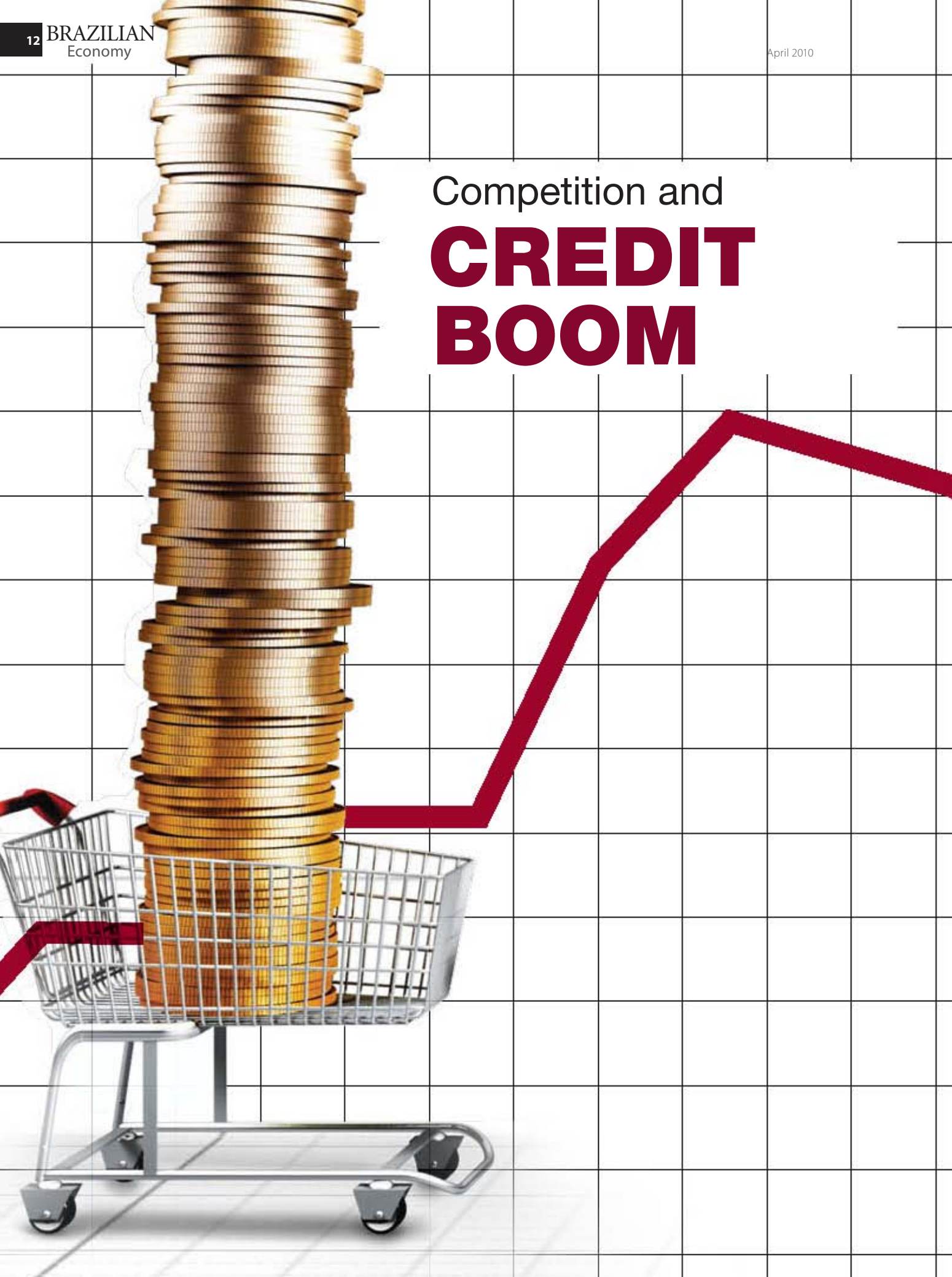


Competition and **CREDIT BOOM**



Liliana Lavoratti, Rio de Janeiro

Credit in Brazil is undergoing a true revolution. The financial system's total loans to households and businesses could very well double from the current 45% of GDP in 10 years, according to estimates provided by banking institutions. Certain signs — such as the unprecedented bank competition being driven by government-owned financial institutions — suggest that the current expansion reflects structural changes. But despite the fact that the competitive pressure is already inducing a decline in the cost of money, Brazilians will still pay dearly for bank loans for some time yet: Brazil has the highest bank interest margin of 130 countries surveyed recently by the World Economic Forum.

The volume of credit in Brazil — about R\$200 billion in 1994 — has soared to R\$1.4 trillion (US\$800 billion) today, increasing 16% just in the last year; Febraban, the Brazilian Banking Federation, estimates that it will increase by at least 20% in 2010. This trajectory could push the credit-to-GDP ratio to 53% in 2011, and possibly 72% in 2020, says Nilton Pelegriño, Bradesco Bank's director for credit and financing. “The expansion of economic activity combined

with its decentralization to different regions increases credit opportunities to companies as well,” says Altamir Lopes, head of the Central Bank economic department, “adding that “the increase in income and formal employment seen in recent months is good news for personal credit.”

Caixa Econômica Federal, the federal savings bank, intends to expand all credit lines by 30%, particularly mortgage credit. Real estate loans totaled R\$8.5 billion in January and February alone — more than in the whole of in 2005. Caixa has now secured 82.3% of the home mortgage market, says Marcio Percival Alves Pinto, its vice-president for finance. At Banco do Brasil, the government commercial bank, which increased its credit portfolio by 33.8% in 2009 and registered the highest yearly profit ever by a Brazilian bank, credit growth is expected to increase 18% — 23% in 2010. Among the catalyzing factors are the good performance of the formal labor market, which reduces income fluctuations, and the 20% increase of investment, says Walter Malieni Jr., Banco do Brasil credit director. Malieni also cites the confidence of consumers and the business sector revealed in recent surveys as another

positive factor for credit supply and demand in 2010. Banco do Brasil functions as loan agent for the Sustainable Growth Program, a credit line from the BNDES (Brazilian Economic and Social Development Bank), which charges corporations an end-user interest rate of 4.5% a year.

So far, however, expanded credit has been driven by household consumption, and has benefitted the retail sector over industry. In real terms, credit to individuals expanded 13.3% in January compared with January 2009, but credit to businesses fell by 1.4%, probably because of last year's economic stagnation and persisting guarantee requirements. From now on, however, credit expansion should be more balanced between individuals and corporations due to an increase in credit for logistics and construction, investment in infrastructure to support economic growth of 5%, and preparations for the Soccer World Cup and the Olympic Games.

Supply and demand

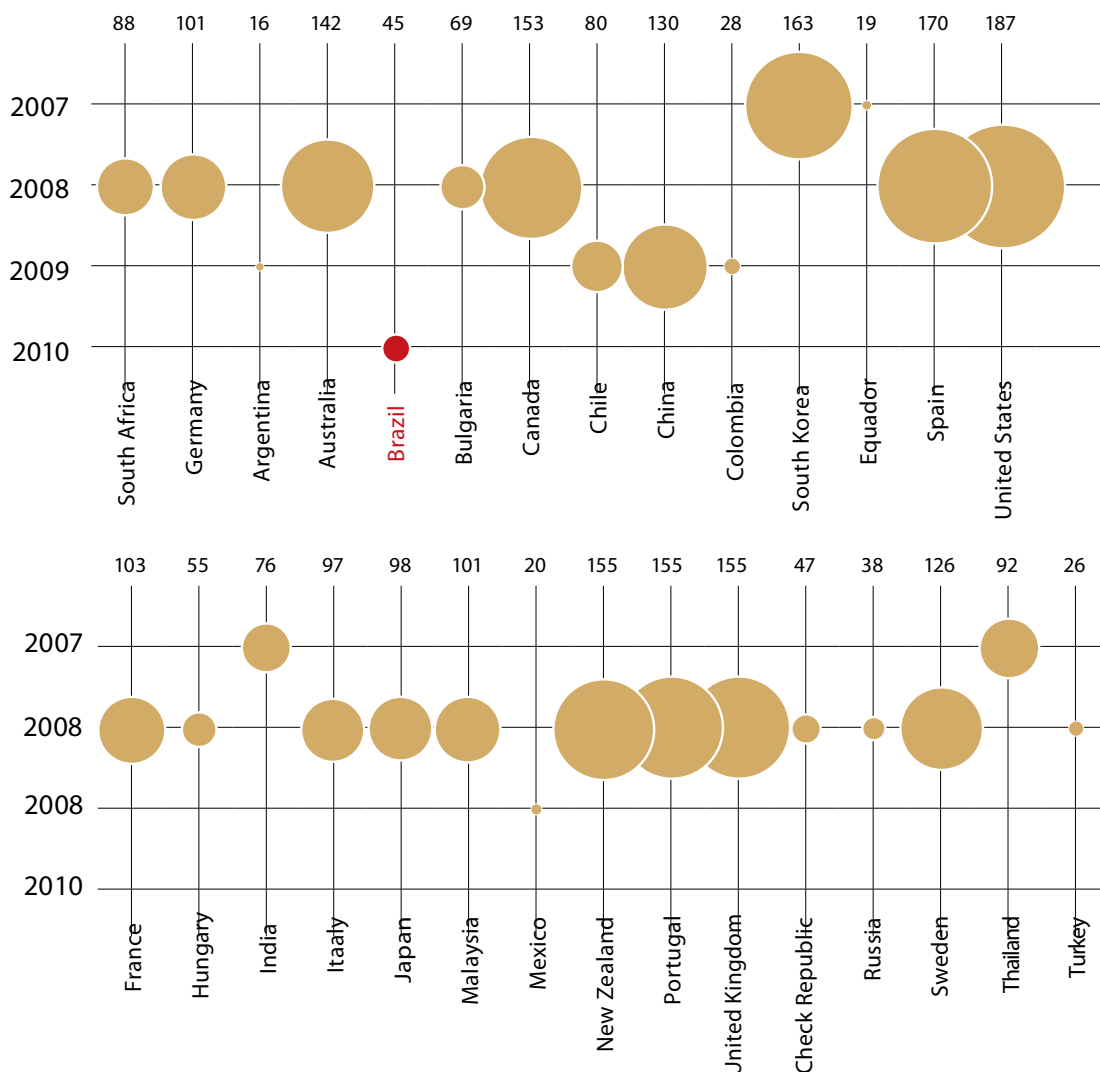
Both supply and demand are fueling credit expansion in Brazil. “Banks have moved away from having the public sector as their sole client;

financing of the public deficit through acquisition of Treasury bills is no longer as attractive since interest rates and the total debt stock have declined,” explains Bráulio Borges, chief economist at LCA Consulting. Here, the intervention of the monetary authorities to persuade government-owned banks to increase credit was fundamental. “Private banks have looked for and

found a consumer ready to spend. That has generated feedback in the form of credit expansion,” says Fábio Silveira, partner and director at RC Consulting.

Longer-term loans have also helped bring about change since they significantly reduce monthly payments. Five years ago the maximum term was 30 months. Because today a car can be financed over 84 months, many more

Credit-to-GDP ratio (% of GDP)



Sources: Credit Suisse, International Monetary Fund, and World Bank.

Brazilians can now fit a monthly car payment into their budget.

Another factor in the credit boom is innovative products, such as the consigned loans created in 2003, for which payments are directly debited from borrowers' salaries. They allow Brazilians earning at least the minimum wage (US\$300) to obtain personal credit. "Today, the stock of consigned loans totals R\$110 billion; in 2003, it was equal to zero," the Central Bank's Lopes reminds us. Consigned loans account for R\$478 billion — 35% of all credit to individuals.

Legislative improvements have also been important, says Rubens Sardenberg, Febraban's chief economist. The bankruptcy law (No. 11,101 of 2005) now excludes the financing for real estate projects from a bankrupt company's assets, and it is now easier to repossess real estate from defaulters. Before those institutional changes in 2003, real estate financing represented no more than 1.5% of GDP. Today it has doubled to about 3%, though that is still far below averages of 10% to 15% of GDP in emerging countries and up to 100% in Europe and the US.

Professor Pedro Cavalcanti Ferreira of the FGV Graduate School of Economics comments that "The lower-middle-class market expanded after the rules on risks became more transparent for both parties to a contract. Today, anyone earning five times the minimum wage (US\$1,500 a month) can finance a home." LCA Consulting's Borges agrees: "The next step after buying or trading in a car is financing a home or improving existing property."

To do so the expansion of wages is essential because it gives the consumer the confidence to purchase real estate. An additional push is the federal government's My House, My Life Program, which subsidizes home purchases by low-income households otherwise ineligible for traditional bank financing.

Bradesco's Pelegrino suggests another reason the financial system may be expanding the supply of housing credit: about 32 million Brazilians have in the last five years risen from the very-low- into the lower-middle-income class: "This represents more people than the combined populations of Paraguay, Chile, and Uruguay. It is a lot of people aspiring to purchase or furnish their homes or to buy cars." As a result, the credit-to-GDP ratio has soared from 20% in 2003 to 45% today.

Corporations

Recently credit to corporations, a structural problem for the Brazilian economy, has also been on the rise, although more slowly than credit to individuals. The crisis is over, the economy has taken off, but the problem persists. "The world is making capital available, and conditions in Brazil are positive; this does not mean, however, that life has been made any easier for the business community," says Humberto Barbato, Chairman of Abinee, the Brazilian Association of the Electric and Electronic Industry. Julio Cesar Gomes de Almeida, a former secretary for economic policy at the Ministry of Finance and now professor at the

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University of Campinas, agrees that “The explosion of credit . . . has yet to reach industry.”

Thus it is still difficult to be an entrepreneur in Brazil. Barbato says, “The high cost of working capital, about 20% a year, and the low level of external competitiveness because of exchange rate appreciation leads to the sad conclusion that the bank ends up pocketing the bulk of the profits generated by industrial activity.” He believes it is impossible for a small or micro-enterprise to operate with bank rates of 50% – to 60% a year for working capital: “No company is that profitable.”

Whereas credit to the retail sector grew 6% and to agriculture 2%, credit to industry retracted by 0.9% in January this year compared with January last year, Gomes de Almeida notes. But he believes this disparity will disappear during the year as production recovers.

Milton Bogus is director of the Department for Micro-, Small- and Medium-sized production companies at the São Paulo Industrial Federation (Fiesp). He says, “Banks keep insisting on looking into the past rather than the present and the future before deciding to approve loans.” Although aware that small- and medium-sized enterprises carry higher risk, he feels that assessment of repayment capacity should be based less on last year’s reduced sales and more on increases in orders: “Industrial production fell by 5.5% last year, but it will be in very good shape in the medium term.”

Gomes de Almeida says that though credit programs and guarantee funds are important, credit

is actually built on a relationship of trust. “The financial system must know the company’s situation before lending money to it. A pattern of relationship between businesses and the banks was developing, but it was interrupted when the crisis broke out,” he explains.

Last August, recognizing the possibilities in the credit market opened up by the revival of investment, Banco do Brasil launched the FGO (Operational Guarantee Fund), making R\$2.7 billion available to micro- and small-sized enterprises in the next five months rather than a planned R\$1 billion. “By ensuring up to 80% of the value of the loan and by replacing the collateral, the FGO reduces financial costs and stimulates lending,” Maliene says. Banco do Brasil also recognizes that medium- and small-sized businesses require more time to pay off debts and has extended its loan terms from the customary 180 days to a full year.

Bradesco Bank is also paying more attention to businesses. Its strategic plan projects growth of 21%–25% in its credit portfolio in 2010, triple the 2009 figure. “From now on, the growth of credit to individuals and to corporations will be more balanced,” Pelegrino says. The bank has opened branches in all municipalities and has been creating products to support local production. It has earmarked R\$750 million for 25,000 micro-enterprises.

Corporate credit in Brazil has run into issues similar to those in other countries: a growing economy, competition between resource suppliers, and a capital market that is still developing. It all

depends, says Rubens Sardenberg, chief economist at Febraban, on “maintenance of a stable macro-horizon, where institutions are preserved, and where the rules of the game remain unchanged.” The high cost of registering a company is another hindrance to starting up businesses.

Long-term investment credit is in practice dominated by the BNDES; all other banks grant credit only for a maximum of three years. Besides the fact that large businesses absorb most of its resources, BNDES lacks a structure to meet the demand generated by its own programs — “which, incidentally, are successful” — Abinee’s Barbato notes. “The release of working capital is slow, and the other banks, acting as financial agents for BNDES, end up pushing their own credit lines to businesses which, although more expensive, win through due to speedier procedures,” he says. That is why FGV professor Cavalcanti Ferreira proposes a more aggressive BNDES stance toward medium-sized enterprises.

The ability to access BNDES credit is what produces the divide between businesses that enjoy low-cost investment — the same large enterprises that have access to capital markets — and medium-, small-, and micro-sized enterprises, points out Gomes de Almeida. The difference in interest rates is enormous, he says: “The average cost of investment funding in the general market is 26.5% a year, whereas BNDES credit lines, even when made available through financial agents, do not exceed 10% a year.”

The head of BNDES Economic Research, Ernani Torres, says that its client base “is the face of Brazil, and includes all types and sizes of businesses that invest.” However, “good projects with real guarantees are submitted to us. And it is the large corporations that invest in infrastructure, which happens to be our primary area of activity. Financing a piece of equipment is one thing; building a power plant is something else.” Of the 304,000 loans BNDES made in 2009, only 1,500 involved large corporations; the rest were to micro-, small-, and medium-sized enterprises.

LCA’s Borges says that “BNDES alone will not be able to meet the country’s entire credit demand for physical investment. Private banks will have to grant much longer-term credit lines compared to what is offered today.” A Chinese bank, which recently opened in São Paulo, is already doing that in order to secure a share of investments in areas China considers strategic: ore, oil and gas, and agriculture).

The future

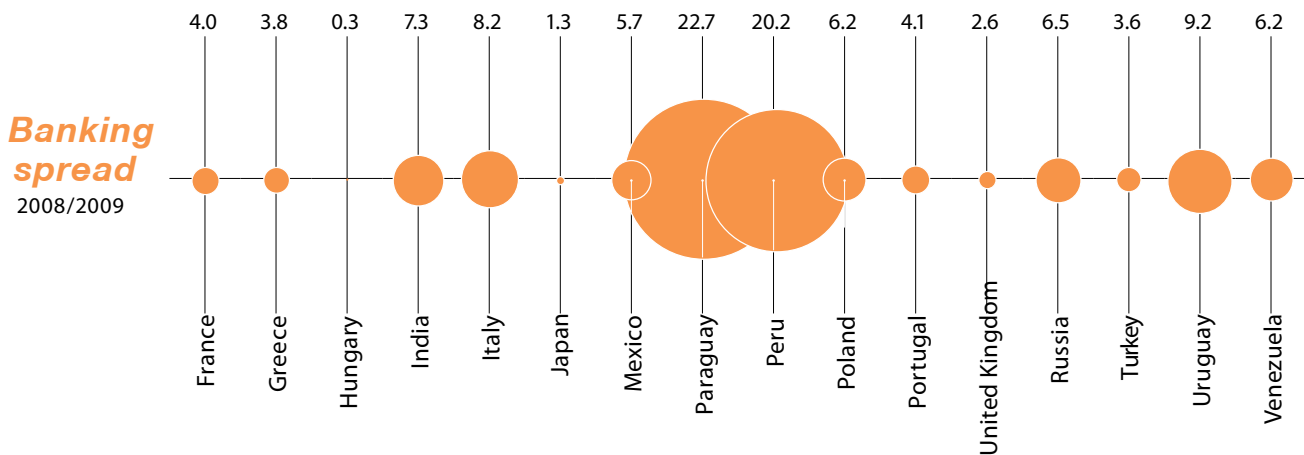
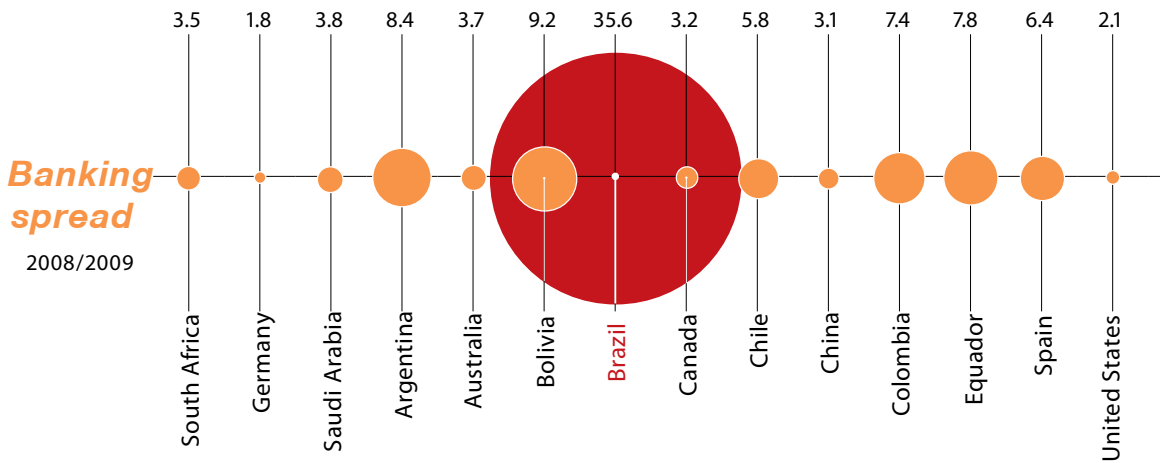
What are the prospects for the credit market? As people borrow to purchase or remodel their home or to trade in their car, says Borges, it is “perfectly feasible that within the next decade credit will reach 80 to 90% of GDP.”

But the transition will not necessarily be smooth. The major challenge is the spread — the difference between what banks pay for funds and the rates they charge when they lend the funds to

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borrowers. Though default rates explain about one third of the spread, “No one can explain why, after a decade of sound economic policy, after six years of sound growth and falling interest rates, bank spreads in Brazil remain so high,” Borges says. A World Economic Forum survey in 130 countries last September ranks the Brazilian spread next to worst — ahead only of Zimbabwe. The average spread for Brazilian banks is 40 percentage points; the world

average is 7. Taking into account variables that help explain disparities in spread in the countries surveyed — protection of property rights and independence of the judiciary, the public deficit, inflation, and taxes on profit — the spread could be reduced by two-thirds, an LCA Consulting study suggests. If the risk built into its interest rates fell to international levels, the Brazilian credit market could grow to 80% of GDP by 2020.



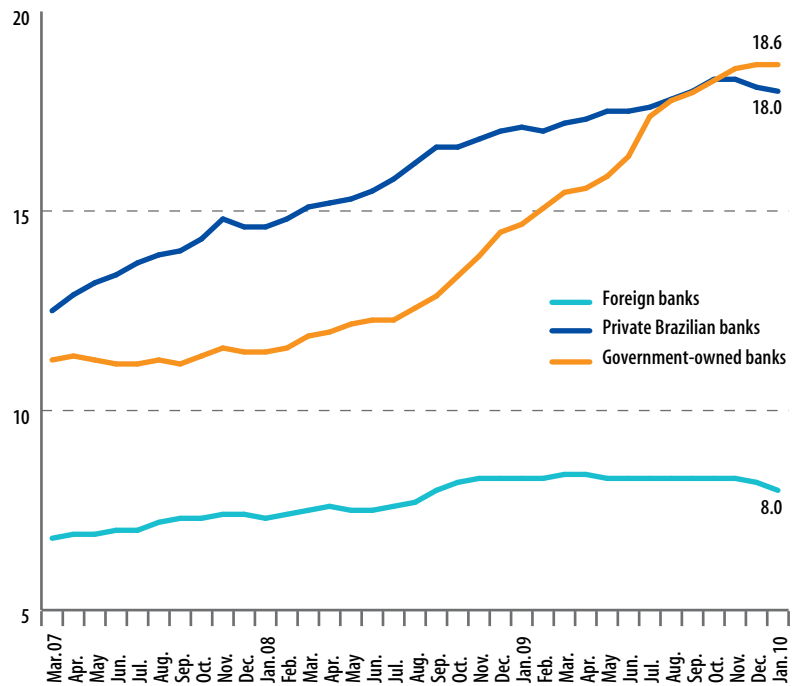
Source: The Global Competitiveness Report 2009-2010, World Economic Forum.

Although Febraban's Sardenberg does not believe the spreads of public banks are much lower than that of private banks — “in similar operations, the rates are quite compatible; however, sometimes the results are distorted because different things are being compared” — he agrees with Borges that the economy's inefficiencies weigh on the cost of money and the laws related to business activity carry a high cost.

The loan default rate does not explain much, Borges says: “The US has a higher default rate than Brazil, but the US spread is infinitely lower.” After a record high of 5.9% in July 2009, 90-day past due loans declined to 5.3% in February and should fall further as income again grows. According to the Central Bank, lower default rates have helped stabilize the average interest rate at 34.5% a year. Official data from February confirm a slight reduction in the average spread from 24.3% to 24.1%.

In addition to the increased competition among private financial institutions triggered by the entry of the government-owned banks into the market, and favorable economic developments and institutional changes, other microeconomic measures may reduce the cost of money. One of the measures the National Congress is considering is a data bank of personal and corporate loans and their payment history. “This measure would have a tremendous effect on the spread,”

Credit to the private sector (% of GDP)



Source: Central Bank of Brazil.

Borges says. Current practice is to send only the names of bad payers to the Credit Protection Services; the data bank would allow banks to also identify good payers and could lead to their being granted lower interest rates.

Also, although it was authorized by the National Monetary Council in 2006 with a view to fostering competitiveness between banking institutions, the transferability of credit — transferring a financial commitment from one bank to another offering more attractive services and rates — is still underutilized and is in fact little known to consumers. ❏

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