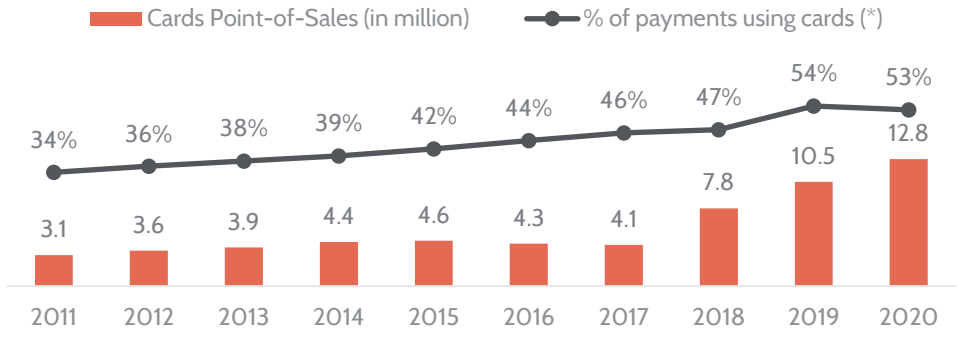
How an ambitious Central Bank fueled Brazil's fintech boom

In the past several years, the Brazilian Central Bank has pushed regulatory changes to promote competition and inclusion in the financial industry, that have spurred the establishment of numerous fintechs, with several of them eventually achieving "unicorn" status. Nubank's IPO is probably the most recent example of a movement heavily impacted by the regulator.

It all began with former Brazilian Central Bank chief, Henrique Meirelles, who campaigned for structural regulatory reforms to remove a duopoly in the Brazilian merchant acquiring space, resulting in the development of extremely successful stories like that of PagSeguro, StoneCo and GetNet. Prior to that, merchant acquirers Cielo (formerly Visanet) and Itaú's Rede (at the time Redecard) ruled unchallenged, with annual returns on equity of over 300%. The end of this duopoly drove a massive increase in the number of merchant acquiring companies in Brazil– there are now 48 companies competing in this segment – and the number of Points of Sale (POS) increased by more than 4x to nearly 13 million units. Moreover, the share of card payments in the system increased from less than 34% to 54% in just over ten years – and it didn't stop there.

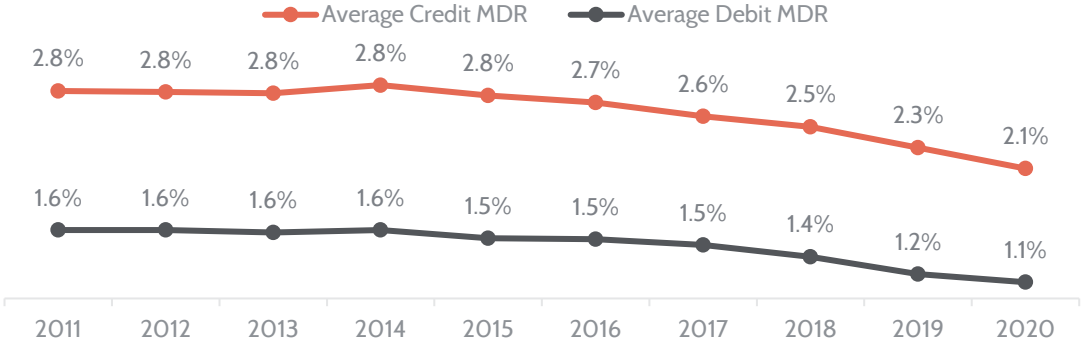
Consumers benefitted greatly from increased competition, as average merchant discount rates on credit (MDR) fell from 2.8% in 2011 to 2.1% in 2020.

Figure 1: Regulatory changes have clearly increased card payments in Brazil



Source: Central Bank of Brazil; (*) includes credit, debit, and prepaid cards

Figure 2: Increased competition drove prices down



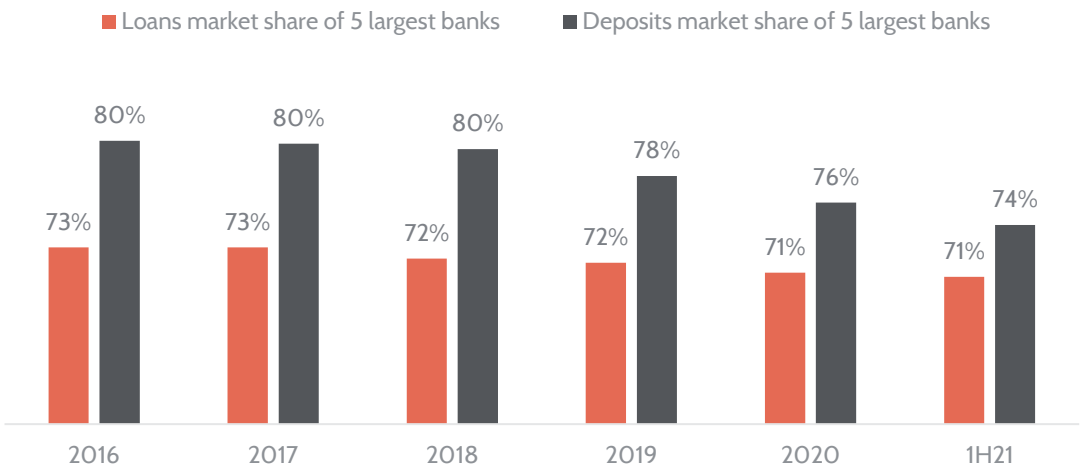
Source: Central Bank of Brazil

Under Ilan Goldfajn, the Central Bank launched its BC+ Agenda, focused on tackling structural issues of the financial system by fostering technological innovation, while pursuing the reduction of cost of credit, the enhancement of the banking regulation, and the efficiency of the competitiveness of the national financial system.

Some of the measures included the creation of the new long-term rate (Taxa de Longo Prazo), which provides transparency to the rates set by the Brazilian development bank BNDES, the creation of "Letra Imobiliária Garantida" – a type of asset-backed security – and last but no less important, Resolution 4553, which classifies financial institutions according to size, aiming to ease regulatory requirements on new market entrants.

Despite only launching in 2016, policies from the BC+ Agenda have already had an impact. Average lending spreads, for example, fell to 14.5% in 2020 from 20.9% in 2017, and the loan market share of the five largest Brazilian banks, Itaú Unibanco, Bradesco, Banco do Brasil, Caixa Econômica Federal and Santander Brasil, has been steadily declining, reaching 74% in 2020, from 80% in 2016. Even though the figure still appears to be high, it is better than the 80% average market share held by the five largest banks in Mexico, Colombia, Peru, and Chile.

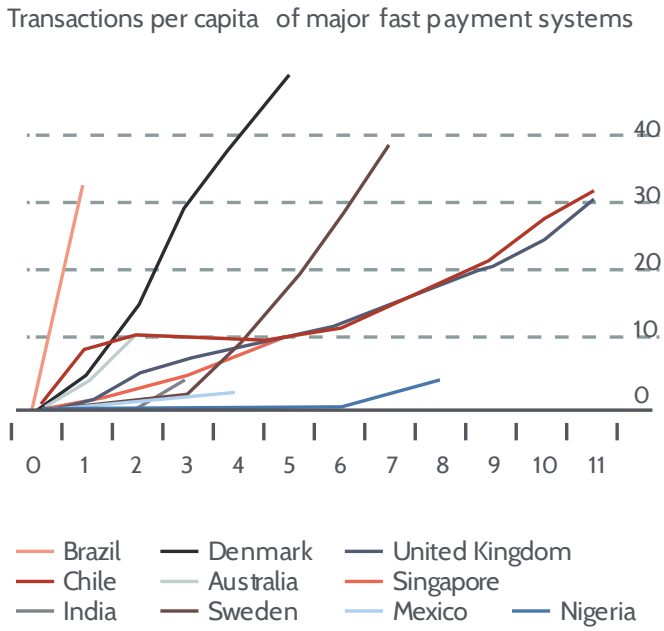
Figure 3: Banking concentration has improved, albeit still at high levels



Source: Central Bank of Brazil
5 largest banks: Itaú, Bradesco, Banco do Brasil, Caixa Econômica Federal and Santander Brasil

While the trend is improving, concentration remains high, signaling that the Central Bank still has a long way to go in addressing inefficiencies in the system. Most recently, Roberto Campos Neto, who became head of the Central Bank in 2019, rebranded the agenda to Agenda BC#. The focus shifted to inclusion, competitiveness, and transparency, and has already bore fruit, with some innovative and exciting initiatives, such as the universal instant transfer system Pix, and the implementation of open banking.

Figure 4: Pix had one of the most successful fast payment implementations in the world

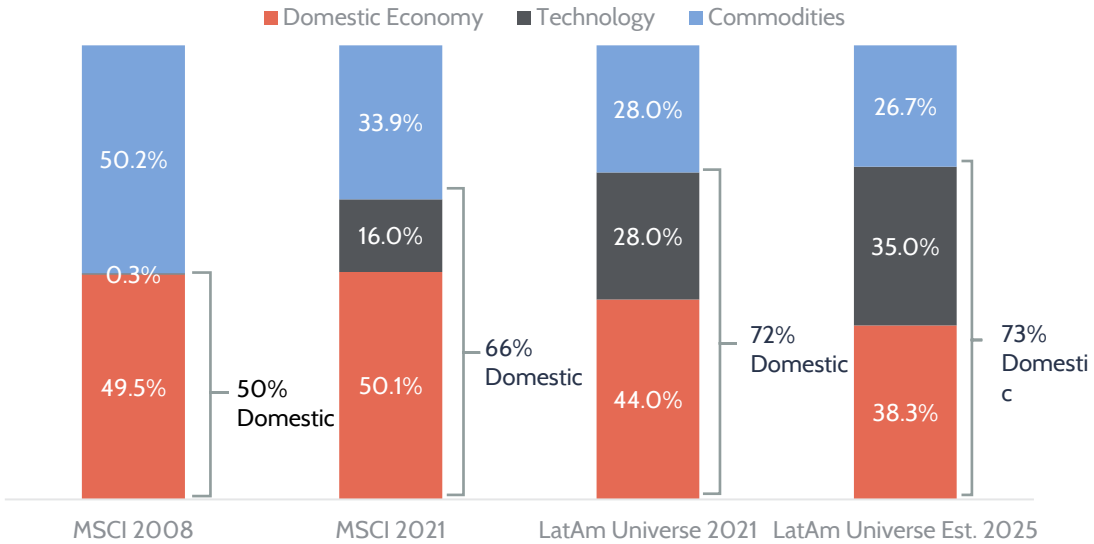


Source: BIS Red Book statistics

Given how quickly these initiatives have altered the system, it is reasonable to expect that the market will look quite different in the coming years. In fact, investors are betting on it – large banks like Itaú Unibanco and Bradesco, have been consistently trading below historical multiples, despite posting returns on equity of more than 20%. It is not unwarranted however, as the welcoming environment for financial innovation has attracted companies from all sectors to try and take a piece of the financial services pie.

Moreover, the technology sector, which currently makes up 28% of Latin America's equity universe – and only 16% of the Latin America MSCI – is expected to reach 35% by 2025, largely fueled by growth in financial technology businesses.

Figure 5: Contrary to the myth, Latin America is not only about commodities



Source: CCAM Research; Bloomberg

While Brazil has been at the forefront of Latin America's fintech innovation, neighboring countries have lagged – either because local regulators have been unable to pass reforms due to bureaucracy and pressure from large banks, or because the most ambitious agendas have not received enough political support. The fact that the Brazilian Central Bank has both the role of regulator and supervisor of the financial system might have also helped push the agenda. Mexico, Colombia, Peru, and Chile have separate authorities regulating and supervising the financial system.

In Mexico, the Fintech Law of 2018 attempted to regulate tech startups engaged in financial services, however, critics claimed it was disproportionately focused on customer safety and less so on stimulating competition in the financial sector.

Mexico's financial services sector, which is known for having the lowest financial penetration in Latin America due to the country's high level of informality, is ripe for disruption. With a mere 30% of the population older than 15 years of age having access to a bank account (according to the World Bank), the second largest economy in Latin America has great potential for startups focused on promoting financial inclusion. However, some recent successes, such as Clip, a digital payment platform, and Konfio, an SME lender, will likely have little to no help from regulators when facing large banks. Bloomberg recently reported on a study commissioned by a fintech organization, criticizing regulators' passivity in the face of what they allege is an "effective monopoly in the country's credit card payments network that benefits big banks while hindering startups in Mexico."

Meanwhile, after several years of negotiations and studies, the Chilean government introduced a Fintech Bill to Congress in September 2021. This Bill, similarly to the Mexican experience, aims to create a legal framework for financial startups to operate in the country, but skeptics argue that too much oversight will suffocate the dynamic nature that typically accompanies startups.

Even though Chile has been undergoing significant reforms, such as the recent attempt to revise its Constitution, the Bill has made rapid progress in Congress and could soon be enacted. Meanwhile, major banks such as Banco de Chile, Santander-Chile, BCI and Itaú CorpBanca have made significant investments in digital transformation to prepare for a more competitive environment.

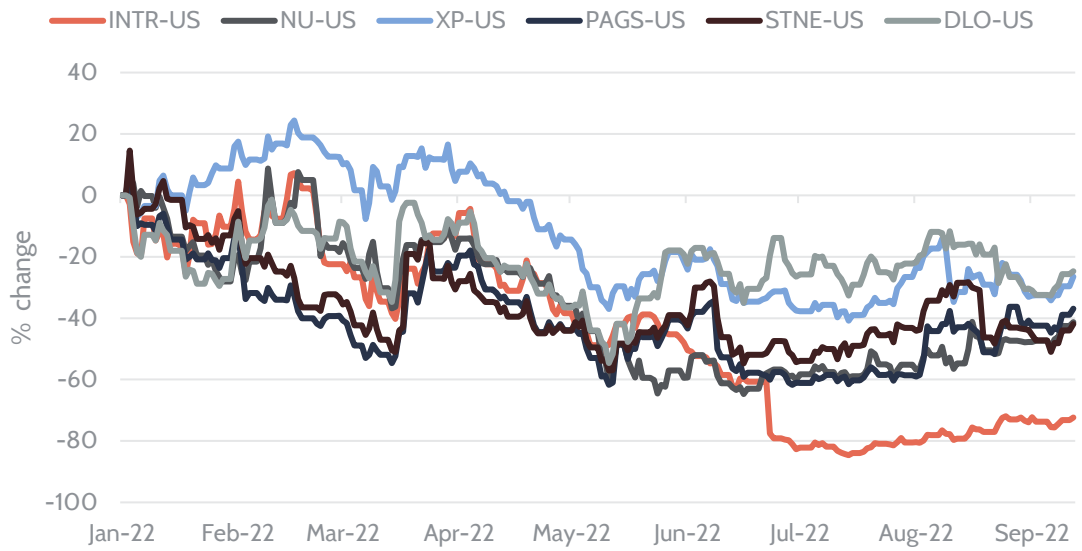
Regulators in Colombia and Peru, on the other hand, have been much less active, mostly offering recommendations on best practices and allowing the free market to work its magic. Peru has recently authorized a regulatory sandbox (a framework set up by a regulator that allows companies to conduct live experiments in a controlled environment), albeit only for supervised companies – mostly banks – and new entrants must apply for a regulatory license to participate. As a result, most innovation in financial services in these countries has so far come from the large incumbent banks, such as Bancolombia's Nequi (13+ million users in Colombia) and Credicorp's Yape (10+ million users in Peru).

At this point, it is safe to say that the outlook of financial innovation in Latin America is quite mixed and will depend on the country in question. Brazil and Mexico have seen many new challengers and the investable universe is somewhat varied, including not only financial companies but e-commerce and traditional retailers directly offering a wide range of financial solutions. For instance, MercadoLibre's fintech business already represents almost 50% of the company's consolidated revenues, and its digital wallet Mercado Pago has over 5.7 million users, while FEMSA's fintech Spin by Oxxo has acquired more than 3.1 million users in less than one year.

Meanwhile in Colombia, Peru and Chile, it might still take a while for disruption to really take place, providing incumbents time to prepare as banks have launched several fintech initiatives to try and lead the wave of financial innovation.

Timing is positive for investors interested in financial innovation. Global recession fears and capital dry-up have recently hindered stock valuations, especially growth stocks. However, Brazil's fintech boom took years of active regulatory intervention to effectively alter the competitive outlook of the financial system, and there is still a lot to be done before the game is over – open banking will likely create a whole new group of challengers. While Mexico is only at the beginning of its innovation cycle. This means that there is great opportunity for investors to be exposed to financial innovation at much cheaper valuations compared to only a few months ago.

Figure 6: Fintech stock sell-off opens opportunity



Source: FactSet prices

With this opportunity in mind, Credicorp Capital Asset Management has launched the LatAm Innovation Equity Fund, with the goal of providing exposure to the abovementioned structural changes in financial technology, as well as innovation in general by applying a diversified approach to investing in companies that create or *re-engineer their processes to seek better products and services* and expose themselves to key secular trends.

We believe innovation can be found through transformation of processes that lead to new and better products and services, as well as changes in business models that allow companies to gain market share and improve profitability.

Latin America is the place to be, with great innovation potential beyond just technology, as scale and opportunity make the region a key player in the global supply chain for a changing energy matrix, efficient food supply, and as a source of talent for global business needs.



Diego Ciconi

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Diego Ciconi is Vice-President of Buy Side Research and the lead financials equity analyst. He has a degree in finance and has been part of Credicorp Capital's investment team for the past four years. Previously, he was the Equity Research Senior Associate covering LatAm Banks with Scotiabank GBM (sell side); earlier working as a senior financial Analyst for Scotiabank's Corporate Banking team. Prior to joining Scotiabank, Diego worked as a third-party equity research associate for top tier investment banks based in New York and participated in M&A projects at PricewaterhouseCoopers Brazil.

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