Bank spreads in Brazil: Not all weapons have been used

As Brazil continues its long march toward becoming a "normal" country from a macroeconomic and financial perspective, overcoming challenges like hyperinflation, external vulnerability, enormous budget deficits, and a double-digit interest rate (which probably reflects all of the above), the remaining distortions become increasingly more evident. Today in Brazil nothing causes as much uneasiness or generates more criticism than the extremely high spreads charged by banks operating in the country. This is true for both private and state-owned banks.

Obviously, before naming a culprit, a rigorous analysis of the various components of bank spreads is necessary. Factors other than bank profits explain the magnitude of the spread. For example, default risk affects the size of spread. Legal and institutional risks make financial agents nervous about whether the client can repay the credit as agreed. This is no doubt one reason for the high default rate in Brazil. Another factor fueling default is the poor performance of the economy, which may cause unemployment, with consequent failures to repay amounts owed to banks.

Other elements also influence the size of the spread, such as taxation of financial transactions, banks' required reserves, and the administrative costs associated with lending. Leaven and Majnoni (2003),[1] Demirgüç-Kunt, Leaven, and Levine (2004),[2] and Alencar, Leite, and Ferreira (2007)[3] offer a detailed analysis of the variables that influence spreads.

Raising funds

Before looking specifically into spreads, it may be useful to briefly examine the evolution of the cost of raising funds for banks operating in Brazil. To a great extent the term structure of the interest rate is determined by the Selic base interest rate (the central bank policy rate), which has been gradually decreasing (with some ups and downs) since the Real Plan was launched.[4] The worldwide financial crisis, combined with the relatively favorable Brazilian economy, has opened up the possibility of reducing the Selic rate to a single digit before the end of 2009, according to the predictions of many financial institutions. The one-year real interest rate, for instance,

has been declining and should reach 4% in the short to medium term. During most of Fernando Henrique Cardoso's second term and throughout the administration of Luiz Inácio Lula da Silva, the real interest rate has fluctuated between 9% and 13%.

This revolution in the raising of funds, however, has not affected the spread at the same pace, though until the bankruptcy of Lehman Brothers last September it was also falling. The reduction of the spread started in December 2005 but it has moved much more slowly than the fall in the cost of raising funds. Indeed, for individuals the reduction of the spread was slightly more significant than for businesses — from about 43 percentage points to 32 between December 2005 and December 2007. This development, however, is for the most part due to the dissemination of consigned credit, in which payments are debited directly out of borrowers' paychecks or pensions. This type of credit to a large extent affects only public service employees and pensioners, a relatively small group within the society — and only the purchase of durable consumer goods. Over the same period, the average spread for businesses fell from about 14 percentage points to 12, and the general spread fell from 29 percentage points to 22.

Leaven and Majnoni (2003),[5] making an international comparison, suggest that the spread in Brazil is indeed high, ranking second in a sample of 72 countries. On the other hand, after making certain methodological adjustments and taking into account the high cost of raising funds in each country, Nakane and Costa (2005)[6] show a better picture: Brazil ranks 11th on a list of the worst 33 countries. Regardless of these findings and the difficulties associated with establishing comparisons, however, any Brazilian citizen or businessman going into a bank to borrow expects to be charged much higher rates than the Selic base rate. That is why the high spreads have become one of the most sensitive issues on the political and economic agenda.

The Brazilian central bank's *Report on Banking Economy and Credit* breaks down the spread in 2007 into its major elements as follows: 37.4% due to defaults; 13.5% due to administration costs; 3.6% due to banks' required reserves; 18.1% due to taxes and fees; and 27% due to reasons not explained, possibly related to banks' profits and implicit subsidies resulting from earmarked credit at subsidized interest rates .

Agendas

The debate on reducing the spread in Brazil centers on three major agendas. The first is the political and institutional agenda, comprising legal and tax issues, such as the government policy of earmarking credit to some sectors. The second covers macroeconomic issues, factors like exchange rate volatility, the base interest rate, and banks' required reserves, as well as the GDP growth rate, which affects bank risk and therefore influences the spread. The third agenda is related to microeconomic issues: market structure and competition among banks.

Factors other than bank profits explain the spread: default risk, taxation of financial transactions, banks' required reserves, and the administrative costs

Successive administrations in Brazil have addressed all three agendas at a moderate pace and subject to the interruptions and setbacks typical of the country's institutional development. Exchange rate volatility is today much less than in the past. While it is true that since last September volatility has increased in response to the hard test of the world financial crisis, the Brazilian real has followed a much

less dramatic course than currencies in other emerging countries.

The real interest rate is falling steeply. Even though the spread is being reduced more slowly, it is obvious that the influence on it of a falling real interest rate can only be positive. GDP growth depends clearly on the recovery of the global economy; most analysts, however, place Brazil among the countries that will more quickly recover to a reasonable level of expansion (though not at the rate we had been seeing going into the third quarter of 2008), perhaps as early as next year.

Regarding effective loan guarantees, there have been some achievements in recent years with the introduction of the new Bankruptcy Law, the establishment of consigned credit, the development of the car leasing market, and the reform of real estate credit. Lenders have improved their ability to timely access collateral (automobiles and real estate) in case of default. There has also been a significant expansion in the maturity of car loans.

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The global crisis has permitted reduction of the banks' required reserves, which combined with the fall in the Selic base rate strengthened the government's battery of measures to revive the economy. It is conceivable that there will be further rounds of cuts in reserve requirements, which are still high, and taxes on credit as part of an effort to prevent a more severe and protracted recession. There is room for this to happen.

Clearly, there is still an intent to reduce the spread. Nevertheless, it is an increasingly disturbing problem for Brazilian society. The slow and irregular rhythm of the fall in the spread is not sufficient to abate the perception of both consumers and businesses that the credit system is fundamentally unfair. To finance consumption and investment, they have to accept costs unparalleled in the rest of the world. It is therefore worth investigating what else can be done to speed the Brazilian convergence to lower spreads — particularly with regard to competition among banks.

Banks' clients

A centralized register disclosing information on the credit quality of clients is a mechanism that would greatly contribute to reducing the problem of information asymmetry, and improving competition in the banking sector, and consequently helping to reduce spreads. Banks process information and know their client profile. A manager's information on the credit quality of clients is perhaps the best asset of a bank network, something a foreign institution planning to enter the Brazilian market is ready to pay a high price for.

The problem is that when banks already established in the country are faced with new competition, they can — based on the information they already have about clients — offer better terms than competing institutions to keep their best clients, letting the not-so-good clients migrate to the new banks. Newcomer banks thus suffer from adverse selection in terms of the clients they can attract, which reduces their capacity to make profits and

compete. The register on the credit quality of clients helps to offset that situation because it makes credit ratings public to those wishing to examine it.

The argument against the register, which has been slow in getting approval from Congress, is that it is discriminatory, since clients not wishing to subscribe to the system will most likely be those of the worst quality. This, however, is an old national difficulty: in trying to protect the most vulnerable we end up harming the vast majority of citizens who have their credit history in good order and would like to access credit at lower cost.

Unconventional weapon

The government does have one good weapon at hand in its effort to reduce spreads at a speed that neither compromises economic and financial logic nor harms social sensitivity. It is possible to use the Federal Savings Bank, Caixa Econômica Federal, which is almost 100% state-owned, to establish profitability parameters in the banking sector. Caixa's lending policy could follow a reference rate of return established by the government, which should obviously safeguard the financial health of the institution. Using that profitability parameter, Caixa would offer interest rates with spreads corresponding to that target.

Because Caixa has a significant share of total bank credit, such a strategy would obviously result in competition forces pushing spreads downward. It would also limit the returns to the banking sector without directly interfering with its functioning, as would inadequate measures, such as interest rate ceilings. Involving Caixa in the effort to reduce spreads in Brazil may seem a daring idea. However, boldness combined with rationality may sometimes be the best answer to distortions that are difficult to correct through conventional means. ■

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[1]Leaven, L. and Majnoni, G. (2003), Does Judicial Efficiency Lower the Cost of Credit? World Bank Policy Research Working Paper 3159.

[2]Demirgüç-Kunt, A., Leaven, L. and Levine, R. (2004), Market Structure, Institutions and the Cost of Financial Intermediation. *Journal of Money, Credit and Banking*, 36, 593-622.

[3]Alencar, L., Leite, D. and Ferreira, S. (2007), Spread Bancário: um estudo cross-country. *Relatório de Economia Bancária e Crédito*, Banco Central do Brasil.

[4]The Real Plan was introduced in 1994 and successfully eliminated hyperinflation.

[5]Leaven, L. and Majnoni, G. (2003), Does Judicial Efficiency Lower the Cost of Credit? World Bank Policy Research Working Paper 3159.

[6]Nakane, M. and Costa, A. C. (2005), Spread Bancário: Os Problemas da Comparação Internacional. *Relatório de Economia Bancária e Crédito*, Banco Central.