

BRAZIL

BANKING

SUMMARY

Foreign participation in Brazil's financial sector is regulated by the Brazilian Constitution. Under transitional provisions in effect since 1988, the establishment of new branches and bank subsidiaries of foreign banking institutions is prohibited. This includes a freeze on increases in the percentage of foreign participation in the capital stock of Brazilian institutions. In addition, the number of branches (including automated teller machines) of a foreign bank cannot exceed the total existing on October 5, 1988. However, the government has in practice allowed substantial foreign entry and expansion to occur in recent years. Since March 1995, transitional rules have permitted exceptions on the basis of obligations under international agreements, reciprocity, or national interest as determined by the President of the Republic. The government will, in general, levy a toll on foreign banks that are newly entering the Brazilian banking system. This varies from an outright payment to acceptance of doubtful assets from troubled institutions subject to central bank intervention.

The Brazilian banking sector underwent a period of painful adjustment following the introduction of the "Real Plan" economic stabilization program in July 1994. Banks had successfully adjusted to the country's formerly high inflation (averaging 1,000 percent per year in the decade prior to 1994) by extending branch networks and emphasizing treasury operations instead of lending and fee-based services. In particular, banks have been able to earn favorable rates of return compared to other sectors of the economy by using float, especially on non-interest-bearing deposits. It has been estimated that banks enjoyed some US\$9 billion in "float income" in 1993, the year inflation peaked at almost 2,500 percent. Following the sharp drop in inflation beginning in the second half of 1994, Brazilian banks were forced to reduce administrative overhead and to increase income from other sources including credit operations. Due to high real interest rates and lack of experience in credit operations, banks began to face rising defaults in 1995. A period of bank consolidation commenced in that year which continues to the present.

The government acted quickly to restore stability to the banking system in 1995, intervening and facilitating the orderly exit of two major private banks and other smaller financial institutions. Beginning in March, it passed regulations permitting the entry or expansion of foreign capital in the banking system on a case by case basis. In November 1995, the government instituted a program to facilitate the restructuring of the private banking sector known as PROER. Up until November 1997, PROER provided some US\$19 billion in financing to six banks. Some 40 private institutions were liquidated, sold, or subjected to central bank intervention during the period. Of 248 commercial, multiple, and savings banks in June 1994, only 211 remain.

The major task remaining is to restructure the country's public sector banking system. Two state banks and one federal bank have already been privatized. Fully two-thirds of existing state banking

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institutions are to be privatized, wound up, or converted into development agencies under the public bank financial restructuring program known as PROES.

Several trends are evident in the evolution of Brazil's banking system since 1994: the share of private sector banks in total assets is increasing; there is a movement toward greater concentration among private sector banks; and the share of foreign bank ownership is growing. Correspondingly, the share of publicly owned banking assets has declined, in large part reflecting the exit of a few state-owned banks from the system and the operational limitations imposed by the central bank on some of the state-owned banks.

Public sector banks play an important role in the Brazilian banking system. The top two banks in the country are owned or controlled by the federal government and the third by the most important state. The last has been under central bank intervention since December 1994 and is slated for privatization. Public sector banks profited greatly from the high inflation environment due to their large branch networks and access to official deposits, but they have also been required to support administration policies and often have been subject to political pressures. As a consequence, both federal and state banks have had greater problems with non-performing loans in the last several years. The second largest public sector bank had massive losses in both 1996 and 1997 and required recapitalization by the federal government. State banks have reported a string of losses in the years since the Real Plan.

Foreign owned or controlled banks accounted for 18 percent of total bank assets in December 1997, up from 13 percent in December 1995. In most cases, foreign investment is approved in connection with the sale of a troubled private or public bank and includes payment of a premium to the government that may be either cash or assumption of problem assets. The most notable case of foreign entry into the domestic market took place in March 1997 when the fourth largest private bank was sold to a London-based global bank.

The U.S. banking presence in Brazil is growing. According to U.S. government statistics, U.S. foreign direct investment (FDI) in the banking sector (depository institutions only) increased by 78 percent to US\$1.5 billion by the end of 1997. Much of this expansion reflects acquisition activity, particularly since 1996. Expansion into investment banking has been a notable trend in recent years.

DESCRIPTION OF THE MARKET

Brazil's financial sector is the largest in Latin America with bank assets totaling US\$697 billion. The banking industry has 240 banking institutions operating 16,300 branches. Banks remain the primary purchasers of Brazilian government debt, both for their own account and on behalf of investment funds that they manage.

Public Sector Banks

Public sector banks play an important role in the Brazilian banking system, and accounted for 51 percent of total assets and 58 percent of deposits as of December 1997. The government-controlled Banco do Brasil, which performed many central bank functions prior to the 1964 establishment of the Banco Central do Brasil (central bank), is the largest commercial bank in the country and the second largest of all banking institutions in terms of total assets. Banco do Brasil acts as the government's agent in many transactions, including provision of export credit via the official PROEX program, and is the depository for federal government receipts. It operates throughout the country via its over 3,000 branches, has the largest deposit base in the country, and is frequently the only bank in town in the country's interior. Banco do Brasil is also the primary lender to the rural sector and is frequently called upon to make loans to support Brazilian development projects. As a result, it also has the largest bad debt portfolio (56 percent of credit operations and 31 percent of assets) of any bank in Brazil with the exception of troubled Sao Paulo state banking institution Banespa.

The Federal Savings Bank (CEF) is the largest bank in the country and the primary source of housing finance in the country. A 1997 real estate law made it possible for more private sector banks to engage in mortgage lending as it simplified the foreclosure process but has not yet been fully implemented. CEF administers funds derived from a number of taxes, accepts deposits, and offers checking accounts. It is second only to the Banco do Brasil in terms of its branch operations around the country. It is less competitive with private banks than the Banco do Brasil because of its narrower mandate. However, CEF accounts for 25 percent of all savings accounts and 35 percent of long-term deposits in the country.

The National Economic and Social Development Bank (BNDES) finances infrastructure and industrial projects and has been particularly active in providing long-term funding in connection with Brazil's ongoing privatization program. BNDES makes loans to companies with financial problems and has on occasion acted on behalf of the government to bolster stock market activity. Through BNDES, the Brazilian government is a shareholder in a number of domestic companies. One of the few sources of long-term finance in the country, BNDES derives much of its funding from international financial institutions as well as from earmarked tax collections. BNDES does not engage in ordinary commercial banking and currently is not considered a competitor of private banks.

Public banks have traditionally enjoyed certain advantages over private banks with respect to the capture of government resources such as tax collections. Due in part to their extensive branch networks, public banks also benefitted most during the high inflation period and were among the hardest hit when it ended in 1994. However, public banks were also subject to statutory mandates and political pressures to make poor quality loans or to accept and continue to roll over state debt instruments. For these reasons, the bad debt portfolio of the public banks is considerably higher than

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that of the private banking sector. In addition, public banks have higher administrative costs both due to their generally larger branch networks and to the difficulty of reducing bloated payrolls.

With the sale of private banking institution Bamerindus to the Hongkong & Shanghai Banking Corporation in March 1997, Brazil largely completed the restructuring of its private banking system following the introduction of the Real Plan. Thereafter, the main attention of the government turned to the public banking sector, especially state banking institutions. The objective of the PROES program, approved in mid-1996, is to liquidate, privatize, restructure, or convert to development agency status troubled state and federal banks. From July 1994 to December 1997, 35 private banks and eight public banks were either liquidated or subject to central bank intervention. Of the 33 state banking institutions existing in July 1994, fully two-thirds are to be reorganized. Rio de Janeiro state bank Banerj, Minas Gerais state bank Credireal, and federal bank Meridional have already been privatized. The next major step is the privatization of Sao Paulo state bank Banespa.

Private Banks

Brazil's largest private banks began as family operations and have become diversified financial institutions. Family interests continue to be important in terms of ownership and sometimes management. Due to increased competition and globalization, small and medium-sized family-owned banks are increasingly likely to be acquired by larger banks unless they are able to exploit a market niche. The fifth largest bank in the country is privately owned Bradesco.

Multiple Bank Licenses

Private and public banks with multiple bank licenses dominate the market. Multiple banks not only provide traditional commercial banking services, but also offer investment banking, consumer credit (financing) real estate lending, and leasing. The advantage of a multiple bank license is mainly lower cost, both in terms of lower supervision cost and compliance capital. With special departments, such banks can carry out activities of two or more financial institutions without the need to incorporate separate entities. Many institutions, including foreign financial companies, have taken advantage of the greater flexibility afforded to multiple banks and have transformed their operations into multiple banks. As a result, multiple banks include both government and privately owned banks. Multiple banks currently constitute 176 of the 240 commercial, multiple, savings, investment, and development banks operating in Brazil.

Creation of a multiple bank requires prior central bank approval and can be accomplished by various means including mergers, acquisitions, or incorporation of new institutions. Multiple banks cannot issue debentures. Only the domestic subsidiaries of foreign banks may hold such a license, not the overseas bank itself.

Financial Institutions (percent of total assets) December 31, 1997	
Multiple Banks	51.5
Federal Savings Bank*	14.0
Banco do Brasil*	12.2
National Development Bank*	7.3
Commercial Banks	4.5
Leasing Companies	4.2
Investment Banks	1.6
Stock Distributors	1.4
Brokerage Houses	1.1
Real Estate Finance	1.1
State Development Banks*	0.6
Finance Companies	0.5
State Savings Banks*	0.2

* indicates public sector institutions

Source: Central Bank

Supervision

The National Monetary Council establishes overall general policies for the financial system. Members of the Council include the Ministers of Finance and Planning and the President of the central bank. The central bank has broad discretion to issue administrative rulings in order to execute policies set out by the Council. It oversees the banking system and conducts on-site inspections as well as off-site monitoring and surveillance, both domestically and overseas. The Central Bank's supervisory activities are mainly carried out by inspectors, many of which are newly hired. Since August 1996, the central bank has been in the process of replacing a number of experienced personnel who left its employ due to a change in the retirement system.

A number of steps have been taken since 1994 to improve bank supervision and regulation. The central bank has received additional powers to act preventively such as the power to recommend changes including merger or acquisition prior to formal intervention or liquidation. Since 1996, outside auditors have been personally liable for the accuracy of their reports. Some Brazilian banks

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have begun using U.S. accounting standards (GAAP) in preparing annual reports. A deposit insurance system was instituted in 1995 that offers protection of up to R20,000 (US\$18,000) per person per institution. This limit covers 95 percent of credit holders and about 50 percent of the total value of demand and savings deposits, certificates of deposit, and other bank liabilities such as mortgage bills, and consumer credit bills. The measure is temporary in that the Constitution of 1988 requires that the congress pass new legislation governing the entire financial system including a fund or insurance to guarantee credits against financial institutions.

A Credit Risk Center instituted in May 1997 is a database of information regarding loans of more than R50,000 in value. Over 400 financial institutions currently provide information regarding credit operations more than R50,000 (US\$43,000) in value based on company or individual name.

In December 1994, all banks were required to meet the 8 percent BIS capital-adequacy ratio. This minimum was subsequently raised to 10 percent and will be set at 11 percent in 1999. Capital adequacy requirements for branches of foreign banks are based on the local capital of the branch. Foreign banks are subject to the same BIS standards and operational and lending limits as domestic banks.

Impact of Lower Inflation

A major factor affecting the Brazilian banking sector during the past few years has been the rapid drop in inflation and the consequent disappearance of "float income" derived from very short-term lending of idle balances and delays in monetary correction of deposits. During the decade prior to 1994, inflation averaged 1,000 percent per year. In this environment, banking profits rose with inflation and the emphasis was on expanding the number of branch offices, treasury operations, and greater efficiency in areas such as check clearing. As a result of inflation-derived income, the share of the financial sector in GDP peaked at almost 16 percent in 1993 before falling back sharply to under 7 percent by 1995.

With the reduction in inflation, banks were forced to reorganize their asset portfolios, reduce operating costs, and rely more on income from loans and service charges. Banks initially expanded credit operations rapidly following the introduction of the Real Plan. However, high real interest rates and lack of experience with credit operations led to a rising default rate beginning in late 1995. The default rate began to fall by mid-1997 as lending policies became more conservative. The Brazilian banking system continues to have one of the lowest credit/GDP ratios in the world at about 30 percent. In spite of considerable reorganization, Brazilian retail banks have a long way to go to attain international efficiency levels. In a recent study, consulting firm McKinsey concluded that labor productivity in Brazilian retail banks was only 40 percent that of the United States. The increasing number of banks (some of them major) encountering difficulties led to the creation of the PROER and PROES private and public bank restructuring programs. Since 1994, the industry has undergone a wave of mergers and acquisitions and it has been predicted that the number of banks

could halve in the next decade.

Total Assets of the Brazilian Banking System (US\$ billions)		
	December 1996	December 1997
Total Banks (218)	559.7	646.5
Largest Banks (20)	170.0	244.9
Foreign Banks (68)	79.7	123.2
U.S. Banks (9)	13.2	11.8

Net Worth of the Brazilian Banking System (US\$ billions)		
	December 1996	December 1997
Total Banks (218)	55.2	55.3
Largest Banks (20)	20.3	21.3
Foreign Banks (70)	7.8	11.6
U.S. Banks (9)	1.2	1.2

Source: Central Bank

U.S. PRESENCE IN THE MARKET

The U.S. banking industry has a significant and growing presence in Brazil. Five banks – BankBoston, Citibank, Chase Manhattan, J.P. Morgan, and GM – are among the top 50 banking groups in the country and the first two are among the top 20. BankBoston and Citibank are active in retail banking with 35 and 21 branches, respectively, as of December 1997. BankBoston increased its number of banking branches by six during 1997. Chase and J.P. Morgan focus on investment banking. Since 1995, a number of U.S. institutions have entered the banking sector for the first time or expanded their presence.

Citibank and BankBoston entered Brazil prior to 1940 as branches of their U.S. parent banks with full commercial banking rights. They retain this status as a grandfather privilege. Since the Second World War, foreign banks have not been permitted to enter as branches. Citibank, BankBoston, and

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American Express have transformed their financial operations into multiple banks. General Motors and Ford hold multiple bank licenses but engage primarily in consumer lending to finance the purchase of company products. Merrill Lynch also holds a multiple bank license but functions mainly as an investment bank. During the last two years, the United States has increased its presence in investment banking, in particular with the addition of Mellon Bank, American Express, and NationsBank.

In addition to nine banks from the United States, 60 other banks with foreign participation currently operate in Brazil. A wide variety of countries are represented with Great Britain, Japan, and, most recently, Spain and Portugal playing prominent roles. As a group, foreign banks account for 18 percent of banking sector assets, up sharply from 13 percent in 1995. In all, 70 wholly or partly owned foreign banks operated in Brazil as of December 1997.

Total Assets of U.S. Banks in Brazil (US\$ millions)		
	1996	1997
BankBoston Bco Multiplo S.A.	5,427.5	4,914.8
Bco Chase Manhattan S.A.	2,972.4	2,328.7
Citibank N.A.	2,945.2	1,623.5
Bco General Motors S.A.	1,411.0	1,040.1
Bco J.P. Morgan S.A.	420.4	791.0
Bco Ford S.A.	628.7	719.9
Republic National Bank NY S.A.	39.7	304.5
Wachovia S.A.	152.3	79.3
Bco Merrill-Lynch S.A.	164.5	36.7

Net Worth of U.S. Banks in Brazil
(US\$ millions)

	1996	1997
BankBoston Bco Multiplo S.A	276.7	336.4
Bco Chase Manhattan S.A.	244.6	264.6
Citibank N.A.	314.5	243.0
Bco General Motors S.A.	128.5	170.6
Bco J.P. Morgan	49.2	68.8
Bco Ford S.A.	55.4	77.9
Republic National Bank NY S.A.	34.8	38.7
Wachovia S.A.	41.5	23.4
Bco Merrill-Lynch S.A.	21.1	17.4

Source: Central Bank

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

Brazil's Constitution of 1988 charged the Brazilian congress with drafting an omnibus law governing virtually all aspects of the financial system from the making of monetary policy to the regulation of banks, securities firms, and the insurance sector. In particular, Article 192 of the Constitution requires a so-called Complementary Law to define the conditions for new or increased participation of foreign capital in the financial sector. Work on implementing legislation has progressed slowly, but there is a good chance that proposed legislation could be voted into law by 1999. In the meantime, Article 52 (a transitional provision) prohibits the expansion of foreign bank ownership and freezes the number of bank branches at the October 1988 level. However, the provision has ceased to have practical meaning in that new entry or expansion of foreign bank branches have generally been approved on a case by case basis. In 1995, the government decided that the Executive Branch could make exceptions to this rule on the basis of international obligation, reciprocity, or national interest. Another important criterion is the degree of financial innovation the foreign bank will bring to the market. The transitional provision has been applied liberally and U.S. banks have not expressed dissatisfaction with its workings in practice. Establishment and expansion of ATM networks, though legally restricted, in practice has also been permitted.

Methods of entry into commercial and investment banking have varied from acquisition of sound or failing banks, with or without payment of a premium to the government, to the establishment of new operations. A primary criterion for entry is the national interest, particularly in the case of

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troubled institutions. Another important consideration is the degree of technical or financial innovation the new firm will bring to the market. Related considerations include improved export competitiveness and access to new markets. The government will, in general, levy a toll (pedagio) to foreign banks that are newly entering the Brazilian banking system. This varies from an outright payment to acceptance of doubtful assets from troubled institutions subject to central bank intervention. Although entry must be approved on a case-by-case basis due to Constitutional restrictions, this has not proved a hindrance in practice.

In WTO Financial Services negotiations held in December 1997, Brazil offered to provide national treatment in banking, pending approval of the Complementary Law and subject to the provision that all members of senior management of financial service suppliers must be permanent residents of Brazil. While there has been some discussion of harmonizing banking standards within Mercosur, the trading block that includes Argentina, Brazil, Uruguay and Paraguay, there have been no concrete decisions to date.