

THE GEORGE WASHINGTON UNIVERSITY

INSTITUTE OF BRAZILIAN ISSUES

MINERVA PROGRAM - FALL 2000

THE BRAZILIAN FINANCIAL SYSTEM

A World in Transition

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Washington, DC

December, 2000

The Brazilian Financial System – A World in Transition

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1. INTRODUCTION

The Brazilian Financial System has been recognized as one of the most developed banking system of the world. Decades of high inflation obliged banks to develop some complex instruments and information systems, in order to attend demand for agility and structured financial products, which preserved the real value of money. After the Plano Real, in 1994, restructuring promoted by Proer and Proes, has permitted the strengthening of the system with the merger, acquisition or simply bankruptcy of banks in a bad or insolvent situation. Also, the framing of banks to the established capital limits to Basle Agreement (Resolution n. 2099/94) was required.¹

Nowadays, Brazil is searching for alternatives to increase economic activity and productivity; the Financial System is required to promote and to consolidate the Nation's self-sustained growth.

This paper intends to relate the basic structure and describe the main changes happening to the system, which can produce some transformations in Brazilian society, through the modernization of procedures, credit risk reduction and the improvement of banking transaction security.

In chapter 2, the current structure of the financial system and its subdivision in normative function (regulation and inspection) and operational function (intermediation) is demonstrated.

¹ Proer – Program of Incentives to the Restructuring and Strengthening of the National Financial System;

Proes – Program of Incentives to the Reduction of State Public Sector in Banking Activity.

In chapter 3, we comment about the institutional framework of the financial system and the principal regulation agents, such as Conselho Monetário Nacional (CVM), and Banco Central do Brasil (BCB). The fourth chapter is dedicated to analyzing and reporting the main changes happening within the system:

The first topic is relative to the New Brazilian Payment System and the Central Bank's intention to share the process, allowing banks to assume their part in operation and credit risk of the system. The Central Bank plans to apply the first measures next February 2001. Also, the creation of market clearing- houses and the implementation of electronic systems in Open-Market interbank transactions are mentioned.

In the second topic a theme which promises serious discussions in Brazilian society is approached. The restructuring of the federal public banks was the object of a deep study promoted by consulting companies, which diagnosed the role of the federal banks in the Brazilian financial system and their problems, proposing some alternatives to follow.

The reduction of the government's share in agribusiness financing is the last topic. This part relates to the measures adopted with the intention of opening the market to investors, both internal and external, who are able to provide resources instead of the government, whose financing capacity is exhausted.

2. STRUCTURE

The current structure of the Brazilian Financial System originated in the institutional reform promoted in 1964/65, when the National Monetary Council (Conselho Monetário Nacional – CMN) and the Central Bank of Brazil (Banco Central do Brasil – BCB) were created. The Law n. 4.728, of 07/14/65, has established norms to the capital market and the Law n. 6.385, of 12/07/76, has created the Securities and Exchange Commission (Comissão de Valores Mobiliários – CVM), transferring responsibility for security market regulation from BCB.

2.1. Normative System

The normative function is executed by regulation and supervision entities, such as CMN, BCB and CVM. The next chapter will describe questions of regulation in more detail.

2.2. Intermediation System

The intermediation function is executed by authorized institutions, which are subordinate to the normative entities. They are:

Financial Institutions that Receive Demand Deposits

- a) Multiple Banks
- b) Commercial Banks
- c) Saving Banks
- d) Credit Cooperatives

Other Financial Institutions

- a) Investment Banks
- b) Development Banks
- c) Credit, Financing and Investment Companies
- d) Real Estate Credit Companies
- e) Mortgage Companies
- f) Saving and Loan Companies

Other Financial Intermediaries or Auxiliaries

- a) Commodities and Futures Exchanges
- b) Stocks Exchanges
- c) Security Firms
- d) Leasing Companies
- e) Foreign Exchange Brokers
- f) Independent Agents

Other Entities

- a) Private Pension Funds
- b) Insurance Companies
- c) Mutual Investment Funds
- d) Foreign Investor Portfolios

National Financial System

Table 2.2.1

Institution Class	Quantity
Commercial Banks	22
Development Banks	5
Saving Banks	1
Multiple Banks	172
Credit Cooperatives	1,119
Investment Banks	21
Credit, Financing and Investment Companies	43
Security Firms	383
Leasing Companies	82
Mortgage Companies	18
Foreign Exchange Brokers	38
Saving and Loan Companies	2
Consortium Management	412
Mutual Investment Funds	3,812
<u>Total:</u>	<u>6,130</u>

Source: The Central Bank of Brazil
(August 1999)

2.3. Clearing System

The settlement of financial operations registered in Brazilian Financial Market are executed by some authorized institutions, depending on the kind of trade:

SELIC – special system for liquidation and custody of government bonds

This electronic system, created in 1979, is used to register open-market operations with public bonds. It is managed for the Central Bank, through SISBACEN system.

CETIP – center for the custody and financial liquidation of private issues

CETIP was created in 1986 to guarantee, take custody and settle operations involving private bonds and special public bonds. Also CETIP works as an electronic system that controls operations being linked to SISBACEN in order to settle bank reserves.

CBLC – Stock exchange clearing system

This service, linked to São Paulo Stock Exchange, clears operations realized in spot, forward and options markets. The financial liquidation of net balance transactions is realized by CETIP.

BM&F – commodities and futures exchange clearing

The operations with commodities and futures markets are cleared in this system, based in São Paulo, which offer special devices to guarantee trade. The financial liquidation of net balance transactions is realized by CETIP.

COMPE – system of liquidation of checks and other documents

COMPE is managed by Bank of Brazil. COMPE clears those transactions in the financial system and informs the BCB, in order to settle bank reserves.

CAMBIO – foreign exchange system

This system is integrated to SISBACEN and clears transactions involving foreign currencies. One leg (R\$) is automatically processed in bank reserves and another (the foreign currency) is liquidated by a correspondent bank abroad.

3. REGULATION

3.1. The National Monetary Council (Conselho Monetário Nacional – CMN)

The CMN is the major entity in the Brazilian Financial System. It is the composite for the Finance Minister (President), Budget Minister and the president of the Central Bank. The main responsibilities of the CMN are:

- a) To coordinate the monetary, credit, budget, fiscal and debt policies.
- b) To oversee the liquidity and solvency of financial institutions.
- c) To promote the improvement of Institutions and financial instruments.

3.2. The Central Bank of Brazil (Banco Central do Brasil – BCB)

The central executive institution of the financial system. The main responsibilities of the BCB are:

- a) To execute monetary policy.
- b) To control foreign capital flow.
- c) To control credit risk of the financial system.
- d) To supervise the financial institutions in the intermediation and clearing systems.

3.3. Other Regulatory Institutions

Comissão de Valores Mobiliários – CVM (Securities and Exchange Commission).
CVM is the normative institution of the financial system, specially dedicated to development, discipline and inspection of the security and the stock market.

Superintendência de Seguros Privados – SUSEP (Private Insurance Agency). SUSEP is responsible for the control and inspection of insurance companies, open private pension funds and capitalization market.

Secretaria de Previdência Complementar – SPC (Complementary Pension Secretariat). Agency of Social Security Ministry, responsible for the control and inspection of the close private pension funds.

In the next section, we are going to explain the main changes that are happening to the financial system and the impact they will cause on Brazilian society.

4. THE CHANGES AFFECTING THE SYSTEM

4.1. New Brazilian Payment System

The Brazilian payment system was structured in an environment of intense macroeconomic instability. At that time, the priorities were agility and safety for the liquidation of bonds, checks and other documents. After Plano Real, with a new sense of stability, and the higher insertion of the country in globalization process, the financial system has suffered deep transformation and has been concerned with individual and systemic risks.

Considering international experience, there are three basic questions involving systemic risk, mainly after recent economic crisis, which reached the world: Banking Supervision, Prudential Regulation and Payment System. The Bank for International Settlements (BIS) has been conducting the discussion about efficient payment systems with the leadership of the G10 central banks.

Bank for International Settlements (BIS) Experience²

“There are a number of international initiatives underway to maintain financial stability by strengthening financial infrastructure. The Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries is contributing to this process through its work on developing core principles for systemically important payment systems.

² “Core Principles for Systemically Important Payment Systems, Part I – The Core Principles”. Report of the Task Force on Payment System Principles and Practices. BIS – CPSS July 2000.

Core Principles for systemically important payment systems

- I. The system should have a well-founded legal basis under all relevant jurisdictions.
- II. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
- III. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
- IV. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
- V. A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
- VI. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
- VII. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.

- VIII. The system should provide a means of making payments, which is practical for its users and efficient for the economy.
- IX. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
- X. The system's governance arrangements should be effective, accountable and transparent.

Responsibilities of the central bank in applying the Core Principles

- A. The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.
- B. The central bank should ensure that the systems it operates comply with the Core Principles.
- C. The central bank should oversee compliance with the Core Principles by systems it does not operate and it should have the ability to carry out this oversight.
- D. The central bank, in promoting payment system safety and efficiency through the Core Principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.”

The Restructuring of Brazilian Payment System

The Central Bank of Brazil has been working in a project of restructuring payment system complying with the Core Principles, which must create three fundamental changes on funds transfers in the financial sector:

- a) The implementation of a Real-Time Gross Settlement (RTGS) – called STR operated by the Central Bank.
- b) The development, or adaptation, of systems, which involve resource transfers and implementation of private-owned clearing-houses that allow clearance and settlement of financial transactions, through credit and liquidity risks management mechanisms.
- c) The constitution of a solid legal base to support the new payment system.

This issue is relatively recent in Brazil, the discussions are open at the financial society, mainly in Febraban (Federation of Brazilian banks) and ANDIMA (National Association of Open-Market Institutions) with the attendance of the Central Bank. There are a lot of opportunities that accompany the project that should be considered in order to promote creation, adaptation and development of systems and procedures.

Bank of Brazil is completely involved in the project and has been putting efforts on it. Recently, it identified and adapted an operational model for the payment clearing-house, which has been adopted with consensus at Febraban as the best one to be implemented in Brazil.

RTGS System

The Central Bank has decided to adopt a RTGS system for the interbank market. It is called Reserve Transfer System (STR). Thus, all the transactions registered in SELIC from next October 2001 on must be integrated to the new model, where financial intermediaries will be affected by their reserves at the Central Bank on-line. Intraday overdrafts will not be allowed. If that occurs, the Central Bank can provide that Institution with an intraday repo (operations involving reserves with collateral in federal public bonds). It is possible that starting a new form of intraday negotiation at the open-market, where the financial institutions can change reserves for a established period of time, at a covenant interest rate.

These modifications will obligate banks to adapt all their information systems. Mainly the largest commercial banks will have to improve their procedures to monitoring their cash flow real-time along the day. Those measures will permit a best resources management. Also customers must change their banking-users habits. Probably banks will like to know in advance the client's expectations to large value transfers.

At the same track, financial market is improving its negotiation procedures. Negotiation of public bonds, at open market, has been realized through phone, connecting two bank traders in a self-regulated ethic code. This market trades around US\$ 40 billion every day. Considering market needs of safety and transparency, two new electronic systems of negotiation are being created. The first one in Rio de Janeiro Stock Exchange, called SISBEX, permits trading in an Microsoft windows? environment with many possibilities of queries, statistics and agility. End-of-day procedures are settled at SELIC system. In the future, system builders intend to apply procedures of guarantee and custody, bringing more facilities

to its users. The second electronic system was created by CETIP, called SIM, which also permits public bond trading.

There will be improvements in stock, futures and commodities markets as well. There is expected reductions on liquidation time (3 days currently to a stock trade) and best safety procedures.

Foreign Exchange Market

Referring to foreign exchange transactions, it is possible that private sector develops a new system which can provide financial institutions of finality guarantees. BM&F has a project in this area and, according to matters published in Valor Econômico, in September 15, 2000, "Clearing de câmbio reduzirá riscos", there is a consensus with banks for installing a clearing-house to process those transactions. It is a special market, because financial liquidation of transactions involves accounting in different currencies. Sisbacen controls operations and commands debits and credits at bank reserves, in Brazilian reais; however, the foreign currency has to be accounted for by the intervening of an external correspondent bank. Currently, there are no systems that assure simultaneous liquidation of both.

The Payments Clearing

Nowadays, the Brazilian payment system is basically constituted by four platforms: SELIC; CETIP; CAMBIO and COMPE, as seen in chapter 2. On December 14, 1999, (MP n. 2.008 re-issued as n. 2.040 in August 2000), specific legislation disposing upon clearing-houses activity in the new payment system scope was enacted.

According to model proposed by Bank of Brazil, payment transfers will be settled through a new private clearing-house, in a DNS (Deferred Net Settlement) system,

inspired by American new CHIPS. This system will offer protection devices, through 'pre-funding' deposited by banks to the Clearing account in the Central Bank. ³

The system will process transfers according to the net balance of institutions, adopting three forms of processing. The first one will process simple transactions where one Bank is debited and another is credited. The second form is bilateral negotiation, where several transactions involving two banks are processed by the net value. The third alternative is multilateral negotiation, where many operations involving three or more banks are processed.

If a Bank does not have a positive balance to honor a debt, the transaction is pending until there are resources to cover it. This process will happen along the day, being foreseen the closing system at the evening, when net registers for each bank will be informed to the Central Bank, in order to process credits in the bank reserves, against debt in the clearing account.

The main advantages in this model are:

- a) No bilateral or global limits required.
- b) Costs reduction: no risk analysis required or STR use.
- c) Defaulters Pay Model – there is no loss to share among participants.
- d) EDI facility – It is possible to join additional information about payments.

According to estimates, this clearing can be installed next August 2001.

The next section introduces a very important theme at this time: new forms of agribusiness financing.

³ CHIPS – Clearing-House for Interbank Payment System – one of the principal systems of payment working in USA. The current project, which CHIPS has undertaken, is called Finality. With this process all CHIPS payments will be executed in real time, and they will be equal a Fedwire payment. This project will be implemented on January 22, 2001. In addition, CHIPS is currently testing EDI capabilities, which will be implemented in June of 2001.

4.2 REDUCTION OF THE GOVERNMENT'S SHARE IN AGRIBUSINESS FINANCING

The history of rural credit in Brazil has two main meanings: the strongest participation of the government in financing activities and a lot of cases of payment default. In fact, when the 1988 Constitution promoted an amnesty for the rural debtors, a phase of "moral risk" was born, that is, several farmers resisted payment of their bills at the banks.

The following tables show the total value of loans (table 4.2.1) and the decrease of financing granted to farmers and cooperatives, from public resources, in the last six years (table 4.2.2).

Table 4.2.1
RURAL CREDIT

Financing Granted to Producers and Cooperatives

By Finality - Brazil - 1994 to 1999

Year	<u>R\$ million</u>			
	Expenses	Investment	Trading	Total
1994	4,678	1,633	2,610	8,922
1995	4,016	1,405	1,060	6,482
1996	4,397	1,509	388	6,293
1997	6,945	2,006	889	9,840
1998	7,461	2,154	1,519	11,134
1999*	7,989	2,026	1,771	11,786

Source: The Central Bank of Brazil / DEPLAN/SPA/MA

* Preliminary

Table 4.2.2

RURAL CREDIT

Financing Granted (1) to Producers and Cooperatives, by Source - 1994 to 1999

R\$ million

Source	1994	1995	1996	1997	1998	1999*
Treasury Resources	2,419	1,277	219	148	185	13
Mandatory Resources	1,035	852	1,062	4,417	4,535	4,748
Rural Savings	3,114	2,338	575	829	1,450	2,217
Free Resources	1,422	1,057	508	592	520	578
Constitutional Funds	446	584	938	555	784	875
FAT – Workers' Welfare Fund	...	...	1,384	1,813	1,765	1,915
FAE – State-Owned Companies Fund	...	...	877	655	124	0
FUNCAFÉ	...	...	...	355	617	571
BNDES/FINAME	...	...	...	333	452	593
INCRA/PROCERA	...	...	...	46	127	9
Other Sources	487	375	732	98	575	268
Total	8,922	6,482	6,293	9,840	11,134	11,786

Source: The Central Bank of Brazil/
DEPLAN/SPA/MA

(1) Expenses, Investment and Trading

* Preliminary

Public funds and BNDES programs still remain granted resources to agricultural activity, but the current main source of financing is the compulsory deposit of commercial banks. Banks have to retain twenty five percent of the demand deposits in order to lend to the rural sector. Alternatively, they can deposit fifty percent of the compulsory funds at the Central Bank, without remuneration. Some Banks prefer to lend these resources to the interbank market, through the purchase of DIR (Rural Interbank Deposit), issued by the Bank of Brazil.

The following table shows the loan rates to the state-controlled resources:

Table 4.2.3

RURAL CREDIT						
Loan Annual Rates to the State-Controlled Resources – Brazil						
Years-Crop from 1994/95 to 1999/00						
	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Expenses	30.54%	16%	9%	6.50%	5.75%	5.75%
Investment (1)	30.54%	16%	9.25%	8.17%	8.32%	8.32%
Expenses/Investment	60.08%	16%	12%	9.50%	8.75%	8.75%
Annual Inflation Rate – IGP-DI (Jul/Jun)	21.32%	13.15%	9.97%	5.74%	8.48%	-

Sources: The Central Bank of Brazil; Getúlio Vargas Foundation; DEPLAN/SPA/MA

(1) Estimate of Effective Interest Rates

New Financing Instruments

The decision to reach primary surplus obliged the government to rebuild the Union Budget and the farmers had to find new forms of financing. An important financing mean has been the direct deal between producers and suppliers. For instance, the producers buy machines, equipment and fertilizer with money from their crop, represented by a credit bond issued by them. Then, the supplier trades the credit bond in the agribusiness market. The difficulty here is to establish a just price for the production, given the low liquidity and absence of an open market. However, the amount negotiated in this category of trade is estimated over US\$ 1 billion per year.

In order to permit more liquidity and transparency for this market, the government has encouraged an increase in trading with financial bonds specialized in agribusiness. The CPR (Rural Producer Note) highlights as one of the main financing tools: First, the producer goes to the Bank and issues the CPR where the characteristics of the product, like kind, quantity, date of delivery and price are registered. The Bank gives a guarantee to the bond and sells it to an investor who usually pays less than the face value, thus obtaining a discount. The market, according to the demand for this investment, establishes the discount. In last July, CPR was being traded for 85% to 90% of the face value. The CPR can be registered in CETIP and negotiated in the secondary market through BM&F, giving more liquidity for trading. By being just financially liquidated, this kind of bond dispenses physical delivery. ⁴

⁴ CPR was created by Law n. 8.929, August 22, 1994, and the possibility for just financial liquidation was authorized by MP n. 2.017, January 19, 2000.

The expectation is the growth of this market, permitting a large amount of trading and long-term bonds, reducing the final cost to the farmer. On the other hand, this could be the result of the decrease in prices to the consumers in cities, improving thus, the efficiency of the economy and the welfare of people.

Protection Against Financial Risks

Producers can get protection against financial risks in the market. They can buy options puts or futures contracts in the domestic market (BM&F) or in the international market (like CBOT, for example), through a commodities-broker. The Bank of Brazil offers this kind of service, which has permitted the improvement of the agribusiness sector in the Country.

The next section introduces the discussion about the federal public banks.

4.3 PLANS FOR RESTRUCTURING FEDERAL PUBLIC BANKS

The public power participation by the financial sector of the economy has been declining for the last years. In fact, several state banks' privatization and the shutdown of some federal financial institutions propitiated a significant participation of the private sector in the banking market, mostly through large international conglomerates. The following table illustrates foreign capital in the financial system:

Table 4.3.1

PERCENTAGE PARTICIPATION OF INSTITUTIONS IN TOTAL ASSETS OF THE BANKING SYSTEM

INSTITUTION	1993	1994	1995	1996	1997	1998	1999
Banks with Foreign Control	8.35	7.16	8.39	9.79	12.82	18.38	23.19
Private Banks	40.67	41.21	39.16	39.00	36.76	35.29	33.11
State-owned Banks (+ state saving bank)	13.41	18.17	21.90	21.92	19.06	11.37	10.23
CEF	14.51	14.98	16.40	16.47	16.57	17.02	17.06
BB	22.93	18.28	13.91	12.52	14.42	17.44	15.75
Credit Cooperatives	0.13	0.20	0.24	0.30	0.37	0.50	0.66
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: The Central Bank of Brazil - COSIF

In the federal scope, the Committee for Management and Coordination of Federal Public Financial Institutions – COMIF, an organ tied to the Finance Ministry, ordered, through BNDES, a comprehensive study on federal financial Institutions, their performance field, and their role as a government organ.

The consortium Booz -Allen & Hamilton – FIPE carried out this study. Booz-Allen is a well-known international consulting company and FIPE is the Economic Research Institute Foundation, tied to Universidade de São Paulo. Last June, the Consortium

introduced the first part of “Alternatives for Strategic Reorientation”, a document that can be found on the Internet site of the Finance Ministry for Brazil, in order to inform the public. By keeping the public informed, the committee can be sent critical suggestions and feedback.⁵

In this chapter the role of federal banks in the current economic context will be analyzed, using “Alternatives for Strategic Reorientation” as a reference.

The Federal Public Banks

In this study, the following five federal banks were evaluated:

? Banco Nacional do Desenvolvimento Econômico e Social – National Bank for Economic and Social Development – BNDES.

? Banco do Brasil S.A. - Bank of Brazil - BB

? Caixa Econômica Federal - Federal Saving Bank - CEF

? Banco do Nordeste do Brasil – Bank of Northeast of Brazil - BNB

? Banco da Amazônia S.A. - Bank of Amazon – BASA

BNDES is a development bank with strategic vision and national performance, especially in the industry and infrastructure areas. BNDES has highlighted the government's financial agency in the privatization of public companies, a process that has been occurring in Brazil for the last few years. The bank owns assets totaling approximately US\$ 43 billion.

Bank of Brazil is Latin America's biggest commercial bank, which has a strong participation in agribusiness and international commerce sectors, acting like the National Treasury's main financial agent. BB owns dispersed agencies for the whole

⁵ The complete version of “Alternatives for Strategic Reorientation” is available at www.fazenda.gov.br

national territory; it is also represented in the main world capitals. BB's total assets equal US\$ 74 billion.

CEF also acts as a retail bank, with strong representation in financing the real estate sector, habitation and urban development, administration of the FGTS, and federal lotteries. CEF is the second largest Latin America bank, with total assets of US\$ 65 billion.⁶

BNB is characterized as a regional development bank, acting in the northeast of Brazil. It also acts as a small commercial bank. It owns assets of US\$ 7 billion.

Finally, BASA acts as a regional development bank of Legal Amazon and as a small commercial bank, possessing assets of US\$ 1.8 billion.⁷

Diagnosis and Critical Matters

According to “Alternatives for Strategic Reorientation”, the Federal Public Financial Institutions – IFPF’s efficiency and effectiveness in executing the government’s goals has been declining over time. We transcribe below the critical matter summary identified in IFPF's diagnosis:

? “Varied effectiveness – disregarded segments, surplus in the constitutional funds, insolvency, low articulation with the private sector, misalignment of strategic view, structural unbalances in the social funds, and performance in unnecessary sectors.

? Assets Devaluation – loss absorption on behalf of the government, no framing in the capital adjustment rules.

? Low transparency – mixture between result of the commercial action and of the execution of government’s objectives, political influence in the managerial

⁶ FGTS – Fundo de Garantia por Tempo de Serviço – Workers’ fund for habitation and retirement.

⁷ Total assets data refer to 1998.

administration, and fewer explanations (in the Union General Budget) about the inherent costs to the social action.

? Low integration and coordination between institutions – deficiencies in the individual planning and absence of IFPF’s planning for the action with economic and social objectives, competition, duplication, market division, little synergy, heterogeneous knowledge, and low qualification transfer.

? Difficulties generated by the proximity to the government – “moral risk”, administrative complexity characteristic of the public service (bidding, administration of human resources etc.), mandatory acting in unattractive markets little controlled by IFPF, and frequent changes in strategic orientation.

? Internal deficiencies – specific matters related to processes and internal controls, demands for investments in technology, structure weight, captivation of specific funds dependence, and high operational costs.

? Loss of competitiveness – evolution of government’s demands, inability for sustaining economic and social programs, growth of the competition in the sector with reduction of marginal revenues in the commercial activities.”

Criticisms Directed to “Alternatives for Strategic Reorientation”

When the work was published, several segments of the society represented for class entities, journalists and economists, among others, objected to the recommendations of the consortium, as well as to the adopted criteria. Part of the criticisms was directed to the financial projections for the operational liquid result, in the period from 2000 to 2009. Such projections indicate loss for IFPF from year 2003 on, considering data based on historical indicators, balance sheets and economic tendency

information. When using historical data, it is possible that the Consortium has ignored recent advances in the government's financial companies' productivity, as confirmed by data showed in "Alternatives for Strategic Reorientation", since during the period from 1997 to 1999, IFPF's set produced results superior to US\$ 1 billion a year.

Another criticism refers to the scope of comparison. The group of IFPF that has important social function in the economy, not always profitable, was compared to a chain of the four biggest private banks in Brazil, whose main objective is to reach profit all the time.

The study indicates that the role of supporting government's goals can be accomplished with larger relative participation of the private sector. In Brazil, it is known that the private sector, historically, does not participate in the less economically attractive segments. We do not imagine that private banks will work in poor regions and in segments that result in little profits, such as agricultural financing and investments in basic sanitation.

The fact that the study considered the chain of institutions, ignoring the companies' individual analysis, their characteristics, markets and economic and financial indicators, was also object of some criticisms. In fact, a specific evaluation could reveal possible dysfunction, easily identifiable and correctable.

The Options for the Strategic Reorientation

The international experience analysis indicates the existence of four main forms of government's performance on coordination and execution activities in the financial sector:

- a) Bidding/Substitution – current Brazilian model, it is characterized by government's strong participation in the financial sector in the social and fomentation areas, as well as in the commercial activity. Thailand and Indonesia also adopt the similar model.
- b) Competition – model adopted by France and Germany, social democratic political orientation countries, introduces public capital high participation in the financial sector, however not so intense as in the previous model.
- c) Partnership – Model where the public sector associates with the private sector in order to promote the risk sharing and funds distribution, thus accomplishing government's goals. Spain, Italy, Mexico and Canada adopt it.
- d) Complementary – Model adopted by developed countries like the United States, England and Australia, where government's participation in the financial system is limited to the regulation and supervision, with marginal action in the meeting of objectives of the State.

The study suggests that a new configuration of the countries with regard to its institutions is motivated by the cost reduction search and by maximization of the private market contribution. Besides, there is a world tendency towards government's priority performance. Here, the government acts as a regulator, abstaining from the executive functions in the financial market. On the other hand, it

cannot ignore the importance of IFPF in the social assistance in sectors not traditionally attended by the private sector.

In this context, four basic forms of IFPF's action were identified:

- a) Commercial Action – It is characterized by availability of products and similar services offered by the private sector with profitability search;
- b) Bank Access Action – Aims supply directly to the existing deficiencies in the market, acting close to the segments not attended by the private sector.
- c) Economic and Social Development Action – It is characterized by intense demand for coordination by the government, mainly in large projects;
- d) Regulatory Action – The government acts predominantly in the coordination and supervision functions.

The action forms identified, combine in five basic families:

- a) Family A - current model – represents the option of keeping IFPF's set in their current form, accomplishing just an optimization by the institutions.
- b) Family B – commercial action, development action and bank access - keeps all the areas where today the Government acts. However, here the government is searching for a redefinition of the system to obtain more effectiveness.
- c) Family C – development action and bank access – Does not necessarily presuppose the government's commercial performance, but it keeps the other functions.

d) Family D – development action – Research maximizes the utilization of private sector resources, keeping the government ahead of the coordination.

e) Family E – regulatory action – the objective is to minimize government's participation in the financial market, allotting all the executive functions to the private sector, except for regulation and inspection.

Nine main options were developed for discussion:

Families of Alternatives

A. Commercial, Access and Development	A1 Current situation with optimization of action scope
B. Commercial, Access and Development	B1 Commercial Bank, Access Bank, Development Bank and Regional Agencies
	B2 Commercial Bank, Access Bank, Development Bank and "Retail" Development Bank
	B3 Commercial Bank, Urban Development Agency, Agriculture Agency, Development Bank
	B4 Commercial Bank, Development Bank (integrated)
C. Access and Development	C1 Access Bank and Development Bank (integrated)
D. Development	D1 Urban Development Agency, Agriculture Agency, Development Bank and Regional Agencies
	D2 Development Bank (integrated)
E. Regulatory	E1 Funds and Regulation Agencies

A New Strategic View

The institutions' constant refinement must be a priority goal by the public power. In the federal, state or municipal level, is mandatory to the government to guard the

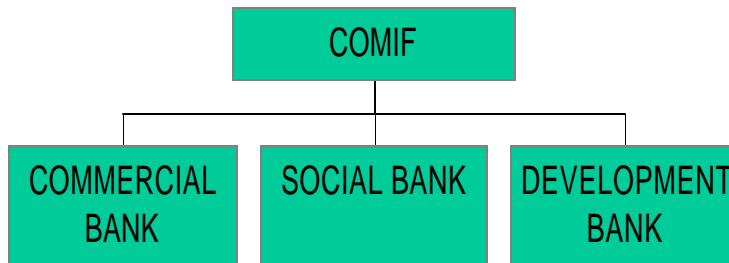
public services' quality and efficiency. We figure that the financial sector must not be different. The Brazilian society wishes to continue relying on the public financial Institutions. Proof of this was found in a poll in which posed the question "what bank do you consider to be the most recognized in Brazil?". The majority polled identified Bank of Brazil as the most prestigious bank in Brazil.

CEF also has been rendering important services to the society with regard to the real estate credit, being the Institution that more captivates saving funds in Brazil. Also BNDES has been a government's important instrument with regard to the investments in infrastructure as well as in the processes of Plano Nacional de Desestatização (the National Plan for Privatization). They are just examples how much those Institutions are important under the economic and social point of view. The Nation cannot do without their financial conglomerates, which are so important for the society.

There is no doubt of what the society has to gain by promoting the system optimization. In this aspect the study introduced by the Consortium opened a wide spectrum of possibilities.

The best option, in our point of view, would be to model IFPF in a new performance scope, which aims at eliminating functional duplicity and trying to focus the activities of each one of the institutions, according to its marketing characteristics. The federal banks strategic performance and their inter-relationship would be directed by COMIF, which would evaluate permanently IFPF's performance.

This would be IFPF's new structure:



Suggestions to the Performance New Scope of the IFPF

A most effective structure can be created since the optimization of the system has been provided. In our point of view, just three institutions would be able to accomplish the State's role in the financial system.

A Commercial Bank:

It would be the unique federal financial conglomerate with strictly commercial performance, freely managing portfolios of captivation and of credit, including agricultural credit, international trade, and business with small and medium sized companies. The main goal would be to obtain profits and provide financial services. Eventually, the bank could act like a government agent in projects of social or strategic importance for society. This bank would act like a National Treasury financial agent in its operations related to the domestic and international financial markets. In the future, the possibility of privatization could be evaluated.

A Social Bank:

This government bank would be responsible for the function access. It would act in segments not attended by the private sector and in social projects, mostly in the

habitation and sanitation financing areas. Also, it would be responsible for the social funds and lotteries managed by the government, aside from benefits transfer. Except for funding captivation to the social projects not attended for exclusive public resources, this bank refrains from commercial activity.

A Development Bank:

It would act as a development bank responsible for the greatest national projects, urban development, regional development, fomentation, exports, and agriculture (mainly long-term financing). This bank would incorporate some regional agencies, acting strongest in the lead of reducing inequalities inside the Country.

Main short-term Consequences

The proposed structure implementation would carry out the function optimization of the IFPF, however it could cause difficulties in the political field. The main short-term consequences would be:

- a) Elimination of duplicated attendant points. In small cities, either CEF's or BB's branches would be closed, unless it were economically viable to keep both.
- b) The other federal banks, according to their marketing purpose, would integrally absorb BNB and BASA structures. Equally, their bank branches would be integrated to the net of BB or CEF, respecting the preceding item criteria.
- c) There would be a huge assets and liabilities portfolio transfer between the federal institutions. The government should be advised to the costs and the resistance of people involved in that.

We figure that human resources must be transferred by the respective areas that are absorbing functions, respecting the law. In the second stage, each institution would

be responsible for restructuring, under accompaniment of the COMIF. It is possible that personnel excess would be identified in certain areas. If this occurs, the damage to the exceeding people can be less traumatic through the implementation of encouraged retirement, voluntary dismissal, retirement by natural processes, and by extinction of vacancies over time. It is important to remember that, in general, the federal bank's employees are people with higher education and vast professional experience.

Admittedly, this analysis is preliminary and it proposes just to suggest a structural organization model. The changes in total implementation would demand the model definition detail and the necessary legal instrument development, as well as the creation and execution of an action plan.

5. CONCLUSION

We can say that the reform process of the Brazilian financial system began in 1994, with the Plano Real. This process has been consolidated in the last years, through the sector opening to domestic and foreign private capital. Now, we have a new phase of improvement of the institutions, procedures and security of the system.

In the beginning, the government promoted a wide clearing of the financial sector, when it decided to intervene and to close some large private banks, such as Econômico, Nacional and Bamerindus. At the same time, several state banks in bad situation were sold in cooperation processes with the federal government.

Basically, national and international large conglomerates realized those acquisitions. Beyond permitting the continuity of the institutions normal activities, those businesses propitiated the sector's development through the dissemination of knowledge, mainly in the areas of project finance and financial risk management.

The recent economic crises of Asia (1997), Russia (1998) and Brazil (1999) show how it is important for a country to have a solid financial system, which can assimilate the negative impact caused by vertiginous global capital flow. In fact, some famous economists say that one of the reasons Brazil recovered favorable of the currency devaluation crisis was its development for the good situation of the financial sector.

However, undoubtedly, the monetary authority must oversee all the stocks, flows and processes that occur, daily, in the financial system. To achieve this goal, the Central Bank must concentrate efforts in regulation and supervision activities, allotting to banks the responsibility for conducting the operational and the clearing systems. Clearings can act in markets, allowing the financial liquidation processes to move fast

and reducing operational and credit risks, contributing, thus, to the strength of the system and to the reduction in vulnerability to international economic crisis.

Also the federal government is evaluating its role in the national financial system. Probably, the State will reduce its participation in execution activities in the market place, a process that has happened in some developed countries. The government must focus on access, fomentation and development activities, and must promote and demand larger participation of the private sector in credit, financing and general banking services activities.

In the trend of federal banks, commercial activity must concentrate only in a unique institution, avoiding duplication in a non-priority government area. Now, it does not seem that the government intends to privatize Banco do Brasil and Caixa Econômica Federal. Even the President of the Republic gives statements in this direction. Both banks are important government instruments. They are the largest banks in Brazil and exhibit trademarks that are possibly the strongest in the Country. It is important to strengthen the federal banks, because in the future they can be privatized in a huge international bid, bringing resources to the National Treasury. But this is another question.

The most important point here is that the improvement of the financial system, public and private, will permit to leverage the Brazilian economy growth through healthy competition between banks. Also, the Brazilian Government must continue searching for budget surplus and public debt stability, in order to permit reduction in basic interest rates of the economy. A more efficient economic and financial environment will propitiate the equilibrium of capital supply and demand, granting credit longer and cheaper, and better serving the citizens.

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