

New Long-Term Funding Options for Brazilian Financial Institutions



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In the midst of a global financial crisis, Brazil has finally become a real alternative for investors worldwide. In 2009, a solid economy supported a reasonable recovery from the 2008 sub-prime crisis. For the remainder of 2010 and the next few years, forecasts are promising, as the country builds a pre-salt oil-regulatory framework and hosts the next World Cup and Olympic Games.

Despite these difficult times for export economies, Brazilian consumer spending has proved to be an important engine of growth and cushion for the economy. The country is obviously not isolated from worldwide volatility, which has haunted the domestic stock market, but in the long run interest rates are expected to drop and inflation to remain under control. In 2010, a presidential-election year in Brazil, analysts expect GDP to grow 6%, a reasonable rate compared to previous years and especially in times of global economic turbulence.

Investors – shifting their investments and savings away from those economies most vulnerable to the crisis – have turned their eyes to Brazil. Indirect foreign investment (in stocks and fixed-income financial assets) reached an historical record of US\$46.2 billion in 2009, while direct foreign investment is expected to peak in 2010, at US\$45 billion.

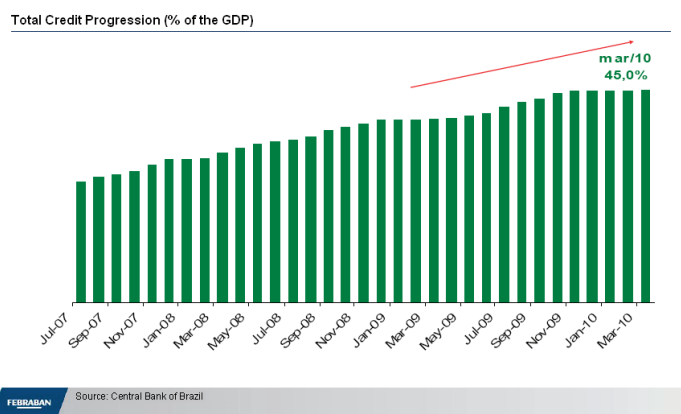
Brazil still depends heavily on long-term investments, mainly in infrastructure, which analysts say is the bottleneck (energy, telecommunications, ports and airports, railways and sanitation). Long-term financing in Brazil has traditionally only been provided to Brazilian companies by the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social – BNDES*), while domestic banks have limited their activities to short-term and medium-term loans. Needless to say, however, that meeting this financial demand is essential for the country's 193 million people to effectively enjoy the benefits of long-lasting economic prosperity. Industrial segments, such as oil and gas, sugar and ethanol, mineral, metallurgical, petrochemical, pharmaceuticals, pulp and paper, electronics and the automotive industry, among others, may also have interesting investment opportunities.

Driven by strong market players, and aimed at improving investor confidence, Brazil has approved important changes to its legal and regulatory framework in recent years. In addition to the safe, expeditious, existing mechanisms for foreign investment and open exchange rules, the financial system - whose role in intermediating supply and demand of financial funding is essential for envisaged economic growth - and creditors in general, have benefited from important legal improvements, such as ranking privileges provided by the 2005 Recovery and Bankruptcy Law, more effective use of fiduciary types of liens, and the creation of important new credit instruments for both funding and lending transactions such as the Bank Credit Certificate (CCB), the Real Estate Credit Certificate (CCI), the Real Estate Credit Bill (LCI), the Agribusiness Credit Rights Certificate (CDCA), the Certificate of Agricultural Deposits (CDA), the Agricultural Warranty (WA), the Agricultural Credit Bill (LCA), and the Certificate of Agricultural Receivables (CRA). These credit instruments represented an important step with regard to legal safety and liquidity for trading financing on the secondary market backed by industrial, consumer, real-estate and agricultural credit rights.

However, a long-standing demand of Brazilian financial institutions, especially middle-market banks that are clearly more affected when liquidity in financial markets is low, is the creation of long-term funding instruments that allow them to match the maturities of their assets with their liabilities. With the growth of credit in recent years from 25% to about 45% of GDP (see figure 1), the average maturity of financial assets became longer than the average maturity of financial

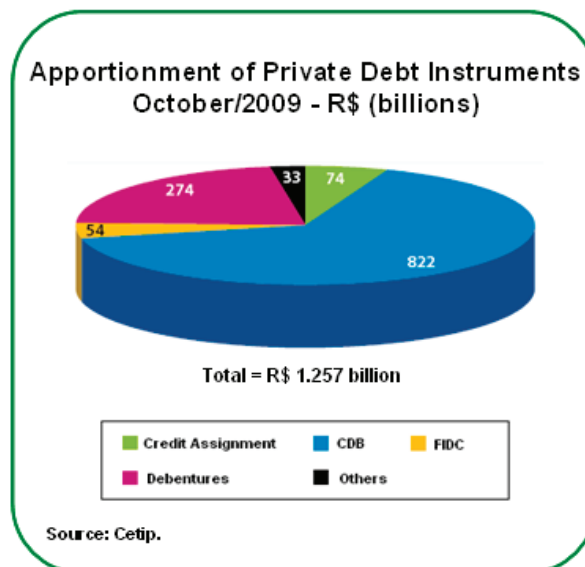
liabilities. It is important to note that banks are prohibited by the National Monetary Council (*Conselho Monetário Nacional - CMN*) from issuing debentures (long-term bonds).

Figure 1. Credit progression (% of GDP)



The primary funding instrument of banks in Brazil is currently the Bank Deposit Certificate (CDB), which has proven to be an important, liquid, transferable, time-deposit instrument (see figure 2). The average maturity of a CDB, however, is less than one year, and the deposit can be redeemed by investors prior to maturity. This leads to the aforementioned asset-liability mismatch.

Figure 2



The so-called Credit Rights Receivable Investment Fund (*Fundo de Investimento em Direitos Creditórios – FIDC*), currently the primary securitization tool on the Brazilian capital market, has played part of that asset-liability matching role. Since 2001, these funds have provided alternatives for banks or companies assigning their credit rights, on one side, and investors, on the other side, the latter often happy to run a limited risk, as the fund liabilities and the underlying securitized pool are ring-fenced and therefore bankruptcy remote. Payroll deductible loans (*empréstimos consignados*), trade bills, corporate credits and even credits under recovery have been securitized through FIDC structures. However, an investment-fund structure is obviously not always suitable.

Figure 3. Middle market banks issuances in the foreign markets in 2009 and 2010.

Issuer	Type of Transaction	Liquidation Date	Maturity in months	Amount US\$ million	Cost %	Yield %
Banco Cruzeiro do Sul	Eurobond	06/17/2009	24	60	9	-
Banco Mercantil do Brasil	Eurobond	08/03/2009	27	26,726	-	9.2*
Banco Cruzeiro do Sul	Eurobond	09/17/2009	36	175	8	8.5
Banrisul	Bank loans	10/21/2009	6	15	-	-
Banco PanAmericano	Eurobond	10/26/2009	36	200	7	7.25
Banco BMG	Subordinated bond	11/05/2009	120	300	9.95	10.25
Banco Fibra	Subordinated bond	11/06/2009	84	110	8.5	8.5
Paraná Banco	Eurobond	12/23/2009	36	100	7.375	7.75
Banco Votorantin	Subordinated bond	01/20/2010	120	750	7.375	7.375
BicBanco	Eurobond	01/20/2010	36	275	6.25	6.25
Banco Pine	Subordinated bond	02/08/2010	83	125	8.75	9
Banco Votorantin	Eurobond	02/11/2010	36	500	4.25	4.375
Banco Cruzeiro do Sul	Eurobond	02/22/2010	60	250	8.5	8.75
Banco Daycoval	Eurobond	03/16/2010	60	300	6.5	6.75
Banco ABC Brasil	Subordinated bond	04/08/2010	120	300	7.875	8.125
Banco PanAmericano	Subordinated bond	04/23/2010	120	500	8.5	8.625
BicBanco	Subordinated bond	04/27/2010	120	300	8.5	8.625
Banco Fibra	Eurobond	04/29/2010	36	200	5.125	5.25
Banco Safra	Eurobond	04/29/2010	42	200	3.5	3.5
Total in 2009				987		
Total in 2010**				3,700		
Total in 2009 & 2010**				4,687		

Source: Financial institutions and international agencies. Elaboration: Valor Data.

* Average profit until maturity (9% until November 08 2010 and 9.5% until November 08 2011).

** Put on November 08 2010. ** Table updated on May 20 2010.

At times of reasonable liquidity, the issuance of notes on foreign markets may be attractive for Brazilian banks, offering them an alternative for raising funds with longer maturities. Between 2009 and 2010, middle-market Brazilian banks raised US\$4.7 billion through foreign-note issues (see figure 3). Scarce liquidity in recent weeks, however, has forced many planned foreign issues to be suspended, at least temporarily.

The sale of asset pools to larger financial institutions may, in certain cases, be the last resort for middle-market banks that need to raise immediate funds. These deals, which had also been suspended during the peak of the financial crisis, have now resumed. A number of larger banks intending to recover market share lost during the financial crisis have purchased asset pools from illiquid middle-market banks.

In 2009 and 2010, a scenario of reasonable domestic economic stability, increasing demand for infrastructure and other long-term financings, the bank asset-liability mismatch and low liquidity on foreign markets, all motivated the creation of two important instruments for long-term funding of financial institutions in Brazil: the FGC Special Collateral Time Deposit (*Depósito a Prazo com Garantia Especial do FGC - DPGE*) and the Financial Bill (*Letra Financeira - LF*).

The DPGE, regulated by the CMN in March of 2009, is a type of time deposit collateralized by the so-called Credit Guarantee Fund (*Fundo Garantidor de Crédito - FGC*), a private non-for-profit organization created in 1995 to collateralize bank liabilities².

The DPGE, which, in principle, is transferrable³, offers 1 to 5 year maturities. Commercial, multiple, investment, development and saving banks, as well as loan, finance and investment companies

(financeiras) are entitled to collect funds through the DPGE.

Redemption of the DPGE – in full or in part – is not permitted prior to its stated maturity.

The DPGE must be registered with a clearing and settlement system duly authorized by the Central Bank of Brazil.

A DPGE interest rate, once settled, may not be renegotiated.

The DPGE limit stated by regulations is the greater amount between (i) twice the respective Tier 1 reference capital, calculated on December 31, 2008, and (ii) the aggregate between the balances of time deposits and bills of exchange (*letra de câmbio*) held by the relevant financial institution on June 30, 2008. This amount in no event may be more than R\$5 billion.

Financial institutions are subject to a required reserve (*depósito compulsório*) of 15% of the DPGE at the Central Bank of Brazil. In addition, they are subject to a special contribution to the FGC at a rate of 0.0833% per month, calculated on the aggregate amount of DPGE agreements in place, which many claim makes the DPGE an expensive tool. Notwithstanding, at times of scarce liquidity for foreign-bond issues, the DPGE is seen by the

Brazilian market as a valuable option for long-term funding.

The LF, in turn - created in December 2009 and regulated in February 2010 - is a transferable and freely negotiable credit instrument issued by multiple, commercial, investment and saving banks, as well as loan, finance and investment companies (*financeiras*), mortgage and real-estate credit companies.

An LF must be issued for a minimum term of 2 years.

Redemption of an LF – in full or in part – is not permitted prior to its stated maturity.

An LF must also be registered with a clearing and settlement system duly authorized by the Central Bank of Brazil.

As for an LF's par value by unit, the regulations state that it may not be lower than R\$300,000 (around US\$160,000).

If not publicly offered, an LF may be subordinated, meaning that, in this case, it will not be paid before the issuer's unsecured and other creditors in the event of liquidation or bankruptcy. When subordinated, an LF shall be classified as Tier II reference capital of the issuing bank for the purposes of the Basel provisions.

LF interest periods cannot be less than 6 months, with interest accruing at either fixed or floating rates.

An LF may be repurchased by the issuing bank for future sale, provided that the buyback takes place on exchanges or through over-the-counter markets. Buyback transactions, however, are limited to 5% of the total amount of unsubordinated LFs issued by the relevant bank.

An LF may be publicly offered, provided however that, in this case, it cannot be subordinated. Public distribution of LFs must comply with all the requirements still to be set forth by the Brazilian Securities and

Exchange Commission (*Comissão de Valores Mobiliários – CVM*).

An LF may be also used by financial institutions as a funding instrument for linked credit transactions (*operações ativas vinculadas*) funded with financing delivered or placed at their disposal by third parties, as permitted by current regulations. Through these linked credit transactions, a financial institution may transfer the credit risk of a certain client to an LF investor who invests in the LF with specific instructions for a further loan to the client. In this case, the financial institution will only repay the investor if the client also repays his debt.

Finally, as for taxation levied on income earned by investors from a DPGE and LF, as a general rule income arising from fixed-income investments in Brazil are taxed at regressive rates varying from 22.5% to 15%, depending on the investment term (this taxation is definitive for non-resident investors or for individuals, and just an advance of part of the Corporate Taxes due at roughly 34%, if the investor is a legal entity domiciled in Brazil). Taxation of income from the sale of a DPGE or LF on the secondary market is still under discussion, but in principle the same rules apply. If (i) the investor is domiciled outside of Brazil, not in a jurisdiction classified as a tax haven by the Brazilian Federal Revenue Service; and (ii) the investment follows the provisions of the applicable CMN rules (Resolution N. 2,689), then the applicable rate is 15% regardless of the investment's maturity.

It is also worth mentioning that, following steps taken by foreign markets over the last 20 years, new legal provisions in Brazil have also authorized financial institutions to issue another instrument called

the Structured Transactions Certificate (*Certificado de Operações Estruturadas - COE*), to represent derivative transactions in accordance with the terms and conditions still to be set forth by the CMN. The COE may also be an alternative for financial institutions in Brazil to raise funds backed by underlying derivative transactions in a pool. This new type of instrument, which has yet to be fully regulated, is promising and expected to be of great benefit for players on domestic financial markets.

From a legal and regulatory standpoint, these improvements are expected to enhance credit, reduce spreads and support the required long-term investments in Brazil. The DPGE offers an alternative to the traditional CDB, while the LF meets a long-standing demand of financial institutions that have not been allowed to use debentures. The numbers provide evidence of interest in these new instruments: in 3 months, the total amount raised by financial institutions through LFs was R\$3.4 billion, while DPGEs currently total R\$16 billion, according to the CETIP, an organized market in charge of registration, clearing and settlement of LFs and DPGEs.

A number of issues, however, are still pending clarification and regulation by financial authorities. Taxation is also still unclear. The perspective of market players, in general, is that the country needs more effective actions to enhance the development of a secondary market for long-term instruments. These actions would involve the reduction of costs and tax exemptions, for instance, as Brazil still suffers from an intricate taxation system, with a considerable number of accessory tax obligations to which taxpayers are subject. ■

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2. As per the FGC rules, the total amount of DPGE credits held by each person against the same financial institution member of the FGC, or against all member financial institutions that are part of the same financial conglomerate, must be collateralized up to a limit of R\$20,000,000 (equivalent to about US\$11,000,000).

3. Due to taxation issues, transferability of the DPGE is still under discussion.