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Global Banking Practice

Lessons from leaders in Latin America's retail banking market

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Latin American banking is a vivid and exciting industry, with strong growth and profitability. And given relatively low banking penetration levels and a large, younger population, there is potential for even stronger performance. As always, there are winners and followers, and competition from both traditional and new players is steadily increasing.

This report looks at the overall progress of the Latin American retail banking industry in recent years and examines how profitability is spread across individual banks in the region. It looks in detail at what leading Latin American banks do to achieve and maintain their position, and expands this perspective to examine what the region's banks can learn from leaders in other regions. We end with an overview of the efforts that Latin American retail banks should pursue to achieve sustainable, profitable growth.

The fastest-growing banking market

Globally, banking industry performance has been stable but unexciting over the past several years, with moderate growth and profits. For seven years ROE has been stuck in a narrow range between 8 and 10 percent—a level that most consider the industry's cost of equity. Valuations also trail pre-2007 levels at a sluggish 1.0 price-to-book ratio for the developed world and 1.2 for emerging markets.

Latin America remains the exception to this sluggish performance, and is the fastest-growing banking market.

Multiple factors contribute to this fast growth. Among them, Latin America has very low banking penetration compared to other regions. In several Latin American countries, 30 to 50 percent of the population over age 15 have an account with a financial institution, compared to more than 90 percent in countries like the US, UK, or Spain, or roughly 80 percent in China. Additionally, Latin America has a young and growing population that contributes to faster growth.

Strong growth expected to continue

Between 2012 and 2017, Latin American banking revenue before cost of risk grew at a compound annual growth rate of 12 percent in constant 2017 exchange rates, reaching \$418 billion. This is six percentage points higher than the global average and more than any other region, including China and Emerging Asia, which are growth champions in many other industries.

We expect the Latin American banking market to remain the growth leader, and to keep closing the gap in banking penetration, with revenues increasing at around 10 percent per year over the next five years, and reaching \$675 billion before cost of risk (Exhibit 1).

Retail banking—particularly mortgage and consumer finance—will continue to drive growth

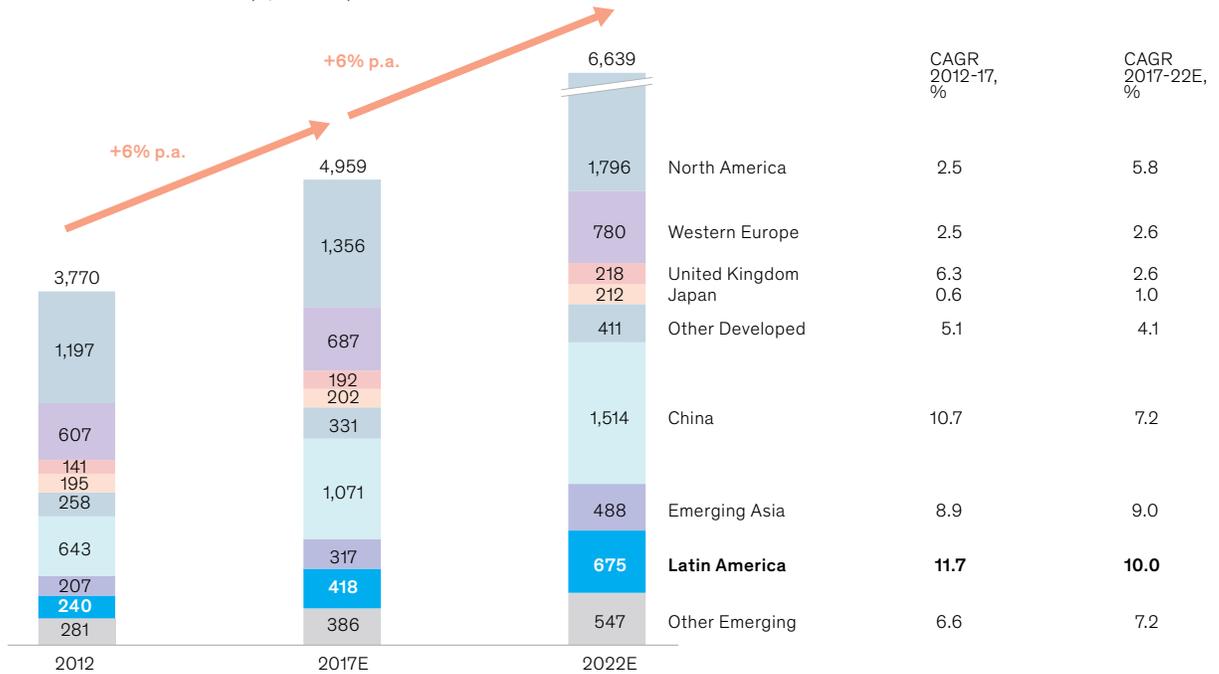
Retail banking has been the key growth driver for Latin American banking, outperforming wholesale by two percentage points and growing at a rate of 12.6 percent between 2012 and 2017. Within retail, consumer finance has been the primary growth engine, and remains the most-developed banking submarket in the region, representing more than one-third of after-risk revenues. However, in relative terms, micro loans, deposits, and retail payments are the fastest-growing submarkets (Exhibit 2).

We expect retail and wholesale banking to grow at rates of 10.2 and 9.8 percent, respectively, through 2022, with consumer finance and mortgage as the strongest drivers of retail growth—although almost all retail banking products will thrive.

Exhibit 1

Latin America will continue to be the growth leader among global banking markets through 2022.

Banking revenue before risk costs, \$ billion, fixed 2017 FX rate

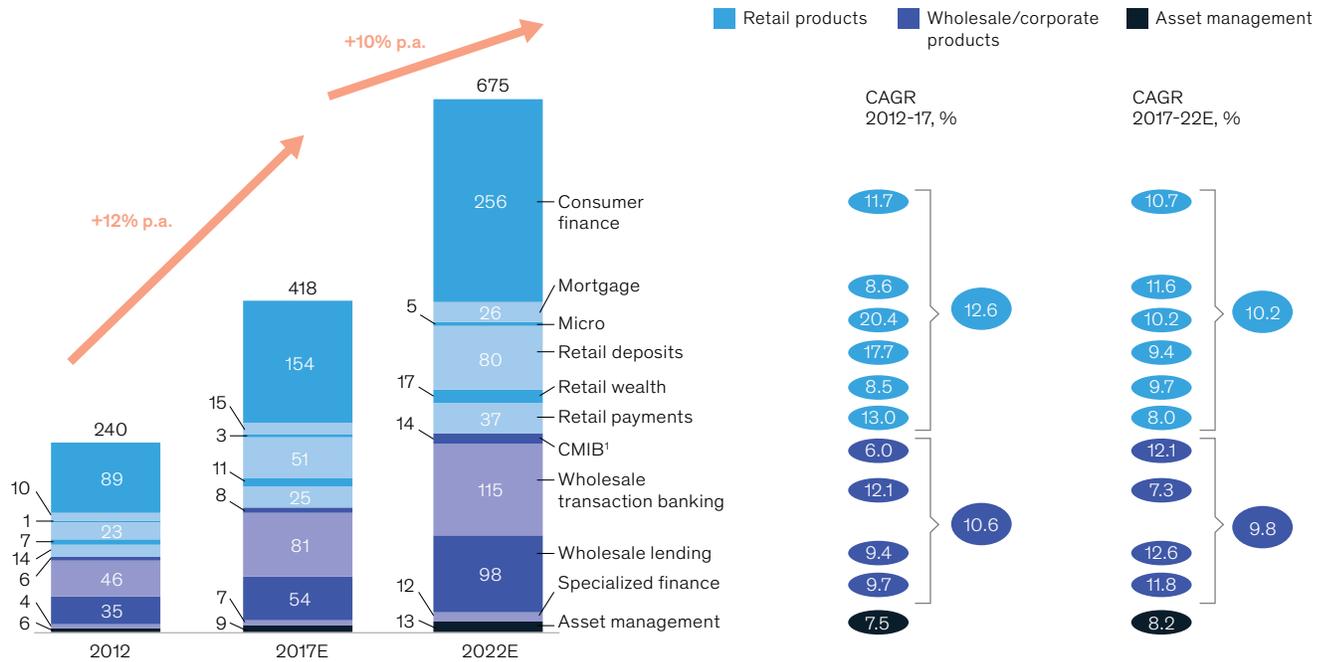


Source: McKinsey Global Banking Pools

Exhibit 2

Retail banking will continue to drive growth in Latin America through 2022.

Banking revenue before risk costs, \$ billion, fixed 2017 FX rate

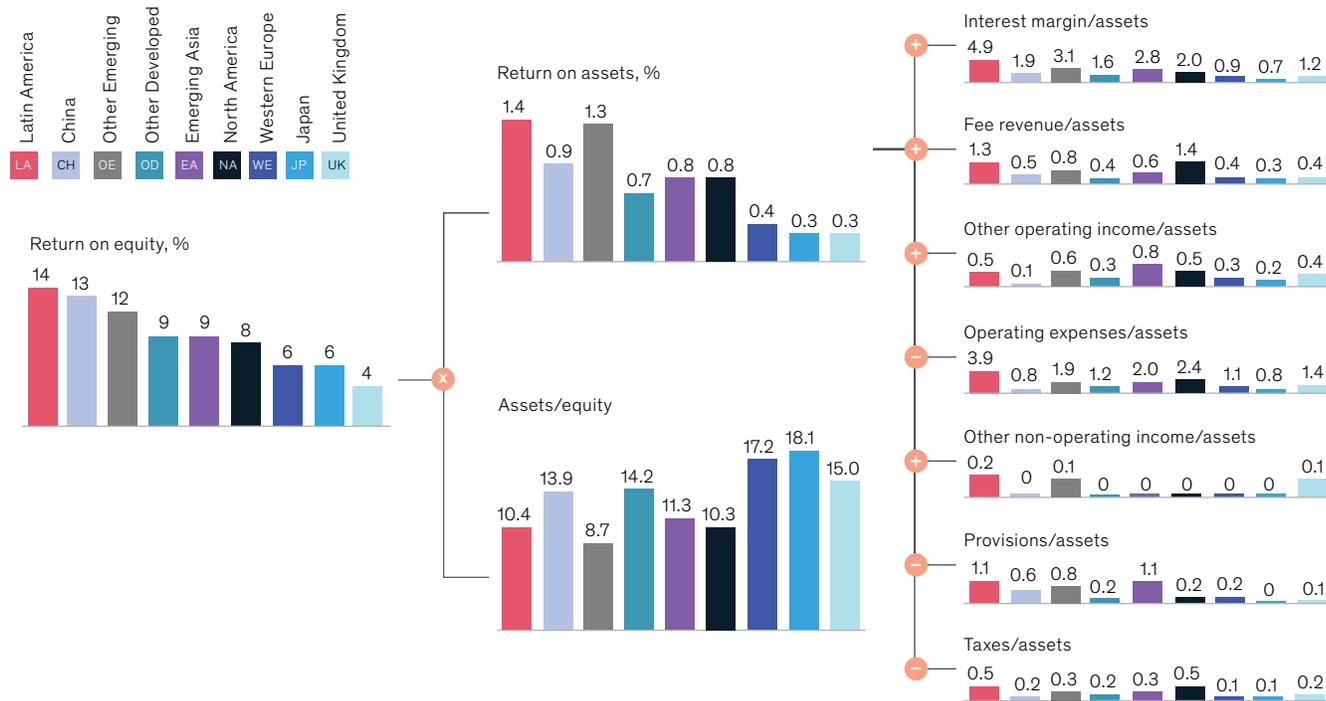


¹Capital markets and investment banking
Source: McKinsey Global Banking Pools

Exhibit 3

Latin American banks are the most profitable, but cost efficiency and operating expenses are a drag on performance.

2017 figures



Source: Official data reported to FI country regulators; McKinsey analysis

Strong profits offset by low cost efficiency and poor asset quality

Latin America is also the global banking industry's most profitable region. Overall ROE in 2017 was 14 percent, outperforming other global regions and more than doubling the 4-to-6 percent range of most developed regions (which for many countries implies that banks are not covering the cost of capital). Revenue is the primary factor in the region's outperformance: interest margins over assets stood at 4.9 percent in 2017, 1.8 percentage points above the closest regions (Other Emerging, including Emerging Europe, Middle East and Africa), and fee margin over assets at 1.3 percent. Latin America's profit advantage is negatively offset, however, by its lower cost efficiency, with operating expenses at 3.9 percent of assets (1.5 percentage points higher than the next-closest region) and its poor asset quality, with provisions at 1.1 percent of assets (Exhibit 3).

Despite strong overall profitability, there are clear winners and followers

Larger banks perform better overall, but there is significant dispersion in profitability

We compiled a financial database of 265 Latin American banks with all or most of their business in retail banking and studied their performance in 2017 to understand how retail banking profitability compares across banks.

Our analysis is based on ROE as the key measure of profitability and uses relative size in assets to the country average as the measure of size within a given market. (This is to acknowledge the fact that being large in a large market does not have the same meaning as being large in a small market; there are many small markets in Latin America.)

Based on their relative size and behavior, we group Latin American banks into four categories (Exhibit 4):

- *National leaders*: Banks with total assets of more than three times their market average

Exhibit 4

Latin American retail banks can be grouped into four categories based on their amount of assets relative to market size.

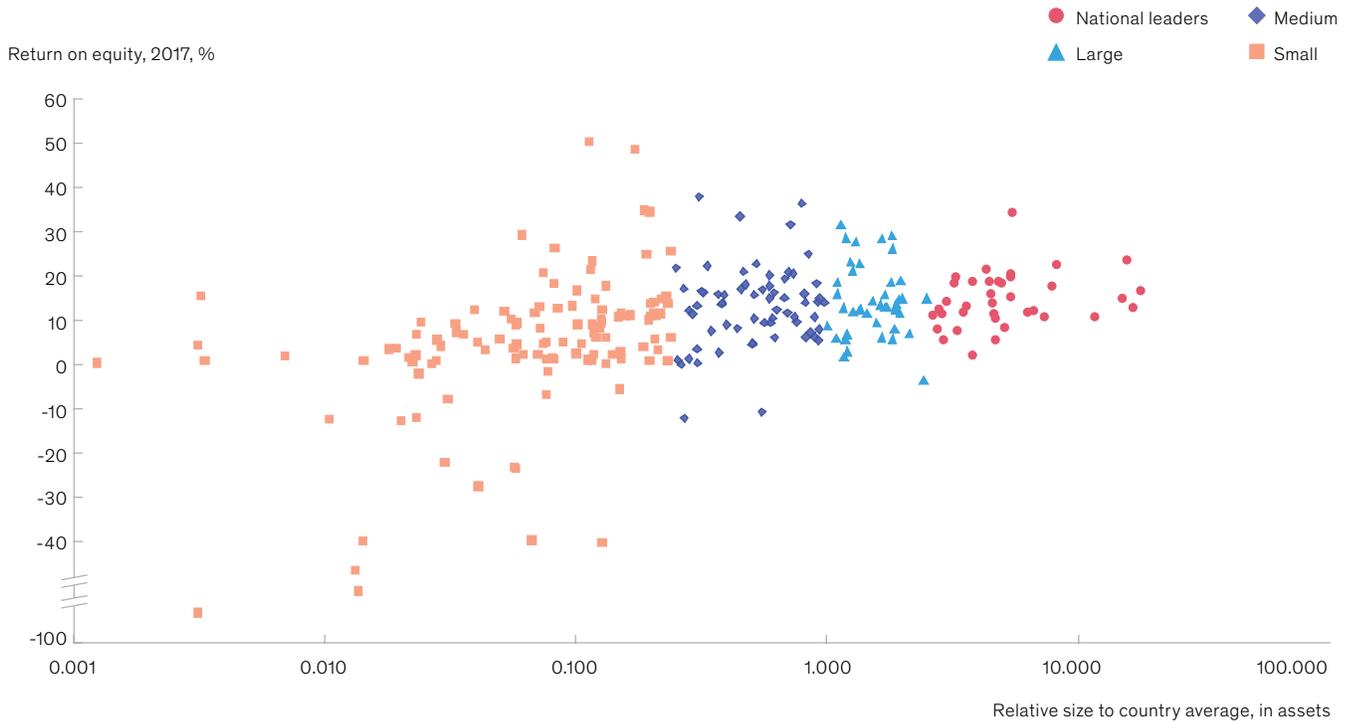
2017 figures

	National leaders	Large	Medium	Small
Criteria in assets	More than 3 times larger than the country average	Between the country average and 3 times the country average	From 1/4 the country average up to the country average	Smaller than 1/4 of the country average
Average assets \$ million	76,210	6,622	2,914	429
Number of banks in sample	32	52	65	116

Source: McKinsey analysis

Exhibit 5

Overall, larger banks are more profitable, but there is wide dispersion among all banks.



Source: Official data reported to FI country regulators; McKinsey analysis

- *Large*: Banks with total assets between the market average and three times the market average
- *Medium*: Banks with assets of from one-quarter of the market average, up to the market average
- *Small*: Banks with assets less than one-quarter the market average

In general, larger banks show higher profitability than smaller ones. However, there is significant dispersion across all four size groups, particularly among the smallest banks, which posted ROEs between -90 percent and 50 percent (Exhibit 5).

In this paper, we will review and compare the drivers of profitability for these four groups of banks.

The four size groups have different profitability drivers

National leaders among retail banks in Latin America are the clear winners in terms of average profitability levels, with a combined ROE of 15.2 percent. Large and medium banks are next at 13.6 percent and 13.1 percent ROE, respectively. The

drivers of profitability are very different, however. While national leaders rely heavily on efficiency, large and medium banks rely on revenues (mostly on the margin side) and on asset quality, with a significantly lower provision ratio than national leaders and small banks (Exhibit 6).

Latin America's small retail banks are the least profitable among the four size groups, with average ROE of 3.9 percent, significantly below the cost of capital. This performance is driven by a low return on assets (ROA) and a lower-than-average leverage ratio. ROA is significantly hurt by more inefficient cost structures and asset quality. It must be noted that dispersion in this group is particularly high—there are outliers with ROEs of more than 15 to 20 percent.

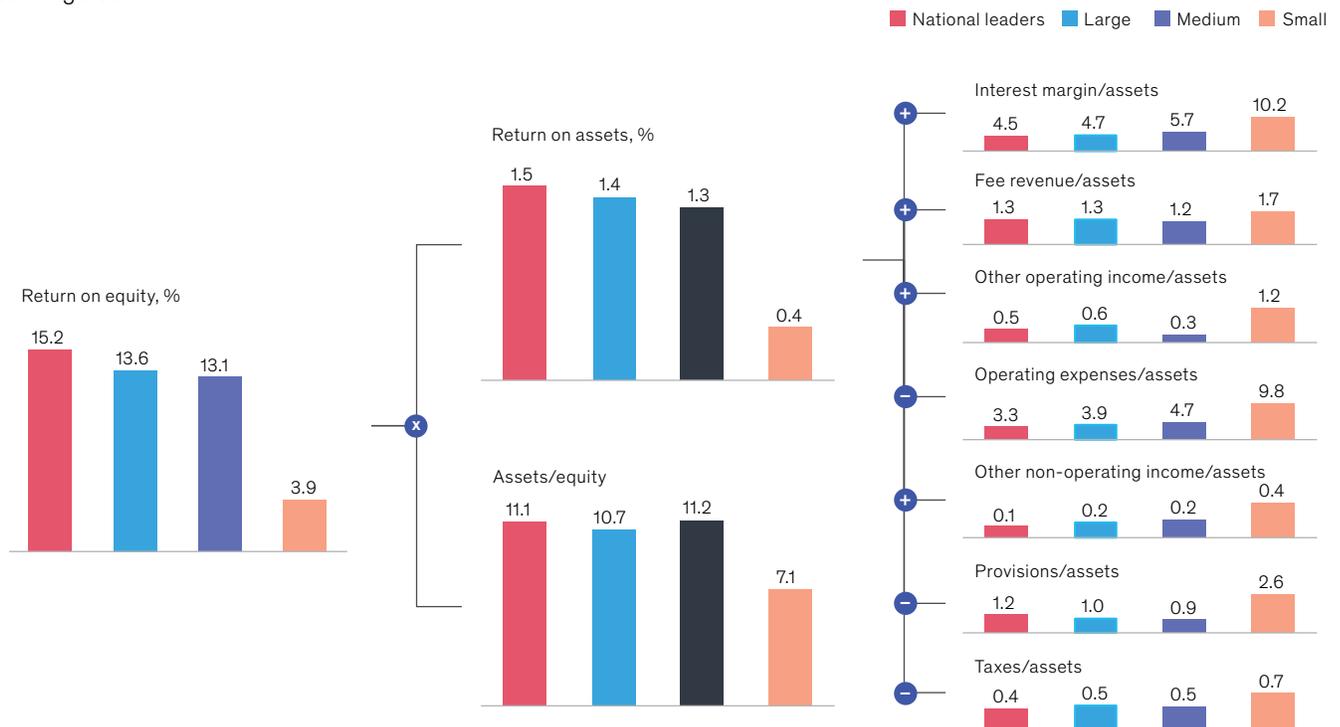
Differences in profitability are driven by business model

The varying performance of the size groups can be linked to many factors, but there is a substantial relationship with the different business models that can be observed in each group:

Exhibit 6

Latin America's largest retail banks are its most profitable; but profit drivers also vary for banks in different size groups.

2017 figures



Source: Official data reported to FI country regulators; McKinsey analysis

1. National leaders: universal banks covering the full spectrum of banked population and SMEs, with well-diversified asset base and efficient branch coverage
2. Large banks: 1) universal banks with a focus on a subset of regions (mostly in large countries); 2) leaders in a large niche (notably consumer finance, mass market, SMEs)
3. Medium banks: 1) universal banks with focus in a specific region (mostly in large countries); 2) leaders in a large niche (e.g., consumer finance, mass market, SME, underbanked finance; as well as less typical business models such as public-servant or agribusiness banking)
4. Small banks: 1) small niche players; 2) regional banks with a focus on small regions/cities; 3) branches of retail banks from neighboring countries; 4) new entrants (e.g., digital players)

How do the leaders lead?

What drives the significant differences in performance within each size group? To understand

what elements of ROE architecture allow a bank to outperform its peer group, we looked closely at some of the strongest banks. A few conclusions stand out (Exhibit 7):

- Top-performing *national leaders* thrive by combining a strong revenue source—margin or fee revenue significantly higher than the average—with high efficiency (either cost efficiency or low provisions stemming from better asset quality).
- *Large banks* tend to have one or two strong revenue sources (margin and/or fee), almost always combined with better-than-average asset quality; efficiency is sometimes a source of strength, but not consistently.
- As with large banks, leading *medium banks* usually have one or two strong revenue sources (margin and/or fee), almost always combined with better-than-average asset quality.
- The best *small banks* have either superior efficiency (with costs over assets up to 2 to 2.5

Exhibit 7

The drivers of outperformance vary for banks in the four size groups.

	Net revenues from financial intermediation/ assets	Fees (commission) revenues/ assets	Other operating income/ assets	Operating expenses/ assets	Non-operational income (expense)/ assets	Credit provisions/ assets	Taxes/ assets	ROA	Assets/ equity	ROE
Outperforming national leaders	>5%	>1.5%		<2.5%		<1%				>20%
Average national leader	4.5%	1.3%	0.5%	3.3%	0.1%	1.2%	0.4%	1.5%	11.1	15.2%
Outperforming large banks	>6%	>2%		<3%		<0.8%				>20%
Average large bank	4.7%	1.3%	0.6%	3.9%	0.2%	1.0%	0.5%	1.4%	10.7	13.6%
Outperforming medium banks	>8%	>4%				<0.8%				>25%
Average medium bank	5.7%	1.2%	0.3%	4.7%	0.2%	0.9%	0.5%	1.3%	11.2	13.1%
Outperforming small banks	>16%	>5%		<5%		<1%				>15%
Average small bank	10.2%	1.7%	1.2%	9.8%	0.4%	2.6%	0.7%	0.4%	7.1	3.9%

Note: All figures from 2017

Source: Official data reported to FI country regulators; McKinsey analysis

times higher than the average) or above-average revenue sources (with financial margins as high as 20 percent of assets and fee margins as high as 5 percent of assets).

Three country archetypes

While there are significant similarities in how Latin American retail banking markets operate, there are also significant differences in banking profitability and its drivers between countries. We plotted financial revenues (both financial margins and fees) after cost-of-risk over assets and operational expenses over assets to understand the drivers of profitability at the country level. Based on this review, we see three distinct market types (Exhibit 8):

- *Markets driven by efficiency:* In these markets, profits are tied closely to efficiency, with operational expense ratio below 3.4 percent of assets, and financial revenue ratios at 6 percent or below.
- *Balanced markets:* In these markets, profitability can be attributed to a balanced combination of

revenue generation (between about 4.5 and 7 percent of assets) and efficiency (operational expenses between 3.2 and 4.4 percent of assets).

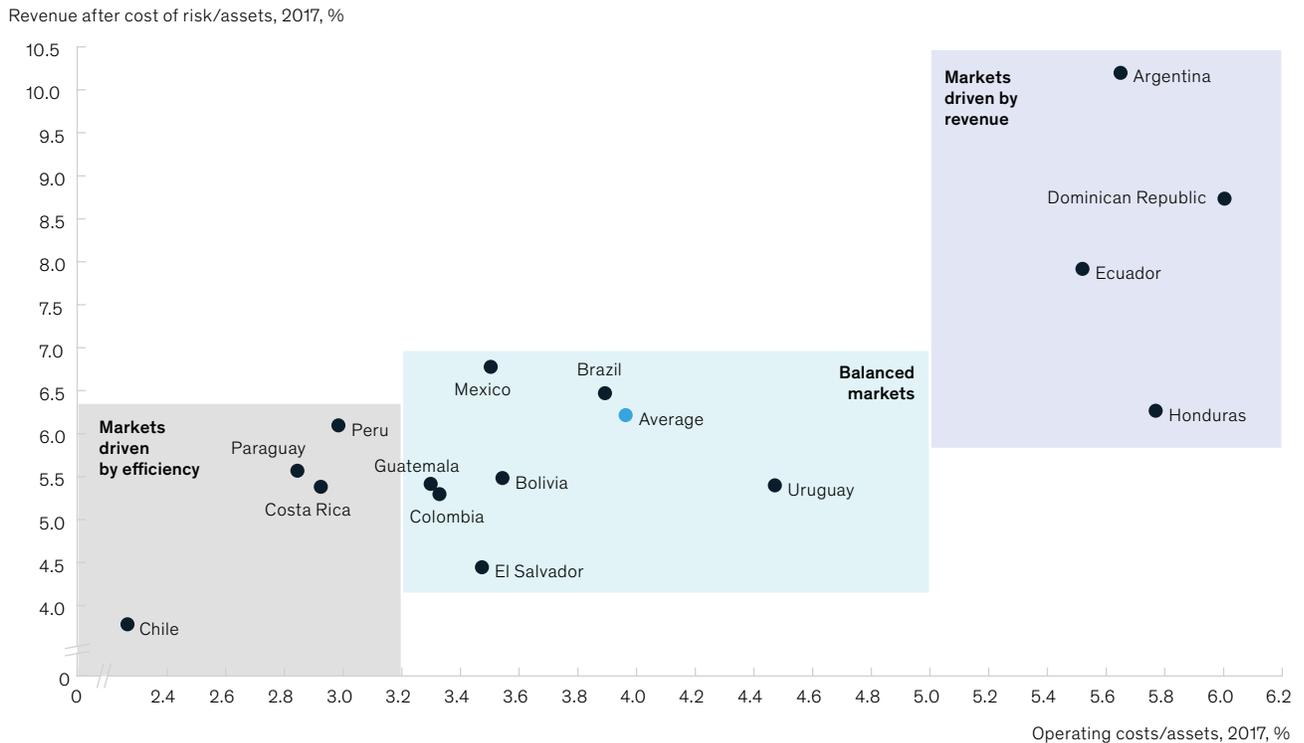
- *Markets driven by revenue:* In these markets, profitability is clearly driven by revenue generation (revenues after cost of risk over assets of between 6 and 10 percent) with low efficiency (operational expenses above 5.5 percent of assets).

This analysis considers some ROE equation components, such as non-operational expenses and leverage ratio (assets/equity), which are typically outside the control of management teams.

Most of the differences outlined above are driven by the different dynamics in each of the markets, including very different regulatory frameworks that significantly impact performance. For example, some countries have loan cap rates (e.g., Colombia, Ecuador) that prevent credit penetration in some retail segments.

Exhibit 8

Latin American retail banking markets can be grouped by how revenues and efficiency impact bank profitability.



Source: Official data reported to FI country regulators; McKinsey analysis

What Latin America’s retail banking leaders have in common

What do winning banks do to achieve their superior margins, cost efficiency, and asset quality? We reviewed public information on the top-performing banks to try to isolate common “winning practices” in the different size groups, to give Latin American banks insights on what actions and strategies will yield the highest impact on profitability. A close up of two leading banks demonstrates how we determined these winning practices (Exhibit 9).

We found that banks with ROEs significantly higher than their peer size group share three common practices:

- Initiatives to **protect** the business model, isolating the source of distinctive returns from competitive pressures
- Incremental steps to **reorient** the business
- **Reinventing** the business or operating model to compete in the “new world”

We also found that these banks shared nine winning practices, with different levels of applicability based on size group and profitability driver (Exhibit 10):

Winning practices for all banks

1. *Excellence in pricing*: Most winning banks possess a distinctive ability to detect and capture pricing opportunities, and to prevent fee

leakage; some leverage advance analytics techniques to do so at a granular level.

2. *Commercial productivity*: Most winning banks achieve high revenue/cost ratios due to a very productive sales force, reaching up to 1,200 to 1,500 sales of products per retail relationship manager (RRM). This performance is typically powered by very strong commercial excellence programs that redesign how RRMs identify and execute commercial opportunities.
3. *Superior risk assessment*: Winning banks of all sizes have better asset quality than their peers, and most demonstrate better-than-average assessment of risk, allowing them to systematically capture a higher share of customers with better credit.
4. *Best-in-class customer-centric segmentation and segment value proposition*: Most winning banks focus on segments and develop tailored value propositions across five dimensions: products, services, relationship model, distribution model, and channels.

Winning practices for national leaders and large winners

5. *Relentless focus on efficiency*: National leaders and large winning banks operate with highly efficient corporate centers and support functions, relentlessly seeking cost efficiency;

Exhibit 9

A closer look at two leading banks.

	Bank 1	Bank 2
Size group	National leaders	Medium-sized banks
ROE	>19%	>23%
Sources of ROE	Revenue strength: Financial and fee margin of ~6.5% Extreme efficiency: Expenses/assets ratio lower than 2.5%	Revenue strength: Financial and fee margin of ~9% Asset quality: Provision/assets ratio of 0.6%
Winning practices	Market segmentation with 5 to 6 strategic segments; and highly tailored customer-centric value propositions Commercial excellence program Digital transformation with focus on achieving a significant percentage of digital sales Relentless focus on efficiency, with emerging agile transformation	Pricing excellence, with sharp focus on one-to-one pricing and avoidance of fee leakage Market segmentation with 5 to 6 strategic segments with highly tailored customer-centric value propositions Commercial excellence program driving significant improvements on front-line productivity Sharp focus on one product line (credit cards)

Note: All figures from 2017
Source: McKinsey analysis

many have multi-year programs that have included multiple cost reduction levers, like lean process redesign or right-sizing.

6. *Higher-than-average digital marketing and sales:* National leaders and large winning banks post higher-than-average shares of digital sales, reaching up to 15 to 20 percent of total sales; these numbers still trail digital leaders from other regions, but there is a clearly emerging Latin American digital “best in class.”
7. *Agility—nimble response to market conditions:* National leaders and large winning banks are embracing agile practices to meet the challenge of complexity and become less siloed; they aim to quickly reconfigure around multifunctional teams to launch new products and capture value. As with digital sales, Latin America’s most agile retail banks still trail global leaders, but they are gaining an edge over their regional peers.

Winning practices for medium and small winners

8. *Focus on niche markets:* Medium and small winning banks in Latin America often thrive by developing targeted value propositions for niche markets that are underserved by other banks; the three most common such niche markets are consumer finance and credit cards, unbanked and underbanked customers, and SME financing.

9. *Efficient (sometimes third-party) distribution models:* Medium and small winning banks leverage alternative and cost-effective distribution and relationship models that overcome the scale problems that typically challenge smaller institutions; examples include digital-only, shared distribution networks (e.g., with a retail firm), and telephone-only.

Lessons from international banks

The battle for profitability is one that many banks around the world are consistently engaged in, particularly in the very competitive and low-interest-rate markets of developed regions like North America and Europe. What can Latin America’s banks learn from the winners in these markets?

In our view, Latin American banks are already following many of the practices of winning banks around the globe—particularly in “protecting” their sources of distinction. However, there are practices that leading banks around the world follow in the “reorient” and “reinvent” areas that many Latin American banks should still emulate (Exhibit 11):

Initiatives that apply to all banks

- *New fee revenue streams:* Latin American banks need to find new sources of revenue to compensate for the reduction of traditional

Exhibit 10

Winning banks share common practices—based on their size.

Bank size group	Winning practices		
	Protect business model	Reorient business model	Reinvent business model
All winners	Pricing excellence	Customer-centric segmentation and value proposition	
	Sales productivity		
	Superior risk assessment		
National leaders and large top performers	Relentless focus on efficiency		Digital marketing and sales Agile organization
Medium and small top performers	Focus on niche markets and pockets of growth	Efficient and innovative distribution models	

Source: Public information on winning banks; McKinsey analysis

banking revenues—without damaging customer experience and satisfaction; innovations could include ancillary revenues such as payments fees or loyalty program fees, but also the development of financial services ecosystems.

- *Next-gen IT architecture, infrastructure, and organization:* Many banks in the region have successfully transformed their digital front end; fewer have transformed core IT processes and structure. Efforts on this front could lead to more sustainable digital growth and higher cost efficiency.
- *Holistic digital transformation:* Latin American banks must focus on full digital transformation (Digital 3.0), including the digital enablement of customer acquisition, customer journey redesign, automation and digitization of the back office, streamlining the operating model, and building a digital acceleration execution model.
- *Create a motivating culture of change, with shared vision and values:* Latin America's banks should follow the lead of winning banks globally by developing a culture that values change, collaboration, creativity, entrepreneurship, bottom-up innovation, and personal ownership.

- *Cybersecurity:* Another area where Latin American banks can learn from winning banks in other regions is to improve cybersecurity practices, including protecting critical information assets, securing the value chain, and defining the security operating model across lines of defense. This is particularly true today, with many recent attacks focusing on Latin American banks.

Initiatives that apply to national leaders and large winning banks

- *Operational excellence leveraging digital and advanced analytics:* As previously mentioned, Latin American banks have excelled in front-end digital transformation, but they need a parallel focus on operational excellence, including a significant reduction in product complexity and a simplification of processes end to end.
- *Shared commodity services across banks:* While the fragmented nature of the Latin American market will make it difficult, banks could start outsourcing and consolidating certain common services that are not part of their core business, including know your customer, procurement, and vendor management.

Exhibit 11

Filling in the gaps: How leading banks in other regions win.

Winning practices			
Bank size group	Protect business model	Reorient business model	Reinvent business model
All winners	Pricing excellence	Customer-centric segmentation and value proposition	Holistic digital transformation
	Sales productivity	New fee revenue streams	Culture of change
	Superior risk assessment	Next-gen IT architecture, infrastructure and organization	Cybersecurity
National leaders and large top performers	Relentless focus on efficiency	Customer-centric segmentation and value proposition	Digital marketing and sales
			Agile organization
Medium and small top performers	Focus on niche markets and pockets of growth	Efficient and innovative distribution models	
		Shared commodity services companies across banks	

Source: Public information on winning banks; McKinsey analysis

Winning in Latin American retail banking

Growth and profitability in Latin America's retail banking industry have been strong over the last five years, and we expect this trend to continue—provided that political and financial stability remains high in the region.

However, overall profitability does not guarantee individual profitability. There are significant differences in performance between winners and

followers, and we anticipate these differences will increase in coming years as winners continue to adopt best-in-class practices.

To outperform peers, Latin American banks should look to the future with the following three fundamental steps in mind: protect the business model by isolating the source of distinctive returns from competitive pressures; take incremental steps to reorient the business; and reinvent the business or operating model to compete in the “new world.”

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