bancomer is the jewel in the region, even though its stake is lower than 60%, the Mexican subsidiary contributes €437m (25%) to group net profit, which is c60% of regional net profit. Mexico offers extraordinary growth potential and is already experiencing double-digit household lending growth.

Banco Provincial is the other relevant contributor to net profit, accounting for €81m, which represents 11% of net profit for the region. Even though the market is relatively small and there are a number of political risks linked to this country, Spanish banks have been able to make profitable franchises in Venezuela.

Chile is also an important country for BBVA, although it only has a 7% market share. The group intends to leverage profitability in the asset-gathering side where the bank holds a 32% market share through pension fund manager Provida.

Although we consider that BBVA has a good positioning within the region, we believe Banco Santander has better short-term growth prospects, due to the appreciation of the Real and a clearer strategy in terms of positioning within G-3 (Mexico, Brazil and Chile). We forecast net profit for the region at €870m (+4.3%) in 2004F, which represents 38% of total net profit. Our LEFAC-derived fair value is €10.6.

Key ratios (%)

	2002	2003F
NII Margin	2.94	2.56
NPLs ratio	1.36	1.38
Cost income	54.4	53.8
ROE	16.4	16.8
ROA	0.81	0.96

Relative Performance

	12m	3m
Absolute(%)	17.9	-0.7
FTSE 300	8.1	5.2
IBEX 35	26.1	0.9
Relative to (%)		
FTSE 300	9.1	15.6
IBEX 35	-6.5	-4.9

Share data

No. of shares	3,196
Daily t/o (€m)	294.35
Free float (%)	98.60
Market cap (€m)	30,041
BVPS (€m)	4.44
Price/NAV (x)	2.44

Share price performance

Source: Bloomberg

Investments and strategy

BBVA invested US$9.2bn in the region, where Bancomer is the bulk of the investment

We estimate that BBVA has invested US$9.2bn in Latin America, which includes banks, insurance companies and asset managers in several countries. BBVA is the leader in Mexico through its 59.4% stake in Bancomer and has the largest pension fund management business in the region.

Fig 88 Historical investments in Latin America (September 2003)

	Investment (US$m)
Argentina	1,533
Colombia	1,120
Chile	900
Mexico	4,196
Perú	290
Puerto Rico	350
Venezuela	570
Resto	187
Total Investment	**9,146**

Note: Includes divestments in Brazil (sale to Bradesco)
Source: Company data

Reporting is not clear and has changed twice in the past two years

BBVA has changed its reporting of the LatAm business, until 2001 it combined its Latin American business as a whole, but from 2001 to 2002 it only reported the accounts of the banks in the region (separating Mexico from the rest), and from 2003 BBVA reported the accounts of Mexico, the rest of the banks and the whole Latin American business including asset managers and also international private banking in Miami.

Our understanding is that BBVA went through a buying spree of banks and asset managers across the region without a clear strategy. With the arrival of a new management structure at the end of 2001, it looks like its strategy is starting to become clearer, ie, to focus on those countries where it has critical mass and sell or gain market share in those countries where, because of its size, it cannot be profitable.

Market position

The strategy is to focus on achieving critical mass in the countries where it is present

BBVA is ranked top three in almost every country in which it is present, except Argentina and Puerto Rico. The bank's strategy has been to achieve critical mass. This is the strategy it is targeting in Chile where it is focusing on organic growth in order to gain market share, to that extent BBVA BHIF has gained 2% market since 2001, reaching a 7% market share of total assets.

Fig 89 Market position in the region December 2002

	Total assets (€m)	Market share (%)	Ranking
Argentina	2,412	6.9	5th
Colombia	1,620	6.7	4th
Chile	2,277	7.0	3rd
Mexico	58,188	24.8	2nd
Perú	3,493	23.4	2nd
Puerto Rico	4,950	N/A	6th
Venezuela	3,184	16.0	3rd

Note: Data is based on total assets. If not available we have used deposits. Colombia data is as of August 2003.
Source: Company data, Central banks, Supervisoras

Latin America represents roughly one fifth or one fourth of BBVA's balance sheet and c30% of net attributable profit as of 1H03.

Fig 90 Contribution of Latin America to BBVA (€m)

	2002			1H03		
	Total	Latin America	% of total	Total	Latin America	% of total
Assets	279,542	81,169	29	277,874	78,007	28
Loans	141,315	26,951	19	142,637	24,528	17
Equity	13,561	3,280	24	12,019	3,005	25
Net interest income	7,808	3,617	46	3,348	1,454	43
Operating profit	5,577	2,417	43	2,479	1,173	47
Net attributable profit	1,719	735	43	1167	344	29

Source: Company data

BBVA's previous strategy in the region was to acquire controlling stakes with local partners. As time passed, it acquired controlling stakes in almost every bank and currently has less than a 60% stake in BBVA Bancomer and Banco Provincial (Venezuela). This low-risk strategy limited losses at times of crisis (as in the case of Argentina, explained on page 50).

Fig 91 BBVA's stakes in LatAm banks

	Stake (%)
BBVA Frances	80
GF BBVA Bancomer	59
Banco Uruguay	100
Banco Ganadero	95
Banco BHIF	66
AFP Provida	64
Banco Provincial (Venezuela)	56
Banco Continental	92
BBVA Puerto Rico	100

Note: As of 2002 except for Bancomer (September 2003)
Source: Company data

Latin America represents 49% of total net profit …

… Mexico and Venezuela represent c70% of the region

Unlike Santander but like HSBC and ABN Amro, there is no equilibrium regarding the contribution of different countries within Latin America. The two most relevant contributors to net profit are Mexico and Venezuela with c70% of the region's total profit, the rest is split between the different banks, asset management, insurance companies and international private banking.

Fig 92 Contribution to net profit by country (€m)

	2002	% of total
Mexico	437	59
Chile	15	2
AFP Provida (Chile)	32	4
Puerto Rico	44	6
Venezuela	81	11
Peru	8	1
AFP Horizonte (Peru)	13	2
Colombia	-12	-1
Other banks	5	1
AFP Porvenir	10	1
Brazil	27	4
Other fund managers and insurers	74	10
Total	**735**	

Source: Company data

Mexico

BBVA's Mexican subsidiary is the jewel of its Latin American subsidiaries. Despite having a stake of just over 50% in the company, it contributed c60% of total Latin America net profit in 2002. Bancomer is the leader in its market and the stake was acquired in 2000 when BBVA merged BBVA Probursa with Grupo Financiero Bancomer and simultaneously took a stake in the company through a capital increase.

BBVA has a leading position

Bancomer, together with Grupo Banamex, is the leader in Mexico with a c50% market share of total loans and deposits. Up until now, Bancomer's strategy has been to improve efficiency following its integration with BBVA Probursa and Promex. Costs in 2003 have continued to fall (by 3.5% as of 1H03).

Bancomer currently has two challenges: defending market share in a low interest-rate environment and growing volumes in a market that for years has offered promise. For the moment, the company is performing well with stable net interest margins and lending to the private sector growing at 3.6% (18.2% in consumer loans, 2.3% in mortgages and 1.0% in commercial lending as of 1H03). This growth is slightly below the target set up at the beginning of the year but is being more than compensated for by the good performance in commissions and costs.

Fig 93 BBVA Bancomer target growth rates (2003) (%)

	Company	As of 1H03
Loans (ex UDIs and Fobaproa)	4-6	3.6
Fees and commissions	6-8	9.1
Costs	Flat to -2	-3.1
Operating income	10	7.5

Source: Company data

The company states that NIM will be stable in 2H03 …

Although these targets are being mostly achieved, the market has doubts regarding the impact of falling rates on Bancomer's P&L. However, in 2Q03, we did not see any margin deterioration and, in fact, Bancomer's NIM rose from 5.0% to 5.1%. The company's guidance is that the margin in 2H03 will be flat or 20bp above the current level, despite the fall in interest rates. Bancomer's management also warned that 3Q03 net interest income will be the lowest in a year. The larger-than-expected fall of CETEs rates creates doubt as to the sustainability of these margins as the company was forecasting a recovery in their rate to 6.5% by the year-end and that rate is currently 4.7%. For the moment, we give management the benefit of the doubt as it has an excellent track record. The group is taking measures to offset margin pressure like transferring time deposits into demand deposits, changing the mix of lending and more active asset and liability management. That would help keep the NIM level stable and, due to volume growth, we forecast a 12.8% rise in net interest income in 2003F, but for 2004F and 2005F we expect 8.8% and 6.6%, respectively.

… although CETEs continue to fall

Dividend policy

We expect Bancomer to pay a dividend, although the payout ratio is not yet fixed

As we have previously stated, BBVA Bancomer's challenges are volume growth and margin defence. The capital situation, on the contrary, is relatively comfortable with a Tier 1 ratio that reached 12.6% (up from 8.8% one year earlier) and strong capital generation because taxes paid are very low due to the P23bn tax shield still existent. Consequently, it is possible that the company could start paying a dividend, which will be decided at its AGM.

Fig 94 Bancomer forecasts (Pm)

	1998	1999	2000	2001	2002	2003F	%ch	2004F	%ch	2005F	%ch
Interest income	52,110	56,730	62,867	58,566	48,881	51,401	5	45,081	-12	47,330	5
Interest expense	(39,792)	(41,611)	(46,008)	(38,974)	(30,464)	(30,630)	1	(22,485)	-27	(23,241)	3
Net interest income	**12,318**	**15,119**	**16,859**	**19,592**	**18,417**	**20,770**	**13**	**22,596**	**9**	**24,089**	**7**
Loan loss provisions	(3,696)	(5,168)	(3,421)	(2,480)	(2,697)	(3,978)	47	(3,668)	-8	(4,181)	14
Commissions income	5,042	5,883	8,332	10,168	12,137	12,976	7	14,143	9	15,558	10
Trading income	(297)	1,456	142	2,040	1,074	1,014	-6	1,286	27	1,982	54
Total operating revenue	**13,367**	**17,290**	**21,912**	**29,320**	**28,931**	**30,781**	**6**	**34,357**	**12**	**37,448**	**9**
Total operating expenses	(13,609)	(14,668)	(18,526)	(19,974)	(18,521)	(18,592)	0	(19,927)	7	(20,896)	5
Non-operating income (expense)	(484)	(51)	(772)	(284)	(225)	(803)	N/M	(800)	0	(800)	0
Inflation gain/loss	1,646	1,303	1,194	694	12	(389)	N/M	(389)	0	(389)	0
Pre-tax profit	**920**	**3,874**	**3,808**	**9,756**	**10,197**	**10,998**	**8**	**13,241**	20	**15,363**	16
Taxes	1,007	(281)	(524)	(3,329)	(3,111)	(3,487)	12	(4,199)	20	(4,872)	16
Associates	(551)	76	(76)	33	(198)	122	N/M0	128	5	200	57
Minority interest	(247)	(241)	(307)	(212)	(227)	(149)	-34	**(265)**	77	**(307)**	16
Extra-items	(232)	0	(1,221)	(157)	0	0		**0**		**0**	
Net income	**897**	**3,428**	**1,680**	**6,091**	**6,661**	**7,482**	**12**	**8,905**	19	**10,384**	17

Source: Company data, ING forecasts

Venezuela

Venezuela is the second-largest contributor to group net profit

Venezuela was the second-largest net profit contributor (11%) to BBVA's Latin American franchise in 2002. In 2003, and despite volatility in the currencies market and a currency control system, Banco Provincial has remained an important contributor to BBVA (€40m in 1H03). As we mentioned above, Venezuelan banks' net profits are large relative to the size of the banking market due to high interest rates and an unsustainable exchange rate (Bs1,598/US$). We think that sooner or later the political risks will have an impact on profitability. Fortunately for BBVA, its exposure to Venezuela is very limited and all of the goodwill has been amortised. It also keeps a structural position in US dollars to hedge against depreciation of the bolivar, although it is much smaller than at Santander because local regulations limit US dollar positions to 15% of equity (which is cUS$50m).

Fig 95 Exposure in Venezuela (€m)

Historical investment Venezuela	570
Equity	330
Goodwill	0
Net profit 2002	80
Net profit 1H03	40

Source: Company data

Although Venezuela represents roughly the same percentage of operating profit in BBVA and Santander, Santander has a larger exposure because BBVA's stake in Provincial is less than 60%.

Fig 96 Comparison of BBVA's and Santander's exposure (€m)

	1999	2000	2001	2002	1H03
Banco Provincial					
Net profit	84	81	82	81	40
% of total	*4.8*	*3.7*	*3.5*	*4.7*	*3.4*
Operating profit	161	175	264	314	110
% of total	*4.7*	*4.0*	*4.7*	*5.6*	*4.4*
Banco Santander Venezuela + Caracas					
Net profit	113.5	115.1	144	159	52
% of total	*7.2*	*5.1*	*5.8*	*7.1*	*4.0*
Operating profit	149	138	270	343	107
% of total	*4.3*	*2.9*	*4.5*	*6.2*	*3.7*

Source: Company data

Argentina

We estimate total exposure of US$1.9bn …

Just like Banco Santander, BBVA Francés responded to the default of Argentinian government debt and unequal pesification by creating a €1.387bn provision to cover the equity of the group and goodwill in AFP Consolidar and BBVA Francés, where the bank currently holds an 80% stake. However, this was not the bank's only exposure to Argentina and we have tried to summarise BBVA's exposure according to the 20F report considering not only equity and goodwill, but also subordinated debt, country risk, bonds held and bought in 2002 (due to a repo agreement) and additional credit lines provided to BBVA Francés in 2002. All in all, we estimate that BBVA's exposure to Argentina was c€1.9bn, above our initial estimates.

Fig 97 Exposure of BBVA to Argentina

	Amount (€m)
Equity Francés + Consolidar	715
Goodwill	365
Subordinated debt	170
Country risk	34
Bonds held at group level	92
Additional bonds (2002)	99
Intra-group exposure (2002)	80
Cross border risk	377
Total	**1,932**

Source: Company data, 20 F

… and the group has recorded provisions and charges for US$1.9bn

BBVA responded to this exposure by creating provisions and charging the currency impact to the group's reserves.

Fig 98 Provisions related to Argentina

Provisions, write-offs & other impacts	Amount (€m)
2001	
Provisions for equity (Francés Group)	447
Provisions for subordinated debt	170
Country risk provisions	34
Provisions for government debt at group level	92
Effect through reserves 2001	469
Goodwill written off for Banco Francés	242
Goodwill written off for Consolidar	123
2002	
Provisions for intra-group exposure	171
Provisions for cross-border loans	175
Charges to reserves	not released
Total	**1,923**

Source: Company data, 20 F

Argentina also had an impact on BBVA's accounts during 2003, as the bank has to raise €261m provisions for general risks and applied it to country risk provisioning. The reason for this extra provisioning was the accounting rules of Bank of Spain relating to country risk (loans to Argentinians with not sufficient collateral). However, as we have tried to demonstrate, all the risks have already been provisioned. BBVA was just using excess provisions on equity (as equity has been reduced because of charges to reserves related to currency depreciation) to cover country risk.

Chile

BHIF is a second tier in the country …

BBVA has been present in this country since 1998, when it acquired a 55% stake in Banco BHIF, this acquisition was complemented in 1999 with the acquisition of AFP Provida, one of the largest mutual and pension fund manager in the region. Even though the bank is not the market leader, it has an aggressive strategy to grow organically.

… although the bank has improved its market share in the past two years …

We believe that the operating evolution of BHIF in the coming years will determine the future presence of BBVA in Chile. We think that BHIF has several advantages in this context:

- The merger of Banco Santiago and Banco Santander will help BHIF make further improvements in market share, especially in loans and deposits, although mutual and pension funds will also have room for improvement.

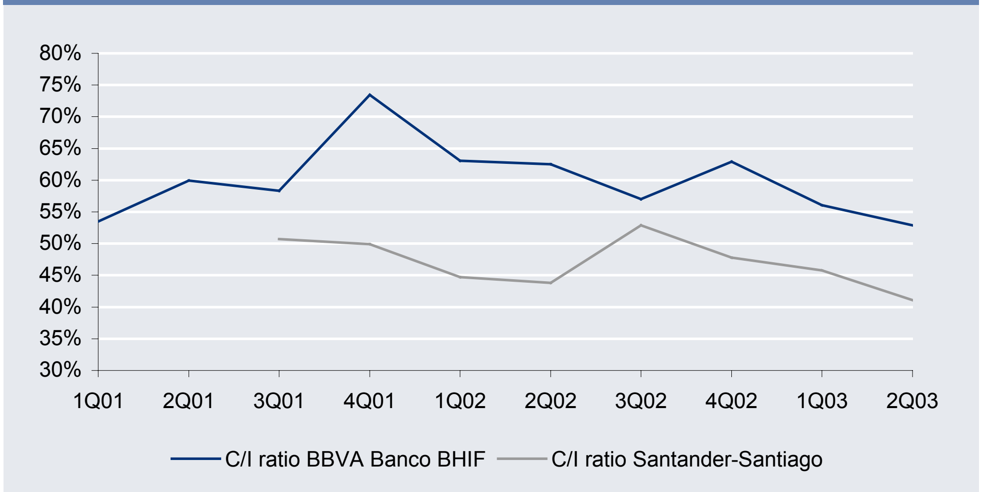
… and implemented several measures to maintain organic growth

- Efficiency ratios are high in a sector context, some measures have been undertaken although there is already some room for further improvement (the cost-income ratio in 4Q02 was 62.9% and in 2Q03 it was 52.9%).

BBVA stated that its strategy will be to focus on organic growth, in fact, the bank has increased market share by 2% in loans in the past two years. However, the sustainability of this strategy may be difficult given the fact that Banco BHIF benefited from the adjusting process that Banco de Chile and Banco Santander-Santiago experienced after the mergers (in 2001 there were two mergers, one among the first and second players and another between the third and fourth). We believe that looking forward, especially during 2004, BHIF will face more difficulties gaining market share.

All in all, we believe there is room for further improvement in the bank's profitability, given the low ROE compared with regional peers. The reason for this low ratio is that BBVA had to undertake several measures in order to reach the group standard. After these cleaning measures, management expects BHIF's ROE to be close to 17% by 2005.

Fig 99 Quarterly cost-income ratio evolution (1Q01-2Q03)



Source: Company data

BBVA is the leader in asset gathering activities with a 32% market share

On the asset gathering side, BBVA has a leading position, with 32% market share in mutual and pension funds. Provida will play an important role in the cross-selling strategy. However, only initial steps for the synergies have been made and there are also several legal constraints to the strategy.

Brazil

In January 2003, BBVA announced the sale of BBV Brazil to Banco Bradesco, SA. BBVA has been present in Brazil since 1998, after the US$850m acquisition of Banco Excel.

The main points of the strategic agreement were:

- BBVA's Brazilian banking and insurance business activities, conducted by BBV Banco and its affiliates, have been integrated with Bradesco by transferring all BBV Banco shares held by BBVA to Bradesco.
- In exchange, BBVA received newly issued ordinary shares and preference shares in Bradesco, totalling 4.5 % of its share capital, as well as approximately US$595m in cash.
- Under the agreement, BBVA was entitled to appoint a member to Bradesco's board of directors. A unit to develop joint businesses between Bradesco and BBVA has also been created.

The transaction made sense for BBVA given the fact that the bank did not have critical mass (being the sixteenth-largest bank by assets in the country with less than 1% market share of total loans) to build up a profitable franchise in the country. As competition is tough with both local (Bradesco, Itau and Unibanco) and foreign (Banespa and Banco Real) competitors, the sale was the best solution, given that further investment in the country should be relevant in terms of price. Maintaining BBV Brazil's status within the banking sector was unsustainable.

Fig 100 Ranking of Brazilian banks by assets (US$000)

Ranked	Bank	Total assets	Total deposits	Net worth	Net profit
1	BB	57,904,681	27,524,784	2,602,967	340,915
2	BNDES	42,733,157	3,414,251	3,495,385	(7,596)
3	CEF	36,345,041	21,681,234	1,309,858	146,225
4	BRADESCO	34,487,131	16,034,112	3,108,231	312,274
5	ITAU	30,486,095	11,187,622	3,034,898	354,149
6	UNIBANCO	20,066,927	7,446,972	1,884,227	152,421
7	SANTANDER BANESPA	15,457,336	5,487,950	1,675,310	418,993
8	ABN Amro	10,309,907	4,466,715	1,634,684	126,168
9	CITIBANK	7,995,663	418,224	1,045,284	262,699
10	NOSSA CAIXA	8,097,996	5,119,507	383,314	28,481
11	HSBC	7,005,879	3,642,495	381,829	22,789
12	BANKBOSTON	6,898,001	986,995	683,819	105,234
13	SAFRA	7,462,649	2,137,765	671,046	85,172
14	VOTORANTIM	5,320,061	2,074,475	493,009	78,792
15	SUDAMERIS	4,547,762	1,620,030	391,529	25,467
16	**BILBAO VIZCAYA**	**4,032,578**	**1,777,304**	**729,34**	**42,086**
17	BANRISUL	3,171,214	1,888,659	196,129	26,754
18	BNB	3,119,939	870,569	331,21	38,294
19	JP MORGAN CHASE	2,545,591	50,165	381,557	40,655
20	LLOYDS	2,319,740	173,459	259,821	51,977
21	SANTOS	1,523,372	323,544	118,978	12,185

Source: Central bank of Brazil

Other countries

BBVA's franchise in the region also consists of stakes in Colombia, Peru, Panama and Puerto Rico. BBVA provides independent figures for Banco Ganadero (Colombia), Banco Continental (Venezuela) and BBVA Puerto Rico.

Banco Ganadero represented 12% of total investment in the region, while the bank had €12m losses in 2002. BBVA has a leading position within the country and we expect it could contribute to net profit with €10 during 2003F. Banco Continental is the group's franchise in Peru, the bank has been present in the country since 1996. Although its contribution to net profit has been scarce during 2002, in 1H03 the bank performed very well. However, we consider that the country's size and the current political situation make Peru not so relevant.

Fig 101 Banco Ganadero, Continental, rest of banks (€m)

	Net profit	Loans
Banco Ganadero	(12)	990
Banco Continental	8	1,594
BBVA Puerto Rico	42	2,461
Rest of banks	4	839

Source: Company data

Conclusions

BBVA's Latin American franchise is widespread across the region, but excludes Brazil. However, it is not as homogeneous as Santander's and Mexico's weighting is quite relevant (Mexico represented c60% of Latin American net profit in 2002 including the asset management companies).

Although in the short term we can consider the presence in Mexico as a weakness (now that the currency is depreciating and Bancomer is not growing as fast as the rest due to its high market share), in the long term it should to be BBVA's main advantage. This is because we think Mexico offers huge growth potential due to its low loan/GDP ratio, also the banking market is clean after the 1994 crisis and the economy has already reached an interest rate level comparable with those of any developed country. Consequently, margins have already (or are still) the effect of falling rates, but volume growth offers huge potential. In 2002, household lending grew 23% and as of May 2003 it was still growing at rates of 23% YoY. Bancomer has suffered from market share losses due to a high market share and because it had been concentrating on managing the merger and improving its cost-income ratio (which in 2000 was 84% and we estimate could finish this year at 60%).

Short term, we perceive a substantial political risk in Venezuela that could translate into a substantial fall in the profit contribution from this country at some moment during 2004F. In 2002, Venezuela represented 11% of group profit in the region. Risks in these cases are usually larger than initially estimated and, although the book value of Banco Provincial is €330m, we must remember that in Argentina every bank lost more than anybody initially estimated. For example, we estimate BBVA's exposure to Argentina increased from €1.1bn to c€1.9bn due to cross border, intra-group exposure and bonds held at group level plus injections of capital later in 2002.

All in all, we think there are substantial risks in the short term, including the situation in Venezuela and the impact of the fall in rates and the depreciation of the Mexican peso. However, in the long term BBVA is the best way to benefit from the growth we expect in Mexico without having substantial exposure to the rest of the region.

BBVA's Latin America forecasts

Fig 102 BBVA Latin America (€m)

	1997	1998	1999	2000	2001	2002	2003F	%ch	2004F	%ch	2005F	%ch
Net Interest Income	**1,410**	**2,240**	**2,319**	**3,583**	**4,841**	**3,948**	**3,006**	**-23.9**	**3,017**	**0.4**	**2,952**	**-2.2**
Fees and commissions	420	674	900	1,419	2,178	2,046	1,701	-16.9	1,732	1.8	1,733	0.1
Recurrent revenue	**1,830**	**2,914**	**3,219**	**5,002**	**7,019**	**5,994**	**4,707**	**-21.5**	**4,749**	**0.9**	**4,685**	**-1.3**
Trading profit	162	145	258	329	323	382	310	-18.8	309	-0.5	306	-0.8
Total operating income	**1,992**	**3,059**	**3,477**	**5,331**	**7,342**	**6,376**	**5,017**	**-21.3**	**5,057**	**0.8**	**4,991**	**-1.3**
Personnel expenses	(575)	(884)	(1,164)	(1,716)	(2,107)	(1,651)	-1,274	-22.8	(1,272)	-0.2	(1,237)	-2.7
General expenses	(539)	(842)	(946)	(1,355)	(1,668)	(1,280)	-974	-23.9	(974)	-0.1	(944)	-3.0
Depreciation	(119)	(166)	(231)	(360)	(431)	(334)	-252	-24.5	(259)	2.7	(269)	3.7
Other op. expenses	(37)	(84)	(97)	(107)	(218)	(185)	-165	-11.0	(173)	5.0	(182)	5.0
Operating profit	**722**	**1,083**	**1,039**	**1,793**	**2,918**	**2,926**	**2,351**	**-19.6**	**2,379**	**1.2**	**2,359**	**-0.9**
Loan loss provisions	(290)	(413)	(471)	(636)	(1,358)	(991)	-646	-34.8	(628)	-2.7	(474)	-24.5
Net operating profit	**433**	**670**	**568**	**1,157**	**1,560**	**1,935**	**1,705**	**-11.9**	**1,751**	**2.7**	**1,884**	**7.6**
Associates income	8	34	6	2	17	22	20	-9.1	20	0.0	20	0.0
Other results	(63)	(186)	(216)	(307)	(741)	(373)	0	N/M	0	N/M	0	N/M
Pre-tax profit	**377**	**519**	**357**	**852**	**836**	**1,584**	**1,725**	**8.9**	**1,771**	**2.7**	**1,904**	**7.5**
Taxes	(83)	(104)	(15)	(150)	(84)	(318)	(380)	19.4	(390)	2.7	(419)	7.5
Net profit	**294**	**415**	**342**	**702**	**752**	**1,266**	**1,346**	**6.3**	**1,381**	**2.7**	**1,486**	**7.5**
Minority interests	(165)	(143)	(79)	(229)	(306)	(511)	(511)	0.1	(511)	-0.1	(550)	7.5
Net attributable profit	**129**	**272**	**263**	**473**	**446**	**755**	**834**	**10.5**	**870**	**4.3**	**936**	**7.5**

Note: Old BBVA America until 2000, new America from 2001. Includes Brazil and Argentina.

Source: Company data, ING estimates

Fig 103 BBVA Group P&L (€m)

	2001	2002	%ch	2003F	%ch	2004F	%ch	2005F	%ch
Net interest income	**8,824**	**7,808**	**-11.5**	**6,655**	**-14.8**	**6,844**	**2.8**	**7,002**	**2.3**
Fees and commissions	4,038	3,668	-9.2	3,240	-11.7	3,367	3.9	3,469	3.0
Recurrent revenue	**12,862**	**11,476**	**-10.8**	**9,895**	**-13.8**	**10,210**	**3.2**	**10,471**	**2.6**
Trading profit	490	765	56.1	780	2.0	736	-5.7	759	3.2
Total operating income	**13,352**	**12,241**	**-8.3**	**10,675**	**-12.8**	**10,946**	**2.5**	**11,230**	**2.6**
Personnel expenses	(4,243)	(3,698)	-12.8	(3,249)	-12.1	(3,289)	1.2	(3,297)	0.2
General expenses	(2,482)	(2,074)	-16.4	(1,733)	-16.4	(1,749)	0.9	(1,736)	-0.7
Operating expenses	**(6,725)**	**(5,772)**	**-14.2**	**(4,982)**	**-13.7**	**(5,038)**	**1.1**	**(5,033)**	**-0.1**
Depreciation	(741)	(631)	-14.8	(523)	-17.0	(539)	2.9	(560)	3.9
Other operating expenses	(286)	(261)	-8.7	(240)	-8.0	(252)	5.0	(265)	5.0
Operating profit	**5,599**	**5,577**	**-0.4**	**4,930**	**-11.6**	**5,117**	**3.8**	**5,373**	**5.0**
Loan loss provisions	(1,919)	(1,743)	-9.2	(1,614)	-7.4	(1,528)	-5.3	(1,410)	-7.7
Net operating profit	**3,680**	**3,834**	**4.2**	**3,316**	**-13.5**	**3,589**	**8.2**	**3,963**	**10.4**
Associates income	393	33	-91.6	297	800.7	312	5.0	328	5.0
Contribution from group ops	954	361	-62.2	300	-16.9	100	N/M	0	N/M
Goodwill amortisation	(623)	(679)	9.0	(600)	-11.6	(300)	N/M	(250)	-16.7
Extraordinaries	(770)	(430)	-44.2	160	N/M	0	N/M	0	N/M
Pre-tax profit	**3,634**	**3,119**	**-14.2**	**3,473**	**11.4**	**3,701**	**6.6**	**4,040**	**9.2**
Taxes	(625)	(653)	4.5	(695)	6.4	(740)	6.6	(808)	9.2
Net profit	**3,009**	**2,466**	**-18.0**	**2,779**	**12.7**	**2,961**	**6.6**	**3,232**	**9.2**
Minority interests	(646)	(747)	15.6	(655)	-12.3	(668)	2.1	(709)	6.1
Net attributable profit	**2,363**	**1,719**	**-27.3**	**2,124**	**23.5**	**2,293**	**8.0**	**2,523**	**10.1**

Source: Company data, ING estimates

Fig 104 BBVA Group balance sheet (€m)

	2001	2002	2003F	2004F	2005F
Cash and central banks	9,240	8,050	8,050	8,050	8,050
Inter-bank assets	23,199	21,476	21,476	21,476	21,476
Loans	150,220	141,315	146,425	155,204	165,696
Fixed-income securities	81,816	68,901	71,582	74,357	77,854
% of total assets	*26*	*25*	*25*	*25*	*25*
Equity securities	11,430	10,071	9,064	8,611	8,611
Total earnings assets	**275,905**	**249,813**	**256,597**	**267,698**	**281,687**
Non interest-earning assets	33,341	29,729	29,729	29,729	29,729
Total assets	**309,246**	**279,542**	**286,326**	**297,427**	**311,416**
Inter-bank liabilities	64,588	56,119	49,584	69,409	72,319
Customer deposits	166,499	146,560	155,772	142,788	149,127
Loan to deposit ratio (%)	*90*	*96*	*94*	*92*	*90*
Bonds and other marketable debt secs	25,376	27,523	30,275	33,303	36,633
Subordinated debt	7,611	6,487	6,487	6,487	6,487
Total interest-bearing liabilities	**264,074**	**236,689**	**242,118**	**251,986**	**264,566**
Non-interest-bearing liabilities	20,923	19,221	19,221	19,221	19,221
Equity	24,538	23,632	24,987	26,220	27,629
Total liabilities	**309,246**	**279,542**	**286,326**	**297,427**	**311,416**

Source: Company data, ING estimates

Fig 105 BBVA main ratios (%)

	2001	2002	2003F	2004F	2005F
Main ratios					
Net interest margin group	3.24	2.94	2.64	2.55	2.46
Cost/Income America	49	43	41	40	39
Cost/Income group	50	47	46	45	44
Profitability ratios					
EPS (€)	0.86	0.77	0.72	0.78	0.86
ROA	0.98	0.81	0.97	0.88	0.90
ROE	22.4	16.4	17.0	14.8	14.5
Yield	4.9	4.5	4.5	5.1	5.4
Risk & capital ratios					
Risk premium group	0.5	0.7	0.6	0.6	0.6
Risk premium America	3.4	3.3	2.5	2.4	1.8
NPL ratio group	0.88	0.81	1.00	1.25	1.45
NPL ratio America	3.1	6.5	7.0	5.9	4.4
Tier 1	8.5	8.4	9.4	9.8	10.2
BIS ratio	12.6	12.5	13.4	13.7	13.8

Source: Company data, ING estimates

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HSBC

Going again in LatAm

Maintained

Hold

17 October 2003

Est fair value

775p

Banks

13/10/03

857p

Bloomberg

HSBA.LN / 5 HK

HSBC's Latin American operations have been a source of great pain and minimal profits over the past few years, but a revamp of the group's strategy bodes quite well for the future viability of the business.

Anni Horribili. HSBC's LatAm operations have lost a collective US$708m since their inception in 1996 by our calculations (the company no longer presents Latin figures together, but as part of both North and South America) on over US$3.7bn of investment – clearly a dismal record.

But don't give up. Nevertheless, we think that HSBC's repositioning as a mass consumer bank in LatAm is a winning strategy, especially when the group will now be able to bring to bear the expertise of both Household and Losango.

Focus on Mexico and Brazil. Management appears to be most excited about Mexico and Brazil, naming them as two of four markets (the others being China and India) where its intends to focus its growth efforts. We see Mexico, in particular, as a ripe market for consumer lending – although our doubts about the Bital platform have not been completely allayed. Our Hold recommendation is based on our LEFAC-derived fair value of 775p.

Forecasts and ratios

	Net int income (US$m)	Core earnings (US$m)	Net profit (US$m)	EPS (US$)	Core EPS (US$)	EPS growth (%)	PER (x)	DPS (US$)	Yield (%)
2004F	23,091	10,986	8,976	0.84	1.03	15.9	16.7	0.60	4.3
2003F	22,048	9,803	7,745	0.72	0.92	9.9	19.3	0.56	4.0
2002	15,460	7,590	6,239	0.66	0.80	23.3	21.2	0.53	3.8
2001	14,725	6,208	4,992	0.53	0.66	-45.3	26.2	0.48	3.4
2000	13,723	7,643	6,457	0.70	0.82	-21.9	20.1	0.43	3.1

Source: Company data, ING estimates

Key ratios (%)

	2002	2003F	2004F
ROE	11.91	11.17	12.48
Core ROE	14.48	14.14	15.28
ROA	0.86	0.96	1.02
Core ROA	1.04	1.21	1.25
NIM	2.44	3.11	2.99
Cost/Income	54.91	52.22	51.09
Overhead	2.36	2.79	2.59
NPLs/total loans	2.63	2.43	2.27
BVPS (HK$)	5.53	6.47	6.71
Price/book (x)	2.53	2.16	2.08

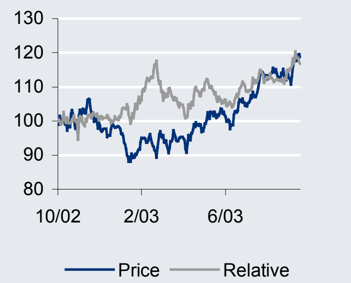
Performance (%)

	1m	3m	12m
Absolute	6.5	16.1	24.6
Relative to FTSE	3.3	8.4	13.3

Share data

Market cap (US$m)	149,712
Number of shares (m)	10,713
Daily turnover (US$m)	491
Free float (%)	100.0
52-week high/low	631/857p

Share price performance (rebased)



Source: Bloomberg

Recent entry

HSBC's presence in Latin America is a fairly recent one, as the group's first major step was its entry to Brazil and Argentina in 1997, via the purchases of Bamerindus and Banco Roberts, respectively. HSBC has continued to grow by acquisition, acquiring at various points over the past five years Mexico's Banco Serfin (later returned to the government) and Grupo Bital, Chase Manhattan's Panamanian assets and, most recently, the Brazilian business (primarily consumer lender Losango) of Lloyds TSB.

In general, HSBC has not been successful at getting value for its LatAm investment dollar; nevertheless the bank has continued to emphasise its commitment to the region – and most specifically to Mexico and Brazil.

We believe that the group may finally have hit on something with its accelerated plan to transfer recently acquired consumer lender Household International's expertise in low-income lending in the US to HSBC's platforms in Mexico and Brazil, with the latter also benefiting from the just-announced acquisition of Losango from Lloyds TSB.

Fig 106 HSBC's major LatAm acquisitions

	Investment (US$m)	Date	Country
Banco Roberts	633	Aug-97	Argentina
Bamerindus	1,000	Mar-97	Brazil
Banco Serfin (later sold)	174	Dec-97	Mexico
Chase Manhattan (Panama)	107	Feb-00	Panama
Grupo Bital	1,140	Dec-02	Mexico
Losango and Lloyds Brazil	815	Pending	Brazil

Source: Company data, ING estimates

The potential to tap an expanding bankable population in these markets is just beginning; by some accounts only 40% of Brazil's working population now have existing bank relationships.

However, in order to have a materially positive impact on group results, we will need to see significantly improved execution on the ground. This is by no means an easy task given that HSBC is competing in these markets against the likes of Citibank, Bank of America, Santander and BBVA – not to mention the frequently far-from-clueless local players.

Share of group profits

Latin America has generally been an insignificant contributor to HSBC group earnings – except in years when it contributes large losses. The peak for LatAm in both aggregate contribution and share of the group total was in 1999, when both Brazil and Argentina were at peak profitability. Note that this peak was only 4% of group pre-tax profits – an important swing factor perhaps but not otherwise predictive of overall performance.

Fig 107 Pre-tax contribution by market (US$m)

	1996	1997	1998	1999	2000	2001	2002	1H03
Europe	2,368	3,201	2,884	3,322	3,658	3,542	3,500	1,869
Hong Kong	2,775	3,246	2,427	3,054	3,691	3,883	3,710	1,840
Rest of Asia Pacific	1,101	651	39	329	1,265	1,088	1,260	734
North America	792	950	987	959	850	481	1,928	1,463
Latin America	16	82	234	318	311	(994)	(748)	206
Total	**7,052**	**8,130**	**6,571**	**7,982**	**9,775**	**8,000**	**9,650**	**6,112**

Source: Company data, ING estimates

Fig 108 Pre-tax contribution by market (% of total)

	1996	1997	1998	1999	2000	2001	2002	1H03
Europe	33.6	39.4	43.9	41.6	37.4	44.3	36.3	30.6
Hong Kong	39.4	39.9	36.9	38.3	37.8	48.5	38.4	30.1
Rest of Asia Pacific	15.6	8.0	0.6	4.1	12.9	13.6	13.1	12.0
North America	11.2	11.7	15.0	12.0	8.7	6.0	20.0	23.9
Latin America	0.2	1.0	3.6	4.0	3.2	-12.4	-7.7	3.4
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Company data,

Change in earnings presentation and disclosure

At FY02, HSBC changed its geographical segment reporting, replacing Latin America with South America, which largely consists of Brazil and Argentina. Mexico and Panama have become part of North America under this new HSBC nomenclature, which tends to obscure their performances given their small size compared with other US and Canadian businesses. This also makes historical comparisons of LatAm returns very difficult.

For this reason, we have attempted to continue measuring Latin American operations, restoring Mexico and Panama to their former category. Note that we inevitably exclude the non-Bital Mexican operations of HSBC under this framework; we do not believe that these are significant enough to invalidate our conclusions, but it bears further scrutiny.

Below are details of pre-tax earnings components for both current reported basis (South America) and the old reported basis (Latin America) as per our adjustments.

Fig 109 Key earnings components – HSBC South America (US$m)

	1H02	2H02	2002	1H03
Net interest income	396	249	645	252
Non-interest income	362	234	596	330
Non-interest expenses	577	483	1,060	431
Goodwill amortisation	5	19	24	3
Provisions	129	87	216	66
Disposals and other	33	(32)	1	(15)
Pre-tax profit	80	(138)	(58)	67

Source: Company data, ING estimates

Fig 110 Key earnings components – HSBC Latin America (US$m)

	1998	1999	2000	2001	1H02	2H02	2002	1H03
Net interest income	1,195	1,097	1,219	1,113	423	683	1,510	729
Non-interest income	912	790	953	919	375	549	1,156	647
Non-interest expenses	1,707	1,440	1,635	1,549	602	1,380	2,514	924
Goodwill amortisation	4	10	13	17	6	19	24	3
Provisions	193	133	204	940	127	621	877	228
Disposals and other	-	-	-	(520)	(12)	(32)	1	(15)
Pre-tax profit	203	304	320	(994)	51	(820)	(748)	206

Source: Company data, ING estimates

Fig 111 Profit before tax – cash basis (US$m)

	1H00	2H00	1H01	2H01	1H02	2H02	1H03
Brazil	124	84	98	38	79	48	46
Argentina	62	50	39	(1,191)	(50)	(160)	19
Chile	8	-	15	2	62	NA	NA
Mexico	5	4	8	6	(1)	(692)	132
Panama	4	(2)	7	4	(27)	10	8
Other LatAm	(4)	(11)	4	(7)	(6)	(7)	5
Total	**199**	**125**	**171**	**(1,148)**	**57**	**(801)**	**209**

Note: Half-year results for individual markets are based on ING estimates and do not necessarily sum to FY regional pre-tax due to constant currency calculation differential and changes in presentation.

Source: Company data, ING estimates

Disclosure

We note with some displeasure that HSBC's disclosure on Latin America has actually become scantier since the recent crisis. In particular, we note that Bital, which used to publish detailed quarterly figures in both Spanish and English, now produces only a five-page English 'highlights' release, and even the Spanish releases have less than half of their earlier heft.

Returns

Immediate profitability has recovered

LatAm's profitability recovered in 1H03 as measured by pre-tax ROA (taxation is done at the corporate level and internal transfer pricing tends to skew post-tax assessments). HSBC earned a 1.6% ROA in the first half, up sharply from 0.78% in 1H02 and a substantial loss in 2H02 (mainly extra Bital provisions post takeover).

Although translating this into a return to shareholders is difficult given that capital is fungible, we assume a tax rate of 25% and a marginal Tier 1 capital ratio for these assets of 8%, which yields an ROE of 15% – higher than the group as a whole and a respectable return.

Fig 112 Pre-tax ROAA (annualised) (%)

	FY96	FY97	FY98	FY99	FY00	FY01	FY02	1H02	1H03
Europe	1.82	2.05	1.62	1.65	1.44	1.19	1.09	1.18	1.00
Hong Kong	2.32	2.18	1.46	1.94	2.16	2.20	2.08	2.14	2.02
Rest of Asia Pacific	2.41	1.25	0.07	0.58	2.26	1.83	1.81	1.96	1.79
North America	1.58	1.40	1.36	1.10	0.75	0.38	1.47	0.84	1.49
Latin America	NA	0.89	2.04	2.00	1.72	-5.80	-3.69	0.78	1.59
Total	**1.87**	**1.86**	**1.38**	**1.54**	**1.60**	**1.18**	**1.34**	**1.42**	**1.42**

Source: Company data, ING estimates

But long-term returns have not been demonstrated

Encouraging 2003 interim results aside, HSBC's overall return in LatAm has been negative since inception by our calculations, with an aggregate loss of US$574m from 1996-1H03. Excluding the extraordinary effects of Argentinian pesification, the aggregate LatAm operations show a slight profit of approximately US$25m – still a slim return for 7½ years of operations and at least US$3.7bn of investment.

Focus on the consumer should help returns

We believe that HSBC's purchases of Bital and Losango, combined with the new products and ideas that Household can bring to the table, essentially amounts to a relaunch of the Latin American platform, with a consumer finance emphasis. Although execution is not a given, we believe that over the medium term this shift to consumer assets should produce a more stable and high-margin stream of income.

Brazil

Along with China, India and Mexico, HSBC's senior management has identified Brazil as one of the group's four focus markets for future growth. In its view, the market opportunity exists because of a rapidly expanding middle class, the majority of whom do not have existing banking relationships; we agree with this assessment but also believe that spreads in Brazil are wider than they will be at equilibrium, and tend to think that Mexico offers better growth potential.

HSBC's existing Brazilian operations are based on the former Bamerindus, which was acquired in 1997 for US$1bn. The HSBC Bank Brazilian platform now consists of approximately 1,600 branches servicing 3.75m customers, making HSBC the tenth-largest retail bank and third-largest foreign bank. Existing Brazilian assets are split relatively evenly between consumer and corporate lending, an aggregate US$3.1bn as of 1H03.

However, the game has changed in recent days as HSBC has finally concluded a long campaign to purchase the Brazilian assets of Lloyds TSB.

In addition to banking, HSBC has substantial interests in insurance (number seven in Brazil), asset management (number five) and investment and private banking (via Banco Múltiplo, the former Banco CCF Brasil).

Lloyds and Losango

HSBC has placed a successful bid (beating out Bradesco, among others) to purchase the Brazilian banking operations of Lloyds TSB, which were put up for sale in June. Lloyds reports total Brazilian exposure of £1.5bn (US$2.5bn) as of 1H03 – a sharp contraction from YE02 despite favourable exchange rates. Lloyds Brazilian assets are mainly retail based, with the Losango consumer finance unit making up the majority of the bank's assets in the country.

Losango's main businesses are auto finance and retail hire-purchase. Most of the company's business is originated through a network of 15,000 merchants, although Losango does operate more than 100 of its own offices and 'mega-stores' as well. The company also offers credit cards (both proprietary and Visa/MC), with over 2.5m cards outstanding in mid-2002.

Another popular product is payroll loans, which offer salaried employees small loans with the monthly repayments deducted directly from their salaries. With more corporate customers, and hence greater access to payroll accounts, we would expect HSBC to add to Losango's business in this area.

Losango's competitors include consumer lender Fininvest, a subsidiary of Unibanco, and BNP's Cetelem unit.

Pricing looks good

The reported price for these assets is US$815m, which would be approximately 5.3x Lloyds' annualised pre-tax profit of £46m on the Brazil book, based on 1H03 figures. Using HSBC's consolidated effective tax rate of 24%, this would value the deal at 7.0x earnings.

Falling rates, rising currency

However, bear in mind that 2003 interim results are likely to have been very strong due to falling interest rates throughout the period. Note that the benchmark SELIC rate peaked in February at 26.5% and has since fallen to 20%, potentially generating extraordinary gains. In addition, the Brazilian Real appreciated 20.3% in 1H03. Even so, we believe that this transaction is likely to be accretive to HSBC.

Why sell?

Lloyds is in the midst of a programme to divest most of its international businesses in order to focus on improving returns in its UK bank and insurance franchise. In line with this focus, the group sold its Brazilian fund management and private banking business, including its subsidiary Lloyds TSB Asset Management, to Banco Itaú in October 2001. Additionally, Lloyds has put its New Zealand banking subsidiary, National Bank of New Zealand, up for sale. Note that HSBC is also reported to be a potential bidder for this much larger business.

Argentina

Argentina has historically been the second most important market in LatAm for HSBC, producing 35% of regional pre-tax income as recently as 2000; however, crisis costs have turned the country into a source of critical concern and poor financial results.

Argentina's huge losses in FY01, amounting to some US$1.2bn, were caused by extraordinary provisions of US$600m and by a US$520m currency loss stemming from pesification. Although the initial crisis has abated and HSBC has been able to write back US$173m of its original general provision, risk in Argentina remains high and losses continued into 2H02 before recovering in 1H03.

We believe that the Argentinian operation – based around the Banco Roberts network acquired in 1997 – will take at least four years to regain its former size. However, once profitability begins to rebound HSBC should have room to increase its sustainable ROE, as many foreign players have exited the market entirely, and the remaining domestic financiers are capital-constrained.

Currently, HSBC Argentina has assets of approximately US$2.4bn, with loans totalling less than US$1bn of the balance sheet after heavy write-offs. This is still good enough in Argentina's parlous banking system to give the group eighth place by market share, with approximately 4.4% of total system assets.

Although it does not seem to be a focus for the group within LatAm, we were somewhat heartened by the appointment of Michael Budd as CEO of HSBCA in early 2003, given his experience in Brazil and various other widespread roles within HSBC.

Mexico

HSBC has completed its tender for and acquisition of the then-troubled Grupo Financiero Bital (Bital) in November 2002, acquiring 99.6% of the company for US$1.14b. Bital had little choice but to sell, as the group was operating under an agreement with Mexican regulators to raise its Tier 1 capital ratio to 8% by October 2002 and to 10% by that year-end (from 6.32% at 30 June 2002), which did not appear possible without outside assistance.

Subsequently, HSBC's management injected an additional US$800m into Bital to restore the bank's capital adequacy – double the US$400m we had anticipated – and allow for expansion of its operations. This brings the total purchase price to US$1.94bn, or some 2.38x pre-injection book value.

Post the takeover, HSBC now owns all of Mexico's fifth-largest bank. Note that this is HSBC's second foray into the market; the group purchased the rights to Banco Serfin from the government in 1997, only to return the bank to government hands (and receive a return of the purchase price) three years later due to persistent asset quality issues.

We are somewhat puzzled by the volte-face on Serfin, especially when coupled with the subsequent bid for Bital. Serfin is, in our opinion, a much more high-quality franchise than Bital, both operationally and in terms of credit and customer quality. However, it would appear that HSBC is aiming at a lower stratum of society for its customer base, targeting a similar style of lending to Household's sub-prime US business. This would have Bital competing more with small local lenders like Banco Azteca rather than with Banamex.

Fig 113 Key earnings components – Grupo Bital (US$m*)

	1999	2000	2001	1H02	2H02	2002	1H03
Net interest income	1,020	946	937	410	412	821	455
Non-interest income	460	427	550	232	303	538	308
Non-interest expenses	1,112	1,087	1,055	524	874	1,412	474
Goodwill amortisation	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Provisions	280	242	354	88	532	638	158
Disposals and other	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Pre-tax profit	89	43	79	30	(692)	(691)	132

*Based on conversion of MXN in constant currency terms
Source: Company data, ING estimates

An expensive transaction

It seems very safe to say that HSBC did not pay a bargain price for Bital either – particularly in light of the following Bank of America/Serfin transaction. Calculating the purchase price against Bital's fairly low historic earnings, as illustrated by the company's 3Q02 ROE of 0.33% and ROA of 5.8%, yields a valuation of almost 60x annualised 3Q02 earnings and 41x FY01 net profit. Even assuming that the injected capital earns an incremental 8% return – by no means a safe assumption if it is meant to write off bad assets – HSBC still paid 20x trailing earnings for Bital.

Fig 114 Valuation of Bital acquisition (US$m)

	3Q02	FY01	FY00
Purchase price			
Shares	1,135		
Capital injection	800		
Total	**1,935**		
Pre-injection equity	813		
Price/BV (x)	2.38		
Net income	24.6	47.1	43.6
PER, annualised (x)	59.07	41.05	44.37

Source: Company data, ING estimates

Expensive compared with Banamex and Serfin

Comparing the HSBC/Bital deal with Citibank/Banamex and BofA/Serfin, it appears that HSBC paid a substantially higher multiple on an earnings basis. Citibank paid 17x trailing earnings (based on the last reporting period before consolidation), and BofA paid 12.5x FY01 profit for Serfin, although admittedly not for a controlling stake.

Fig 115 Comparative Mexican bank acquisition valuations

	Bital	Serfin	Banamex
Acquirer	HSBC	BofA	Citi
Purchase date	Nov-02	Feb-03	Aug-02
Purchase price (US$bn)	1.94	1.60	12.50
Percentage stake (%)	*100*	*25*	*100*
P/BV (x)	2.38	3.21	2.82
PER (x)	47.14	12.47	17.34

Source: Company data, ING estimates

Household mitigates network disadvantage

We believe that both Citi and BofA have better ability to get value out of their Mexican franchises than does the existing HSBC USA platform, as they are already concentrated in the key California market (Citi added 335 branches in the state through its acquisition of Golden State Bancorp, while BofA has 948 branches and is number one in terms of deposit market share). California's large population of Mexican immigrants generates an increasing amount of cross-border financial activity, including a very lucrative remittance business with volume reported at US$9.3bn annually.

In contrast, HSBC's existing banking customers are concentrated in the Northeast (only four Californian offices) and have fewer connections with Mexico. However, HSBC's acquisition of Household International changed the group's profile quite significantly, adding at least 86 branches in California and over 70 in Texas, another state with large economic ties to Mexico. Here as well, however, BofA pulls ahead, with 455 branches and 12% deposit market share (number two).

It remains to be seen whether HSBC can tap the HI network for remittance and other business, but we think such cross-border business could add considerable value to Bital.

Panama

HSBC entered Panama in 1972, but was a relatively small player in the banking haven until May 2000, when the group acquired the branch operations of Chase Manhattan Bank (now JP Morgan-Chase). Although the purchase price was unstated, we believe that HSBC's total investment including recapitalisation amounted to US$107m.

At the time of acquisition, the Chase platform included US$752m in assets spread across 11 branches (seven in Panama City, two in Colon City, one in David and one in Chitre) and had book value of approximately US$27m. By comparison, HSBC then had five branches and total assets of US$477m.

The combined network of 16 outlets and US$1.3bn in assets now collectively operates as the Panama branch of HSBC Bank USA, the US-domiciled entity which includes the assets of the former Republic Bank and Marine Midland acquisitions. Because of this ownership, HSBC's Panamanian operations are reported under 'North America' in HSBC's disclosure rather than under 'Latin America' as they were until 2002.

However, using figures provided by the Panamanian regulatory authorities we can still break out separate figures for Panama; bear in mind that these may be skewed by the effect of assets originated in Panama but booked elsewhere.

Fig 116 Key earnings components – HSBC Panama (US$m)

	2000*	2001	1H02	2H02	2002	1H03
Net interest income	10.3	39.7	21.4	22.1	43.5	22.0
Non-interest income	5.5	16.5	9.9	12.7	22.6	8.3
Non-interest expenses	14.0	40.5	19.5	22.3	41.8	18.8
Goodwill amortisation	N/A	N/A	N/A	N/A	N/A	N/A
Provisions	6.0	9.7	20.4	2.8	23.1	3.5
Disposals and other	N/A	N/A	N/A	N/A	N/A	N/A
Pre-tax profit	(4.1)	6.0	(8.6)	9.8	1.1	8.0

* August to December only

Source: Superintendencia de Bancos de Panamá, ING estimates

As Figure 116 illustrates, HSBC Panama did have significant asset quality problems post the Chase acquisition, resulting in escalating charge-offs through 1H02. However, the 12 reported months since have been reasonably free of credit charges, and the bank is now earning at a rate of US$16m pa, a respectable but unspectacular pre-tax ROA of 1.22%.

The bank's current focus is on retail mortgages, which account for approximately 25% of HSBC Panama's assets.

Other LatAm

HSBC does not have much else in Latin America of substance. Chile was a good profit contributor in the past, but most of HSBC's stake in the country ended in 1H02, when group profits were augmented by a US$38m gain on the sale of HSBC's share of Banco Santiago. The group retains two branches in Chile.

HSBC's other Latin banking operations consist of four branches in Uruguay and a rep office in Venezuela; neither is significant to HSBC overall and we do not forecast any major new investments into these markets.

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