
Chazen Society Fellow Interest Paper

Itau and Unibanco: A Merger to Change the Emerging Markets Banking Sector

RITIJA GUPTA MBA '10

Brazil's banking sector has been making news in the wake of the global financial crisis, presenting itself as a resilient force to be reckoned with once the dust has settled and banks can begin to focus more on competing with each other instead of merely surviving. The largest banks within the country, Itau-Unibanco, Bradesco, Banco de Brazil, and Banco Real have had long legacies of growth through mergers and acquisitions, conservative approaches to investing in the wake of major financial and currency crises, and novel approaches to consumers in part due to government policy. These banks are not only healthy relative to their global competitors; they represent a new frontier of banking due to recent expansions and a unique internal culture.

Brazil's largest bank as of this year, the recently merged Itau-Unibanco, has been able to partially insulate itself from the most devastating effects of the global financial crisis. The merger, which was announced last November and completed March 31st 2009, has long been the subject of speculation. Itau's position as the second largest bank in the country combined with Unibanco's position as the third largest seemed to provide a good foundation to take on Bradesco, a large and competitive bank that had achieved its status through intelligent and well-timed acquisitions. During the global financial crisis, it seemed prudent to combine these entities to create a whole greater than the sum of its parts, as opposed to many bank mergers that have taken place in the US which have left some larger banks having to deal with the large loads of debt that their acquisitions have carried.

Itau-Unibanco's position of strength resulted mainly from its ability to react to a previous banking crisis in the mid to late 1990s, and its focus on accumulating a higher quality of capital

and higher BIS ratio overall.¹ Now the 16th largest bank in the world as measured by total assets, Itau-Unibanco is positioning itself for global expansion and seems poised for success. As the banking shakeup has altered the public's view of financial institutions, and the Latin American *diaspora* is gaining economic power around the world, Brazilian banking could be a very strong competitor and not just as a regional player.

Brazil's President Luiz Inácio Lula da Silva has worked with the government to focus on differentiating the banking sector in what appears to be novel ways. First off, banks are incentivized to focus on "sustainability," a term with a broader definition than usual. In addition to concerning itself with environmental protection and "green" innovation as in the US and many other countries, in Brazil the banking sector also includes what we might consider socially responsible policies, such as accessibility to the disabled and a focus on microfinance.

Microfinance has gained so much momentum in the country that the government has mandated that 2% of all deposits are earmarked towards small entrepreneurs and poorer individuals who want to make small commercial purchases. While it is unclear whether that means the entire 2% was supposed to be lent to micro-entrepreneurs, or include administrative fees as well, the idea and policy are quite unique to Brazil and may position them well for the future by giving accessibility to a wide number of their rural and urban constituents. These lending policies could eventually assist in diminishing the wealth gap and its ensuing social issues. Along those lines, prior to the merger, Unibanco had created a credit card specifically for micro-entrepreneurs and other users of microcredit: Hipercard. Credit cards for micro-entrepreneurs represent a novel kind of access to capital in microfinance which is not often seen around the world. Furthermore, in an effort to safeguard their loans both Itau-Unibanco and Banco Real (a recent acquisition by Spain's Santander) are working on creating better models to understand creditworthiness and are trying to streamline approval processes via a combination of automated systems and field loan officers to facilitate coordination and efficiency to the benefit of micro-entrepreneurs. These innovations represent a significant investment by these banks in time and resources. However, the largest banks appear to be pursuing these innovations with gusto, partially since it is a top-down initiative from the government, and the "most sustainable bank" will be the best off (in terms of brand reputation in a country whose culture values sustainability as well as monetary incentives for compliance).

The sustainability policies of the Brazilian government have promoted competition between the banks to become the "most sustainable bank", or rather, the bank that is perceived by the public and world at large to be the most socially responsible. Whatever the motivation, it

¹ BIS ratio is from the Bank for International Settlements in Basel and indicates the ratio between risk-bearing capital and risk weighted assets.

seems that low-income users stand much to gain, though it will take some time to scrutinize properly how well these banks have been able to merge their motivations with the well-being of the population. To that end, the pursuit of sustainability may not simply be a philosophical move on their end, nor a move to comply with new government standards but more of an opportunistic strategy to take advantage of policies that could drive profits for banks that were able to comply early, as well as finance other ventures that were based on compliance. There would also be many happy returns for banks that were considered the most reputable, as the country overall has been moving towards a “greener” ethos, similar to the United States. However, it is not enough to just be the “most sustainable bank.” Brazil’s banks know that, in order to stay relevant and become competitive on a large scale, they must not only go global, they must also learn from their competitors. These often include US and European banks that have flirted with insolvency.

In terms of global reach, before joining forces with Unibanco, Banco Itau already had many branches throughout Latin America, including Argentina, Uruguay, and Chile, as well as outside the continent, including offices in New York City, Tokyo, London, and Lisbon. Through a combination of international expansion and heavy investment in automated services, including online banking and ATMs, Banco Itau gained momentum within Brazil’s banking sector, supplementing much of the organic growth it experienced in the 1960’s with savvy acquisitions and alliances.² Prior to the merger, Itau and Bradesco had been trading places as “Brazil’s Largest Bank” because of these acquisitions. Both were able to find solid footing despite the economic crisis in the 1990’s which saw a rapid devaluation of currency and massive consolidation. As a result, one could surmise, both banks took a slightly more conservative approach to using financial instruments and leverage after the crisis abated—partly because government regulation forced them to keep relatively high internal cash reserves, but also due to the quality of their assets.

The largest banks in Brazil, perhaps as a result of this crisis, stricter lending policies or a more conservative approach towards using financial instruments, appear to have a competitive advantage in terms of asset quality. In recent years, Banco Itau has maintained a strong position with respect to other domestic and international banks in terms of Tier 1 capital/BIS ratio and its level of assets. In fact, Banco Itau had ranked worldwide at number 54 out of the top 1000 banks (as determined by *The Banker* and the *Financial Times*) in 2006, up from 90 the previous year. While the BIS of the combined Itau-Unibanco is yet to be released, Banco Itau in general has had a very healthy BIS ratio of 18% relative to its ranking peers (its immediate peers being in the 10-12% range). Banco Bradesco, widely touted as the number one Brazilian bank in terms of total

² Banco Itaú S.A. “History of Banco Itaú S.A.,” <http://ww13.itau.com.br/PortalRI/HTML/ing/conheca/historia.htm>

assets prior to the merger between Itau and Unibanco, has slightly less Tier 1 capital than Itau: 11,527 M to Itau's 13,200 M which gives Bradesco a ranking of 64, with a slightly lower BIS ratio as of 2006.³ Regardless, it is evident that between the top two banks in the country—top three prior to the merger—the general philosophy around banking in Brazil was focused on accumulating a higher quality of capital for its asset base. This strategy may have prevented these banks from vaulting to the highest echelons of global banks because their growth rates may have seemed lower overall, but Brazil may be the 'tortoise' in a race with US and European 'hares'.

What is fascinating about this emerging market economy is precisely how it is emerging on the global stage. Though the merger between Itau and Unibanco reflects a reaction towards the potential threat of foreign banks—and as some analysts would posit, the relative weakness of Unibanco in the past few years because of some ill-fated moves with foreign exchange derivatives—the new entity formed is undeniably unique in its makeup and its broad reach throughout Latin America. It has not had to deal with the same kind of fallout, either of reputational or financially, from the banking crisis (the 3rd quarter report from 2008 indicates that, while their growth rate has slowed, it has not gone negative, nor is it expected to in 2009), and its main competitors, Bradesco and Banco Real, are similarly well-positioned because of their global reach, especially in the case of Banco Real which is associated with ABN-AMRO and Santander. Even more fascinating than what seems to be a uniquely conservative approach to banking, is the momentum they are building around sustainability. If President Lula's predictions are correct, banks will be able to precipitate a movement that can help diminish the income gap and propel Brazil, which has been making great strides in the social sector in the last decade, to become not only a model for other so-called developing countries, but developed countries as well.

³ Top 1000 Banks, 2006, *The Banker*