Family-Led Banks in the Global Economy

Twenty years ago I would never have dreamt that we would be the ninth-largest bank in the world.

—Emilio Botín III, in Euromoney, 1 July 2005

Santander is one of the most remarkable stories in modern banking.

—Euromoney, 1 July 2005

Banco Santander is an oddity in the big leagues of global banking. Barely two decades ago, this proud financial institution was no more than a second-tier player in Spain, a country rarely if ever regarded as being on the cutting edge of banking. Nowadays, Santander is not only one of the world’s ten largest banks but also the pioneer in European cross-border banking acquisitions with its 2004 takeover of Abbey National in the United Kingdom, a deal worth US$15 billion. This book tells the story of Santander’s striking transformation from being a medium-sized Spanish bank to becoming the largest financial institution in Latin America, the largest bank in the Euro Zone with a market capitalization of nearly US$115 billion, and a major competitor in consumer finance in Northern and Eastern Europe. The bank has also made headlines around the world through alliances and equity stakes in MetLife, First Union, Royal Bank of Scotland, Société Générale, Vodafone, Shinsei Bank, and a number of other companies, from which it eventually divested and obtained more than US$7 billion in capital gains.
Santander stands out as an example of a modern corporation blending family guidance at the top with professional management throughout the organization. It is the only large bank in the world in which three successive generations of the same family have held the top executive position, despite owning a mere 2.5 percent of the equity. After taking the helm in 1986, Emilio Botín III embraced deregulation of the domestic banking sector and initiated a series of bold competitive moves, first in Latin America and later in Europe and the United States, that eventually catapulted the bank from 152nd in the world to the number 10 spot. When he retires sometime in the next few years, his daughter Ana Patricia, a seasoned executive, could well become the first woman to run one of the world’s largest and most influential financial institutions.

Santander is neither as global in geographic reach nor as diversified in terms of the services it offers as Citibank or HSBC, the world’s two largest banks. Most of its operations are focused on commercial (e.g., retail) banking, an activity in which operational efficiency, information technology, and marketing are fundamental tools when it comes to increasing market share or boosting profitability. Higher-margin activities such as wholesale, private, and investment banking represent very small shares of revenues or profits at Santander. Still, in 2006 the bank reported the seventh-largest banking profits in the world, €7.6 billion (about US$10.3 billion). After years of depressed profitability due to financial crises in Latin America and acquisitions in Europe, the bank’s 2.3 million individual shareholders are now enjoying annual returns in excess of 30 percent, above those for most other comparable banks.

The rapid rise to global prominence of a family-led bank originating 150 years ago from a rather marginal provincial town in northern Spain raises a key question. In a recent article, the Economist (16 February 2006) asked, “Why are Spanish companies—hailing from a middle-sized country with little entrepreneurial tradition, income levels that are still below the European Union average, weak language skills and few natural resources—becoming the hunters, and not the hunted?” Much of the evidence in this book focuses on the two main answers to that tantalizing question, as reported by the same magazine: “First, many used expansion in Latin America as a training ground, gaining size and management skills, and hoarding cash. Second, Spain has opened its domestic markets to competition
more quickly and more thoroughly than many other European countries. That has taught Spanish firms to sink or swim."

Besides the more general question of what has made a number of Spanish companies successful in the global economy, Santander itself raises intriguing questions specific to its own experience. What capabilities have made it possible for a firm in a mature industry to better its rivals in so many different countries around the world? What aspects of family-led management have made it possible to grow so fast via acquisition? How has the family managed to exercise influence over corporate governance and strategic decision making while owning just 2.5 percent of the shares? What are the issues surrounding managerial succession? This book seeks to answer these questions by analyzing Santander in the context of a banking industry undergoing rapid technological and competitive changes since the mid 1980s and by providing information and insights into not just Santander but also its global competitors in Europe and the Americas.

We begin our journey in this chapter by reviewing the characteristics of banking as an economic activity and examining the prevalence of family banks in the world in general and Spain in particular. In chapters 2 and 3, we tell the story of the humble origins of Banco Santander in the mid-nineteenth century; its growth via acquisition starting in the 1940s to become a national bank, with the Botín family already leading the bank; and its daring diversification into a wide variety of businesses during the 1960s and 1970s, albeit to a lesser degree than its competitors, which helped it weather the industrial crisis of the 1970s and 1980s. Chapter 4 delves into the complex and intrigue-filled process that led to the combination of three of Spain’s largest banks (Banesto, Central, and Hispano Americano) with Santander to create SCH (Santander Central Hispano). In this chapter we will also point out that Santander’s family character enabled it to take the initiative while its rivals were enmeshed in difficult mergers and managerial struggles. Chapters 5, 6, and 7 focus on Santander’s internationalization, first in Latin America through acquisitions and in the United States through minority positions in the Mid-Atlantic region, then in Europe in the form of alliances with other banks, and lastly with acquisitions in Europe. In those chapters, we also deal with the bank’s increasing sophistication in the areas of information technology and marketing. Chapter 8
Bankers and Banks Worldwide

In the course of history, bankers have engaged in many different types of financial activities, ranging from issuing currency, taking deposits, and extending loans, to discounting paper, providing capital to manufacturing firms, brokering all sorts of transactions, making markets, and managing assets.¹ Historians, clerics, economists, princes, and potentates have variously depicted the bankers and their banks as the heroes and the villains of the market economy. Bankers have occupied the spotlight because of both their rise to prominence
Banking, Industrialization, and the State

Banking is a prominent and symbolic activity because banks tend to play a crucial role in economic development. Manufacturing growth requires the transfer of massive amounts of resources from backward to dynamic economic sectors and often from foreign lenders to targeted domestic recipients. Beginning with Gerschenkron’s landmark book, *Economic Backwardness in Historical Perspective* (1962), the literature has studied banks in the abstract, focusing mainly on their contribution to the development of manufacturing industry and placing a strong emphasis on state-bank and bank-industry relations. Despite decades of research, there is no agreement in the literature as to whether the banking sector—and financial markets in general—should be organized according to market- or state-centered principles in order to accelerate economic development (Cameron 1972; Cameron et al. 1967; Fry 1995; Haggard and Lee 1993; Loriaux 1991, 1997a, 1997b; Zysman 1983), though some recent research shows that government ownership of banks during the 1970s was associated with slower subsequent financial development and lower growth of per capita income and productivity (La Porta et al., 2002).

Due to historical legacies, power struggles, and political compromises, countries have adopted different systems of banking during boom times and their fall from grace during financial panics. The popular imagination has always portrayed banks as powerful actors. Thomas Jefferson thought that “banking establishments are more dangerous to our liberties than standing armies.” Mark Twain was no less critical: “A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain.” Fully cognizant of the role of banks during the nineteenth century, before governments around the world asserted their authority over monetary matters, Mayer Anselm Rothschild used to say: “Permit me to issue and control the money of a nation, and I care not who makes its laws.” And industrialists the world over have tended to fear and loath their power. As a representative of many similar statements, Henry Ford’s declaration captures the sentiment: “It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning.”

"Banking, Industrialization, and the State"
regulation. In some countries, such as the United States, legislation in the early twentieth century restricted the power and range of activity of banks, resulting in a system in which retail banks are not as prominent as in other countries, such as Germany, which allowed them to operate as universal financial institutions engaging in both commercial and investment banking (Deeg 1999; O’Sullivan 2000). In other countries, banks have operated under strong state controls, as in South Korea until the mid-1980s (Fields 1995; Woo 1991); in still other countries, such as India, the state owns much of the banking sector.

Previous scholarship on economic development has largely focused on the determinants of industrial growth, under the assumption that services merely “support” industrialization (Amsden 1989; Guillén 2001; Haggard and Maxfield 1993). However, banks are part of the financial system. In theory, effective financial systems allocate capital to the “best,” or highest return-for-risk, projects. In doing this, they maximize value added for a given capital cost by identifying and funding those firms and entrepreneurs with good projects but insufficient resources. (What is perhaps less appreciated is that they also deny funding to poor projects. Furthermore, the better the financial system, including the banks, the less funding there is of bad projects, and the less rejection of good ones.) Effective financial systems equalize the cost of capital across similar projects and lower it by borrowing from the most patient, allocating risk to the least risk-averse, and by transforming risk and liquidity through credit contracts and risk pooling. They do this by developing new products, distribution channels, and services. The lower cost of capital then increases potential output. These tasks are not trivial, and it is clear that finance matters to development (de Gregorio and Guidotti 1995; King and Levine 1993; Lewis 1978).

A vibrant banking sector can potentially offer many other benefits in addition to effective and efficient resource mobilization and allocation to investors. First, it has the potential of creating large numbers of jobs, ranging from low-skilled bank tellers to highly educated financial analysts and managers. Second, it can generate multiple linkages to other activities, such as insurance, tourism, education, information services, software, and telecommunications. Third, if banks become internationally competitive and start expanding abroad, they may create new market opportunities for other domestic firms, manufacturing or otherwise.
The Rules of Competition in Retail Banking

Given our focus on banking as a service activity in its own right and the fact that Santander has over the years come to concentrate its competitive efforts in retail banking, it is important to review the basic rules of competition in this industry. Banks attempt to borrow cheap and lend dear; the resulting interest rate spread is a primary source of income, one that observers commonly label “asset-based income.” Banks also obtain income from the fees and commissions they charge for services, such as funds transfers and brokerage. The common label here is “fee-based income.” Not surprisingly, the saying in the industry is that “retail banking is boring, and if it is not boring, then it isn’t retail banking.” Lastly, banks may earn capital gains on more speculative activities, such as trading in the foreign exchange or interest rate markets, or holding securities in countries where they may invest in nonfinancial enterprises. This abstract characterization, however, omits the creativity involved in improving processes to cut costs and in marketing efforts to develop innovative products that offer convenience, reward customer loyalty, or solve customers’ problems. In all of these activities, there is money to be made. As a result, successful, large retail banks command a great deal of power and influence in many countries around the world.

One may think of a bank’s strategy from two, complementary perspectives. First, there are Porter’s (1980) three generic strategies. Overall cost leadership involves establishing efficient operations and taking advantage of economies of scale. Product differentiation, by contrast, is all about quality and service. Finally, a niche strategy entails segmenting the market in order to identify profitable groups of customers. These three strategies are not mutually exclusive and banks typically pursue all, though with differing priorities depending on the market, and especially on the behavior of competitors.

The second perspective is a spatial one. Walter (1988) coined the acronym CAP—for client, arena, and product—to describe the three-dimensional matrix or space that a financial institution occupies. The description of a cell in this matrix requires that one specify which type of customer the bank is serving, where in physical space the customers are, and what product the institution is delivering to these clients. Clients may be governments, nonfinancial corporations, financial corporations, high-net-worth (wealthy) individuals,
and retail customers. A bank’s strategy then consists of enumerating where the bank chooses to locate itself in this three-dimensional space. To these three dimensions, one may add a fourth reflecting the value-added chain of linked activities, including where the various parts of the production process for a particular product take place (Tschoegl 2000). The full strategy then consists of which cells in the matrix the bank occupies, and how it competes in each space.

The banking sector is undergoing some important changes worldwide. A key trend has to do with deregulation of financial markets, which has facilitated the international expansion of some banks. This change has taken place during different periods of time and at varying rates of speed depending on the country. As a result of these differences, distinct patterns of international expansion of banks (including Santander) have taken place. Another important trend is disintermediation, or the arrival of competition for banks from nonbanks such as retailers (e.g., Wal-Mart or Carrefour), the financial arms of industrial firms (GE Capital, Honda Financial, Ford Financial Services), hotel chains (Hilton), or Internet-based intermediaries (PayPal). Technological change also has profound implications for back-office operations, customer interface, data interchange, fund transfers, and the enhanced potential for the offshoring of back-office and customer service operations. Finally, the financial and technological culture of the population in various parts of the world has also shifted.

One area in which these changes are readily visible is the choice of distribution channel. Nowadays, about 40 percent of banking transactions in the United States takes place inside a bank branch, 30 percent through an automatic teller machine (ATM), nearly 20 percent over the Internet, and 10 percent over the phone. The trend is toward a greater proportional importance of the Internet channel, whose cost per transaction is only one-hundredth the one at a traditional bank branch. Still, research indicates that banks find it much easier to sell new products at a branch or over the telephone than over the Web, indicating that customers very much desire interaction with human beings when it comes to making important financial decisions (Capgemini 2006). Automated delivery of services, whether via ATMs or the Internet, is most suitable for routine transactions. First-time or one-time transactions appear to require human interaction.

The successful incorporation and exploitation of technology in banking is not straightforward because many applications entail
the development of two-sided networks in which the value of the network to an existing participant on one side increases with each additional participant on the other side (Eisenmann et al. 2006). For instance, an ATM network becomes more valuable to a customer if the service is available through more banks and at a greater number of locations. Conversely, a bank will find the ATM network more attractive to the extent that it has customers using it. Similarly, credit cards are more valuable the greater the number of merchants that accept them, and merchants will be more eager to join if more customers use them as a means of payment. Two-sided network dynamics generate winner-take-all races, enhance the value of loyalty, and invite pricing structures in which the provider uses one side of the network to subsidize the other in order to gain scale. Thus, banks have pursued alliances and other arrangements to roll out technological platforms successfully.

In spite of deregulation, disintermediation, and technological change, retail banking continues to be a business driven by the classic forces of competition (Porter 1980). Like companies in other industries, retail banks seek to erect barriers to entry, reduce rivalry, preempt the threat of substitute products, and reduce the bargaining power of customers and suppliers. Let us analyze each in turn.

To keep competitors at bay, retail banks use several techniques. The most important historically has involved establishing extensive branch networks and fostering customer loyalty. While telephone and Internet banking are eroding the effectiveness of this barrier to entry, bankers reckon that it is not easy to use those channels to enter a new market or dislodge an incumbent bank with many physical branches. Moreover, people trust their bank and are reluctant to switch to a new entrant. This is the main reason why banks prefer to use acquisitions as their preferred mode of entry, especially in foreign markets, as the Santander story illustrates. In some industries, economies of scale too can be a barrier to entry, although in banking increasing size beyond a certain minimum threshold seems to offer little advantage (for a review of the evidence, see Tortella 2001; Walter 2004), except for a few activities such as global custody, asset management, back-office operations, and information systems. Another key barrier to entry, capital requirements, has diminished with the globalization of financial markets. Finally, technology can be a barrier to entry because purchasing it is easy but blending it with existing operations and using it effectively is not. In general,
deregulation of banking around the world has tended to lower barriers to entry.

Like companies in other industries, retail banks seek to reduce rivalry as a way to enhance profits. Rivalry in retail banking markets is higher in developed than in developing countries, a fact that has prompted many banks, including Santander, to pursue growth in emerging economies. In developed markets, the best option to reduce rivalry is to engage in product and service differentiation, a strategy that most banks have followed through marketing and technological innovation. Looking for attractive market niches in which to launch highly specialized products is another way in which banks have sought to enhance profitability. The case of private banking’s catering to the needs of high-income customers is perhaps the best illustration.

Retail banks are on safer ground when it comes to substitute products. For instance, consumer finance has recently risen as a major alternative to traditional lending products. Credit cards have also revolutionized consumer borrowing in many markets around the world. Banks, however, have moved swiftly into these new areas, frequently in competition with nonbank financial intermediaries. Retail banks have been strikingly effective at preempting the competitive threats stemming from substitute products, as the story of Santander also illustrates.

Finally, retail banks can be quite effective at reducing the bargaining power of customers and suppliers alike. Because retail banks deal with millions of customers, it is relatively easy and cost-efficient for them to generate customer loyalty for some products, particularly the basic bank account. The challenge is to sell the customer other products, a skill that large banks such as Santander have come to master in their home markets. Moreover, the globalization of financial markets and the increasing sophistication of financial products make it hard for customers to do without banks when it comes to satisfying their financial needs, except for the very powerful customers, who can bypass the bank. On the supplier side, retail banks are blessed by the growing importance of global financial markets and the evolution of the information technology (IT) industry toward fierce competition. Hence, banks can secure their most important inputs at low cost, although it is true that IT applications need to be customized to the bank’s specific needs and that personnel needs to be trained. In general, retail banks can exert
a reasonable degree of bargaining power over both customers and suppliers.

In sum, retail banks have two basic competitive tools at their disposal. First, they may use marketing to enhance brand reputation and awareness, segment the market, cross-sell products, and generate customer loyalty. Second, they may leverage technology to cut costs as well as support marketing. As the next chapters show, Santander has over the years sought to develop these marketing and technological capabilities in the home country and to exploit them in foreign countries.

The Global Potential of Retail Banking

While retail banking continues to be a relatively profitable activity thanks to the possibility of erecting barriers to entry, reducing rivalry, preempting the threat of substitute products, and reducing the bargaining power of customers and suppliers, retail banks have historically had a very hard time expanding beyond their domestic market. The rise of multinational retail banks such as Citibank, HSBC, BNP Paribas, Santander, BBVA, ABN AMRO, or Royal Bank of Scotland has taken place in an industry that does not naturally lend itself to global expansion (Claessens et al. 2001; Demirgüç-Kunt and Huizinga 1999; Dopico and Wilcox 2002; Grubel 1977; Jones 1993; Tschoegl 1987). The reasons are diverse and have to do with market, cost, regulatory, and competitive factors (Yip 1989).

Retail banking markets differ massively from country to country, making it harder for foreign banks to compete against local banks. A first important dimension is customer preferences and tastes. For instance, in markets such as the United States, customers prefer fixed-rate mortgages, whereas in most of Continental Europe the norm is variable-rate mortgages. Differences in preferences also extend into the way in which the service is delivered. In most of Europe and in Latin America, for example, face-to-face interaction is preferred. As a result, in some countries banks maintain extensive branch networks. Spain is one such country, with about ninety-six branches per 100,000 inhabitants. By contrast, Germany has forty-nine; Canada, forty-six; and France, forty-three. In the United States and the United Kingdom, the numbers are thirty-one and eighteen, respectively. Banks themselves have contributed to the differences by adapting marketing strategies to the specific
characteristics of local markets and even having different brands for different markets.

Another major source of cross-national fragmentation in retail banking has to do with government regulation. Although cross-border capital flows are relatively free and technical standards have converged, thanks to arrangements such as the Basle Accords, regulations concerning licenses, minimal capital requirements, deposit coefficients (required reserves), legal acceptability of diversification into other financial services, and specific product regulations differ greatly from market to market. As noted previously, in some countries regulations restrict banks in the extent to which they can deal in securities, offer insurance products, engage in real-estate activities, or hold stakes in nonfinancial firms. For example, in terms of product regulations, Chile forbids lottery-linked savings accounts, whereas neighboring Argentina permits them (Guillén and Tschoegl 2002).

The degree of market concentration too differs from country to country, both reflecting and affecting the competitive situation. The only developed banking markets that are very highly concentrated are those of relatively small countries. For instance, in Canada, Belgium, Sweden, or the Netherlands, the top four banks account for upward of 75 percent of total deposits or loans. In midsized countries such as Italy, Spain, or France, the top four banks represent between 30 and 60 percent, a moderate degree of concentration. In large economies such as Germany or the United States, the top four banks account for less than 25 percent. In these markets, savings and loans or other types of regional and local financial institutions have proliferated over the years. Among emerging economies, Chile, Mexico, and Brazil have very high concentration, while South Korea or Argentina do not. Differences in concentration from market to market make it harder for any bank to pursue uniform, global strategies.

Lastly, from the point of view of cost, the retail banking industry is more global and less fragmented than market, regulatory, and competitive factors suggest. The opportunities for outsourcing back-office and customer service operations (“call centers”) are growing very quickly thanks to improvements in telecommunications technology (UNCTAD 2004). Economies of scale may not be very steep beyond a certain minimum threshold, but the globalization of financial markets has made wholesale and corporate banking more subject to them (Walter 2004). Finally, economies of scope are
becoming ever more important as restrictions on universal banking are disappearing and banks seek to cross-sell products in order to enhance customer loyalty and boost profitability.

The relatively high level of fragmentation of retail banking markets around the world has several implications, which one must keep in mind when analyzing Santander’s pattern of growth over the past two decades. Foreign entrants tend to acquire local banks instead of building their operations from scratch. This accomplishes two goals. First, in moderately to highly concentrated markets, acquisitions help overcome competitive barriers to entry. Second, the acquisition of local assets offers the foreign entrant knowledge about the peculiarities of the local market. Fragmentation also leads foreign entrants to organize their operations on a country-by-country basis, with cross-border coordination oftentimes limited at best to some back-office operations.

Santander as a Family-Led Bank and a Professional Bank

The complexity, sophistication, and fragmentation of competition in retail banking cumulate to create what many regard as too daunting a challenge for any bank to overcome on an international basis. In the past, few banks were strong players in the retail segment in more than one country, as the literature has pointed out (Tschoegl 1987). Santander not only is one of those rare multinational retail banks but is also the only bank among the world’s top ten in which three generations of a family have exerted a key influence over decisions concerning corporate governance and overall strategy. Because of this combination of features, Santander is an almost irresistible case study in which to explore the advantages and disadvantages of family control and management. The fact that members of the family own only 2.5 percent of the equity makes their influence even more intriguing to study.

Family dynasties are part of the folklore of the banking industry. The stories of the Medicis and the Fuggers in early modern Europe, the Rothschilds, Bleichröders, and Peréires during the nineteenth century, the Morgans, Warburgs, Mellons, and Rockefellers during the Gilded Age, and the Wallenbergs and Botins during the second half of the twentieth and into the twenty-first century show
that banking has often been a family affair. Many of today’s large banks have a family origin, including Barclays, Mitsubishi-Tokyo, Paribas, or JP Morgan Chase. In a study of the international growth of Singapore’s largest banks, several of which are or were owned, controlled, and managed by families, Tschoegl (2002b) argued that although family management could provide higher growth through the lessening of principal-agent problems, it might do so at the cost of higher risk due to less effective governance. As Landes (1993) demonstrates in his paper on two of the great nineteenth-century German private banks, Bleichröders and Rothschilds, succession is a problem with idiosyncratic elements that can contribute to deteriorating performance (Bleichröders) or continuing success (Rothschilds). Many family banks have successfully made the transition from family to professional management, without the family losing control, as in the cases of Singapore’s Oversea-Chinese Banking Corporation (Tsui-Auch 2004), Sweden’s Skandinaviska Enskilda Banken (Lindgren 2007; Sjögren 2006), or Santander itself (for these and other family banks, see table 1.1).

In this book, we seek to understand how a bank led by the third, and perhaps one day the fourth, generation of a family manages to outgrow not only its domestic counterparts but also most of its international competitors. One may argue that family leadership can be a source of competitive advantage in an oligopolistic industry characterized by entrenched incumbents and high barriers to entry because decisive action is necessary to counter competitors’ moves and to pursue acquisitions aggressively whenever the opportunity arises to enter a new market. In fact, our previous research suggests that Emilio Botín III has been central to the identification and pursuit of specific merger and acquisition opportunities over the past fifteen years (Guillén 2001, 2005; Guillén and Tschoegl 2000). Many observers attribute Santander’s rapid growth to his charismatic and decisive management style, which has enabled the bank to seize unique opportunities and to deliver good returns to shareholders.

We seek to use the case study of Santander to better assess the transformation of family firms over time. Santander underwent four transitions. It began as a provincial bank back in 1857, only becoming a national bank a century later, that is, during the 1950s and 1960s. Then it went from being a focused retail bank to an emerging diversified financial and industrial business group during the 1970s and early 1980s. Next, it transformed itself from being a mostly
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<th>Tier-One Capital (billion US $)</th>
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Sources: The Banker (July 2006); Factiva.

*By the end of 2006 the percentage had climbed to 2.5 percent.

*Acquired by Bank of America in 2003.
domestic financial institution into one with a strong presence in Latin America during the 1990s, at a time when it also decided to refocus on retail banking. In the first five years of the new century, it has shifted from being a Spanish-speaking bank to a European financial powerhouse with global ambitions. In each of these shifts, successive generations of the Botín family have played a crucial role. How exactly did Banco Santander manage to outsmart its Spanish and European competitors to reach its present position? What have been the risks associated with Santander’s expansion strategy, and what role did its family-led character play in assuming or mitigating those risks? Did family influence interact in any significant way with the external environment of liberalization and deregulation to produce better performance? How can control be exercised in excess of ownership without dual-class shares or ownership pyramids? These are the key questions pursued in the chapters that follow.