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The Evolution and Development of the Corporate Debt Market And Its Applicability to the Brazilian Reality

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1-) Introduction

"…*Bond Market can provide useful guidance for the setting of macroeconomic policy. Because bond markets react quickly to policy decisions, policies can be adjusted at an early stage. Governments can be sent a clear e immediate message about the sustainability of their fiscal policies. The political impact of higher bond rates can be all the greater when household mortgages are linked to bond rates: voters usually will not welcome greater government borrowing if it means they have to pay more for their mortgages.*"

Philip Turner – Bond Market Development: What are the Policy Issues?

The major reforms have indeed take in place many emerging markets, and several have established programs to nurture local bond markets. But in some ways the results have been disappointing: despite a huge increase in issuance, market liquidity has not developed as much as had been hoped. In this way, there was a substantial evolution in Brazilian Capital Markets' in the last 7 years, motivated by aspects related to the macroeconomic issues, regulation ,and transparency; challenges exist that will need to be overcome in future years. In order to overcome these challenges these paper will cover two problems that still persists today:

? **The development of the liquidity in secondary market and lengthening of maturities of corporate bonds;**

2-) Bonds: General View:

Bond is a kind of debt securities. Debt securities entitle their holders to a priority claim over the holders of equities to the assets and the income of economic unit. They are either negotiable or nonnegotiable. (E.g. Bonds, Notes, Accounts Payable, and savings deposits). [1]

First of all, the well functioning of Corporate Bond market's is a consequence of many different variables; above all must focus on Government; The Government sector affects corporate bonds development in many different ways. Based on Government Bonds market features' the private sector will be able to shape its own market.

The development of bond markets raises issues and policy dilemmas across a broad spectrum of policies – financial, fiscal and monetary.

By the end of 2001, outstanding of domestic debt securities in the emerging markets amounted to more than US$2 trillion, up from US$ 1 trillion at the end of 1994. Latin Americas' market share was roughly 25%.[2]

As mentioned by Philip Turner in the paper " Bond Market Development: What are Policy Issues?", bond markets help to make financial markets more complete by generating market interest rates that reflect the opportunity cost of funds at wide range of maturities. Moreover, if borrowers finance long-term investments with short-term debt, they become exposed to significant mismatches between their assets and their liabilities. On the other hand, if the firms attempt to compensate the lack of long-term domestic market by borrowing in international bond markets, they may expose themselves to excessive exchange risk. In addition, as bond markets become more liquid, the hedging of maturity risks becomes cheaper and more reliable.

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[1] Money and Capital Markets (2005) Rose, Peter S. p.27
[2] The Future of Domestic Capital Markets in Developing Countries (Litan, Robert) -2003 p. 79

The second reason pointed out by him is that development of bond markets can avoid concentrating intermediation on banks. It is better to spread some corporate risk in capital markets than to concentrate all corporate risk in the banking system. This aspect accentuated the 1997-1998 Asian crisis. There is also a governance issue that can be very important in countries where banks are public sector entities or where they are subject to official guidance to invest in "socially desirable" projects.

The final reason is that liquid debt markets facilitate the operation of monetary policy. A well-functioning money market is crucial for the smooth transmission of policy moves that is increasingly reliant on indirect instruments of control.

Recent studies have attempted to examine empirically why bond markets developed in some countries but not in others. There are no decisive conclusions about the issue; however, several suggest that domestic policies are important.[3]

1-) High and variable inflation – undermines the demand for local currency paper;

2-) System of controls that constrains the price mechanism in the allocation of funds. This can involve interest rate controls, the non market pricing of loans, and "captive market" arrangements that force local financial institutions to buy government bonds;

3-) Narrowness of the local investor base – Part of this reflects consumer behavior. The nonbank savings of Asian households have often gone into property or equity rather than into bonds. It is an inadequate realization of diversification benefits that bonds can offer in low-inflation environment - typically rising in value when property and equity values fall.[4]

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[3] See Burger and Warnock (2003)

[4] Several Central Banks that met at the Bank for International Settlements in December 2001 noted the importance of efforts to educate the public about the value of investment in bonds. They also said that local

The Institutional Investor is the key to accelerate the movements toward to "long-term land"; based mostly on economic incentives.

However, certain regulatory provisions often inhibit active trading by institutional investors such as pension funds and insurance companies; in many countries both are allowed to carry bonds on their balance sheet at historic cost , unaffected by, market price development. Under this system, valuations change only upon sale or default, the supporting argument being that to avoid a short term's view, the results: trading is avoided because it could show how good or bad are the numbers directly into balance sheet.

The local bond markets are unlikly to develop if governments rely either on short term debt, or when they borrow long term, on foreign currency-denominated borrowing. The case against a heavy reliance on short-term borrowing is that using the funds to long-term investments exposes the borrower to greater interest rate and refinancing risks.

The other macroeconomic consequences of different borrowing strategies, domestic or foreign borrowing can affect the private sector; local government borrowing pushes up domestic interest rates crowding out private sector borrowing, most likely forcing the private sector to borrow abroad.

3-) Bonds: Risk Issues

Macroeconomics then affects bonds in another way; Bonds are vulnerable to economic changes that can undermine their value. The biggest economic threat to bonds is raising interest rates. An Investment portfolio composed by bonds would be worth less if interest rates go up; the value of its bonds on the open market, with few

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banks were reluctant to advise their customers to buy bonds, sometimes because banks saw such instrument as direct threats to their own products.

exceptions, will go down. However, if the investor plans to hold the bond to maturity the value of its bond does not change because interest rates change. It will still get the amount promised when he or she bought the bond, all other things being equal. In this case the opportunity cost of keeping the bond in the investment portfolio instead of holding another one that would has better combination of both risk and return must be considered.

In the other hand, if the investor plans to own bonds for investment purposes - that is buy and sell bonds as he or she would stocks - then interest rates are very important.

Interest rates are not the only factors that affect in bond prices.

The majority of the financial models used to measure market risks have premised the existence of a unique market price for each asset negotiated. This perception is according to the standard economic paradigm that predicts that a walrasrian auctioneer aggregates bids and asks of the players in the marketplace and he or she establishes a unique market price in agreement, as mentioned by Luiz Antonio Barron Vicente, in the book Gestão de Riscos no Brasil (Antonio M. Duarte Jr.) (2003).

However, if the number of participants that are going to immediately buy a particular asset in a given instant is not like the number of participants that are going to sell it at that moment, a unique price becomes itself impossible to find. The solution for this lack of equilibrium would be a payment of "*a price by the immediacy".* This procedure of offering a higher price could create an incentive for participants that would not otherwise want to negotiate immediately to do so; this would restore the equilibrium between buyers and sellers.

A straight consequence of this is the differentiation between the purchase and sale prices for a specific asset. The liquidity risk, in general form, is related to the factors that determine this price by the immediacy. The higher the difference between the buyers' and sellers' prices, the more illiquid and so liquidity riskier it tends to be.

An important aspect of yield differentials (caused by changes in prices) between various grades of bonds is their cyclical behavior over time. During periods of economic downturn, the risk premium might be expected to widen and the opposite might be expected while during periods of prosperity. This pattern of behavior may be attributable to investors' utility preferences. The prime concern in recessions is safety. On the other hand, during a period of prosperity they may be willing to bear more risk of default. A sufficient number of investors behaving in this manner would narrow risk premiums in periods of prosperity and widen them in times of recession.[5]

A related reason for this behavior relates to liquidity. The liquidity tends to be more valued in a recession than it is in a period of economic expansion.

Models to measure liquidity risk focus on two different approaches, endogenous matters and exogenous matters. While the first considers insignificant the impact by one individual in the marketplace, the second does not, but rather considers that in illiquid markets one player can put pressure on prices.

The key to understanding price changes is the investigation of a relationship between trading activity and price changes. In other words, this is the price impact of trading activity, as mentioned by Jun Muranaga and Makoto Oshawa in the paper – "Measurement of Liquidity Risk in the Context of Market Risk Calculation" – (1997) - Bank of Japan. Certain firms regularly check the difference between the necessary liquidation time for less liquid positions forecast by traders and the actual time needed to close the positions.

How to measure the impact of trading volume on price?

This is the more complex part of measuring liquidity risk. However, the prevailing use of computer-driven asset management and the growing interest in

[5] See more in Financial Markets Rates and Flows (2001) Van Horne, James C. p.130

evaluating the performance of pension funds more accurately tend to increase the need to quantify the price impact.

The standard Value at Risk[6] model assumes that any quantity of securities can be traded without influencing market prices. In reality, most markets are less than perfectly liquid and many securities cannot be traded with ease in markets. This is especially true for emerging market economies where the process of financial sector reform is currently taking place. As mentioned by Aravind Mahadevan, in the paper "Incorporating Liquidity Risk" in VAR Estimation -2001(www.iciciresearchcenter.org), risks associated with market illiquidity have not been effectively incorporated into the Value-at-Risk (VaR) models.

In the face of sudden and persisting off-market prices of some of the securities in their portfolio, the Indian financial organizations often find it difficult to offload these securities without booking significant trading losses. As a consequence, several securities exhibit very low levels of turnover in the secondary segment of the debt market. Also, in most cases, measures of market risk fail to capture the costs of carrying illiquid assets in their portfolio. This becomes a constraining factor for market growth.

The Asset/Liability Management method also considers duration[7] and convexity[8] to measure volatility and sensibility of changing in bond prices.

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[6] In economics and finance, value at risk (VaR) is a measure (a number) saying how the market value of an asset or of a portfolio of assets is likely to decrease over a certain time period (usually over 1 day or 10 days) under usual conditions. It is typically used by security houses or investment banks to measure the market risk of their asset portfolios (market value at risk), but is actually a very general concept that has broad application.

[7] In economics and finance, duration is the weighted average maturity of a bond's cash flows or of any series of linked cash flows. This measure is closely related to the derivative of the bond's price function with respect to the interest rate, and some authors consider the duration to be this derivative, with the weighted average maturity simply being an easy method of calculating the duration for a non-callable bond.

[8] In finance, convexity is a measure of the sensitivity of the price of a bond to changes in interest rates. It can be positive, negative or neutral.

4-) Economics Issues

The Director of Risk-Office Consultancy, Carlos Antonio Rocca, in his book Soluções para o Desenvolvimento do Mercado de Capitais Brasileiro (2001), however, emphasizes the international financial market improvements carried out in the last fifteen years: modernizations in the banking system and the increasing share of capital markets in credit allocation for the productive sector. It has generated competitive advantages for those countries that followed on this path.

In the development system, growth rate is divided into two different coefficients:

1-) Share of GDP that flows to increase capital stock (Investment rate) and,
2- The marginal growth of GDP caused by any such given additional capital unity (investment productivity).

An efficient financial system can enlarge the investment productivity by:

- Increasing quality of the resource allocation therefore destines funds to the projects with higher rate of return;
- It makes feasible the adoption of optimum scales and technologies, making it possible to overcome the lack of available resources to entrepreneurs;
- growing productivity levels as well as increasing the efficiency of household investments in the business sector as follows:
    - accelerates creation of new technologies, including capital supply to emergent companies of technological innovation;
    - Offers new ways to manage and balance risks, by using diversification, hedge and insurance, allowing the separation of the risks including risks that entrepreneurs do not want or can

not afford; (e.g. risk of fluctuations at exchange rates or changes in interest rates).

As mentioned by Rocca, from the mid 80's on, innovations in technology and telecommunications, deregulation, privatization and improvements in financial technology promoted a change in the developed countries markets. Large funds that previously were mediated by banking systems that shifted flows to the capital market can be accessed directly by the firms, using issue of bonds (debt) and stocks (equity).

The enlargement of this method is related to logical economic thinking; this new method of reach funds to finance entrepreneurial activities is more efficient and less costly. This tendency could be observed in the United States, where capital markets are offen presented advancements; the market highlights of 1996, showed that the balance in financial assets emitted by non financial private companies was more than the double of banking assets.

Nevertheless Japanese and European banking systems were the dominant source of capital; Banks are the most important fund providers, even though capital market has been increasing lately. However, more transparency and information disclosure are usually needed to use capital market funds.

5-) Regulatory Issues:

In the September 1998, International Organization of Securities Commissions (IOSCO) released 30 principles of securities regulation which IOSCO members believe form the basis for an effective system of regulation of securities and derivatives markets. The secondary market section is composed by 6 principles[9] as follows:

? The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight;

[9] The Development and Regulation of Non-Banks Financial Institutions (2002) Carmichael, Jeffrey- p.147

- Ongoing regulatory supervision of exchange and trading systems should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants;
- Regulation should promote transparency of trading;
- Regulation should be designed to detect and deter manipulation and other unfair trading practices;
- regulation should aim to ensure the proper management of large exposures, default risk, and market disruption, and
- The system for clearing and settlement of securities transactions should be subject to regulatory oversight and designed to ensure that it is fair, effective, and efficient and that it reduces the systemic risk.

Joseph Stiglitz, Economics Professor at the University of Columbia and the winner of Nobel Prize of Economy in 2001, criticized the accentuated of deregulation occurred during the 90's:in his paper "ETHICS, MARKET AND GOVERNMENT FAILURE, AND GLOBALIZATION" (2003):

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> *"In the United States, the corporate, accounting, and banking scandals – in each of which individuals were simply acting in ways which reflected their own interests, and most of which were, at the time totally legal – raised (for most people) serious ethical issues. CEO's and other executives deliberately took advantage of their positions of trust to enrich themselves at the expense of those they were supposed to serve. They did not disclose information that they should have.*
>
> *These are market failures, failures which led to what I (and most others) view as unethical behavior. There were also public failures. The government not only failed to address the problems posed by the conflicts of interest and the misleading accounting – even after public attention to these problems had been drawn – but with the repeal of he*

Glass Steagall Act they even expanded the scope for these conflicts of interest. Rather than correcting the market failures they exacerbated them.

At what point do these actions cross over the line, so that they can contribute not only to economic inefficiency but can be considered unethical?
Those who commit these acts almost always come forward with self-serving arguments for why what they are doing is in the public interest. For example the elimination of the restrictions designed to prevent conflicts of interest are described as allowing for more market flexibility, enabling the market to respond better to the ever changing landscape."

Stiglitz pointed out in his book The Roaring Nineties (2003) the huge damages to American households caused by market imperfections, moral hazard issues and lack of regulation: US$8.5 trillion disappeared when the bubble of technological companies burst, only in the American Capital Markets; one third of the amount of investments of pension plans 401 (k)[10] had gone; two million jobs were smothered.

The valuation of securities is correlated to the economic foundations as well as the perception of the markets (individuals) regarding its accounting legitimacy and the expectations about future tendencies, as well as the measurement of risk of default is based on these accounting reports. An initiative like the recent reformulation of securities law (Sarbanes and Oxley act) moves once more the market toward regulation. Anyway, the creation of bubbles must be avoided, and so strengthening the foundations of the market and the investors' confidence.

[10] The 401(k) plan is a type of employer-sponsored retirement plan that allows a worker to save for retirement while deferring income taxes on the saved money or earnings until withdrawal.

In the book The Private Sector in Development – Entrepreneurship, Regulation, and Competitiveness, (2003) The World Bank - Michael Klein coined the name "New Swedish Model"; It is a model that have been used since 1990's by Sweden as well as Netherlands among others industrial and emerging economies. This model tries to match the competition in the productive sector with regulatory frameworks that safeguard social and environmental standards and to maintain or build effective social safety nets.

The book Reinventing the Bazaar – The Natural History of the Markets" (2002), written by John McMillan, Professor of Economics at Stanford University describes the operation of many different markets of various products in diverse countries from time to time; he quotes the conditions that serve of general rule for it works well:

> "*For a market to function well, is necessary for the people involved to trust each other; it should be certain that the properties will not be expropriated; the information about what is available, easy to obtain and of good quality must flow easily; any side effects about third parties should be avoided; and there must be competition.*"

The points mentioned by Stiglitz reinforce the idea that asymmetry of information is created by lack of information, lack of transparency or incorrect information available. Moreover, insufficient control under situations that exists with conflict of interest harmed many investors.

Luiz Chrysóstomo Filho, in the book Mercado de Capitais e Crescimento Econômico – Lições Internacionais, Desafio Brasileiro (2005) emphasizes that the securities law has been influenced by increasing competition factors and by the financial globalization, with greater exchange between financial intermediates, Central Banks and institutional investors, in the face of steadily increasing complexity of the financial products and pursuing the continuous technological evolution.

So, both regulators and legislators have been attempting to become more sophisticated as well as being more up-to-date, in order to provide safety and transparency to the investors.

As he mentioned, the greater the capacity of a country or market in make improvements in its legislation, the greater the probability that capitals flows into it. He pointed out that one of the factors that has been permitting this development is the enlargement of the Self Regulation Organizations (SRO).

Nowadays it has 31 SROs in the United States, as informed by Securities Exchange Commission (SEC). The SROs act as diverse functions, according to regional matters, competitiveness of the markets and legal-institutional traditions. Professional certification is an example of an activity that can be under the SRO responsibility as well as the establishment of codes and rules of conduct, and even the creation of supervision mechanisms, auditing and the definition of sanctions, penalties and arbitrations. They can play a complementary role to the formal regulation office, disseminating and ratifying decisions of the public sector, in an independent way; to set in motion propositions that anticipate changes and discuss structural alterations in the legislation.

The most activist SROs, like the Association of Securities Dealers Regulation Inc. (NASD) or the New York Exchange Commission (NYSE), whose broad action is of high caliber, influences the regulatory field. Others like the Emerging Markets Traders Association (EMTA) acts in specific areas. This Association defined the code of conduct for operations in market and the International Swaps and Derivatives Association (ISDA), which standardizes the international contracts of derivatives.

In the case of Brazil, two examples are the São Paulo Stock Exchange (BOVESPA) and the National Association of Investment and Development Banks (ANBID).

Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, respectively from Dartmouth College, Yale University, and Harvard University, in the working paper “What works in securities laws?” number 3-22 (2004) The World Bank, carried out econometric research with 49 countries, of the relations between legislation, private organizations and public ones in the capital market development; they search defined variables that could distinguish ranks of efficiency of what they called private enforcements, as opposed to the public enforcements. The results are as follows:

> *“Financial markets do not prosper when left to market forces alone. Second, our findings suggest that securities laws matter because they facilitate private contracting rather than provide for public regulatory enforcement. Specifically, we find that several aspects of public enforcement, such as having an independent and/or focused regulator or criminal sanctions, do not matter and others matter in only some regressions. In contrast, both extensive disclosure requirements and standards of liability facilitating investor recovery of losses are associated with larger stock markets. Our results on the benefits of disclosure support similar findings of Barth, Caprio, and Levine (2003), who find that their proxy for “private monitoring” is positively correlated with the size of the banking sector.*
>
> *These results point to the importance of regulating the agency conflict between controlling shareholders and outside investors to further the development of capital markets. They also point to the need for legal reform to support financial development, and cast doubt on the sufficiency of purely private solutions in bridging the gap between countries with strong and weak investor protection.*
>
> *Finally, our findings further clarify why legal origin predicts stock market development. The results support the view that the benefit of*

common law in this area comes from its emphasis on market discipline and private litigation. The benefits of common law appear to lie in its emphasis on private contracting and standardized disclosure, and in its reliance on private dispute resolution using market-friendly standards of liability."

Two recent examples can be observed in the Brazilian case.

The first one is the elaboration of the Code of Self-Regulation of Securities Public Offerings, concluded in 1998 and modified in 2005 by the ANBID. All the public offerings lead by the members of that entity have obliged to follow some standard procedures in regards to the handling of information disposed to the investors that address the decision whether to do the investment or not. Each offering along with its documents have been submitted to The Self-Regulation Committee. There are other Technical Commissions composed by members of different segments of the market; with the application of a stamp of constant guarantee in the documentation of the offerings, among them the prospectus and the public announcements for disclosure to the investors, the Committee assures that for each deal all of the procedures established in the Code were contemplated and respected. Such practices move the underwriters toward the standardization of procedures, improving the quality of information to the investors. Moreover, ANBID elaborated a Self-Regulation Code for Investment Funds and another one for Securities Custody.

The second successful example was the creation by the BOVESPA in 2001 of a specific segment for listing companies that attended to the devices of transparency and corporate governance; it was named New Market and Levels Differentiated of Corporate Governance Procedures and was based on the German model.

The three levels are: Level Two, Level One and New Market; each one is more restricted than the previous one. The company listed in this segment assumes a bigger commitment with the level of disclosure of information and transparency of management. For instance, there are minimum levels of liquidity of the stocks circulation (free float level) and reduction of the differences between the stocks in the marketplace. The New Market level is accessed by companies that issued only common shares with 25% at the minimum free float level. At the other side, minority shareholders (non controllers) tend to pay more to buy New Markets' stocks.

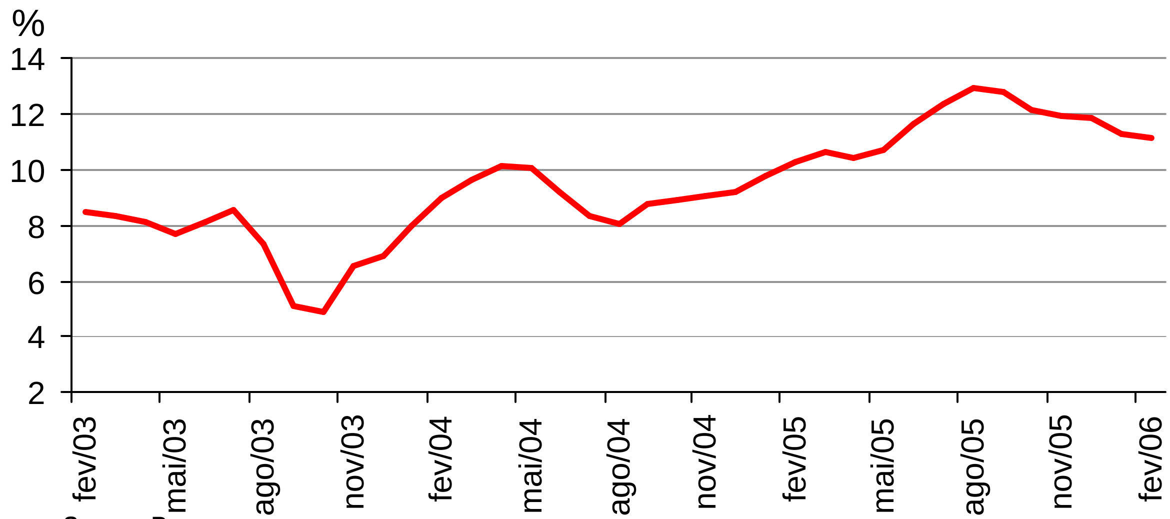
Chrysóstomo emphasizes that the activities of the SROs should be monitored by the formal regulating organs; therefore, among the problems observed in the action of the SROs are those related to the risk of cartelization, when players get together to make rules in their own cause, creating obstacles for the competition and transparency. After all, there is a conflict of interest in SRO's nature and Stiglitz mentioned failures in the complex American's system. It has been being the greatest challenge for official regulators.

The interaction and intense collaboration between Government and Market Representatives have provided the most important legal improvements in Brazilian Securities marketplace. The SRO's are very important to the making rule process but, for activities such as Investment Advisory, even in US is directly inspected by SEC without any SRO.

6-) Brazil: An Emerging Market in Developing Country - Overview

Considering that interest rates have been decreasing since the second semester of 2005, as shown at the graph, the domestic capital market is more sophisticated and stronger, so it can play its role better now than it did some years ago. Furthermore, decreasing interest rates are going to be a very important issue to firm's investment decision making; this aspect will increase projects' Internal Rate of Returns - IRR.

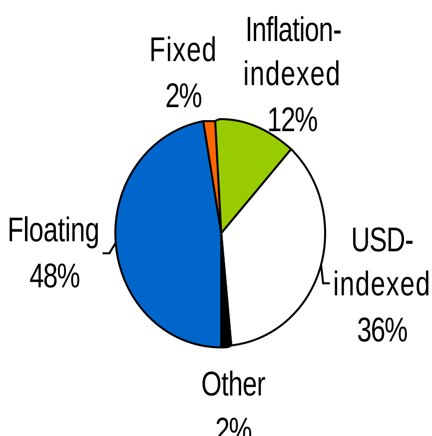
Real Interest Rate – Selic[?] - 2003-2006



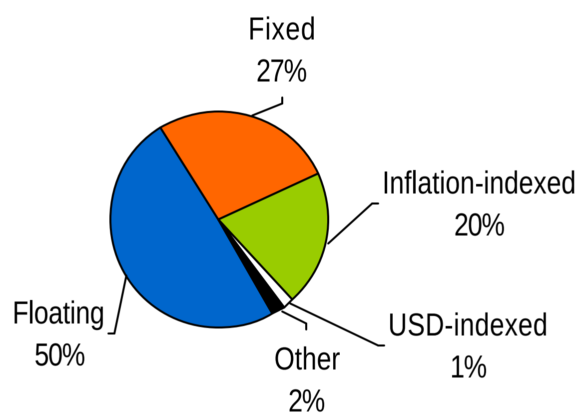
Source: Bacen

The shape of Brazilian domestic sovereign debt has been changing, increasing Prefix rates and decreasing USD indexed, strengthening channels of monetary policy and decreasing external vulnerability.

November 2002



February 2006

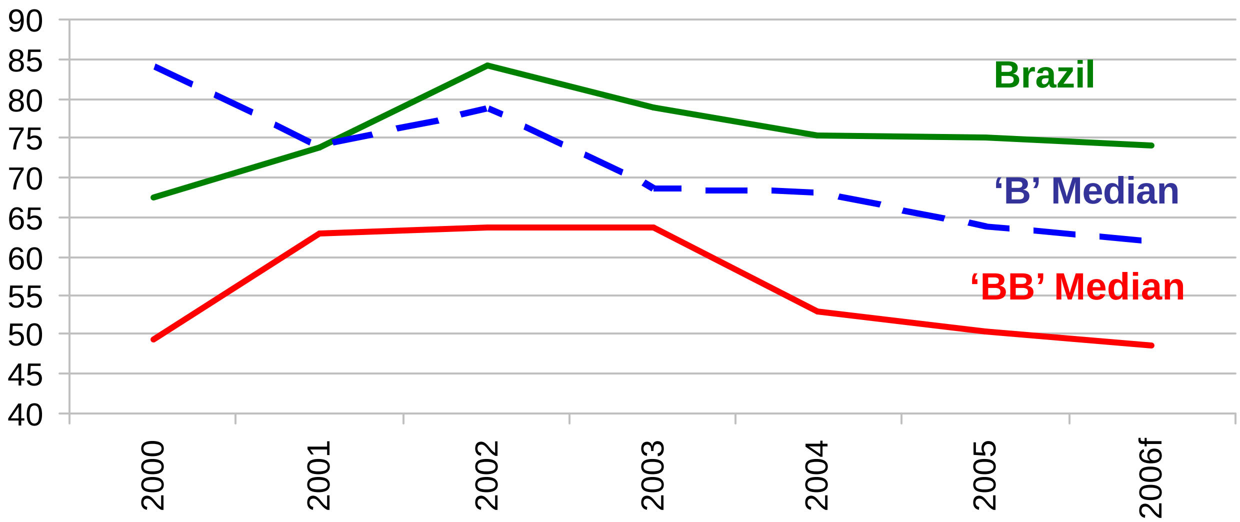


Source: Bacen

[?] Note: Not prospective real rates. Uses average nominal Selic and average inflation (IPCA index) from the same period. Source: Bacen.

However it should considered the evolution in the Brazilian rating; In other words, how fast it will be able to move toward the investment grade level. The graph below shows that something that should be done has not been done yet:

General Government Debt/GDP (%)



Source: Fitch Ratings

Brazil has performed fiscal effort using the implementation of legislations such as Fiscal Responsibility Act (Lei Complementar 101, 05/04/2000) and the Reform of the Well Faire System (Emenda Constitucional nr 41, 12/19/2003). Moreover, making improvements of the public institutions of inspection and collection. Unfortunately, it is not enough. The Governments' expenditures must be reduced to reinforce fiscal policy in order to increase, indirectly, Private Disposable Income, as follows[11]:

Private Disposable Income[?] = Y[?] + NFP[?] + TR[?] + INT[?] - T[?]

[11] Macroeconomics (2005) – Bernanke, Ben p.37 - Saving and Wealth

[?] Private Disposable Income increasing will increase savings and consumption;

[?] Y = Gross Domestic Product would increase by the higher levels of Investment and Consumption

[?] NFP = Net Factor Payments from abroad would be able to increase, depending on the fluctuations of exchange rate as well as the intensity of increasing imports, that also tend to goes up;

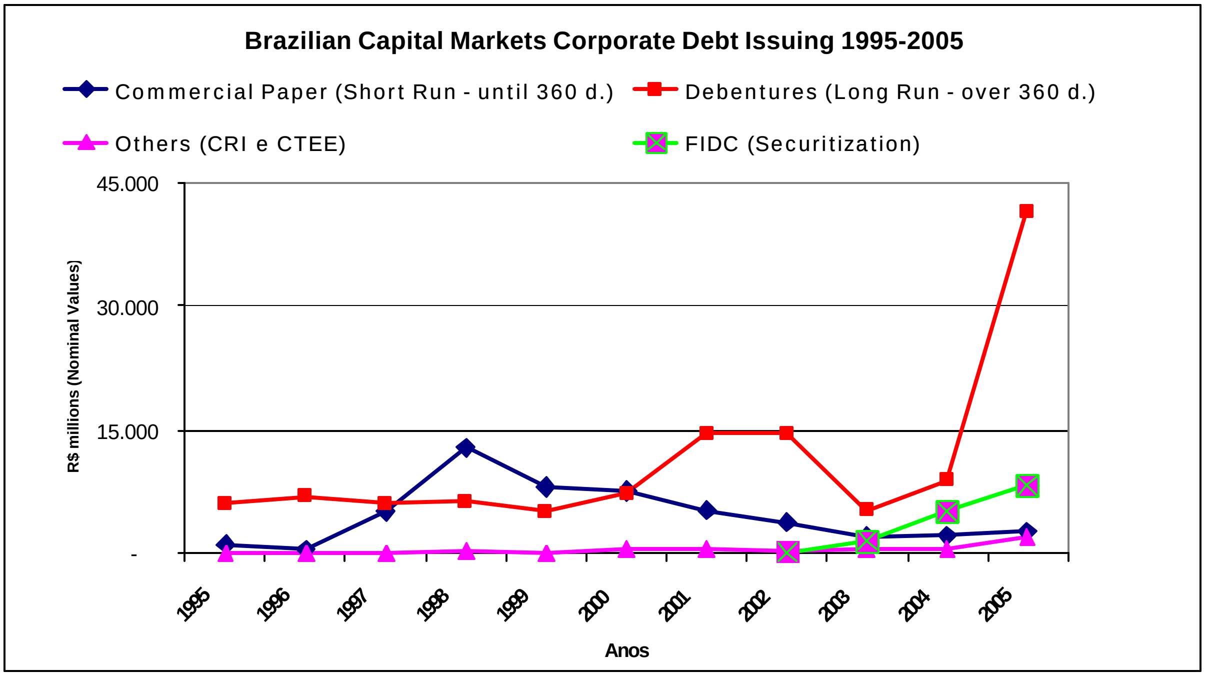
[?] TR = Transfers received from the Government keep at the same level;

[?] INT = interest payments on the government's debt will decrease, it will reduce, indirectly, cost of capital to private sector;

[?] T =Taxes will be able to drop gradually from the highest level of roughly 40% of GDP.

The Investment Grade Level is a key point in order to widen the investor base. The most important global investors have many restrictions for allocate resources in non investment grade assets.

6.1-) Brazilian Market – Issuances Approach – Capital Amount



Source: ANBID[?]

The Fixed Income Underwriting activities to Brazilian companies skyrocketed in 2005. The total amount of R$ 54.4 billion was the highest number ever reached. It was pushed mainly by the traditional debentures deals that reached a peak of R$ 41.5 billion. It was 363% of the previous year's .

Its maturity tends to be longer than the others, mostly compared to the Commercial Papers used by companies to finance its needs in the short run.

? 1-) FIDC – Fundos de Investimentos em Direitos Creditórios was created in 2001- by the Law 01/10303, Instrução CVM 356/01 and Decisão Conjunta BC/CVM número 10 of 05/02/2002;
2-) CRI – Certificados de Recebíveis Imobiliários was created in 1997 by the law 97/9514;
3-) Certificados a Termo de Energia Elétrica was created in 1997 by Instrução CVM 267/97

The Commercial Papers activities level has been decreasing moderately since 1999. One would consider CPs the best way to get into a domestic capital market. However the new instrument called Investment Fund for Credit Receivables – FIDC has been used to accomplish the task.

This instrument can be used by companies that want to reach investors' money but still do not want to become publicly held. On the other hand, investors rely on the contracts structure and legal framework to invest. Its new funds increased significantly since 2003. During 2005 it reached R$ 8.2 billions, around 60% higher than the previous year.

Rating companies have been playing an important role. The underwriting price has been increasingly based on ratings scores by the underwriters. They are using fairer methods to find out market prices. The "book building" method is broadly used. It is a method in which the underwriting price is determined by intersection between supply curve and investors demand curve. Underwriters also have been using success fees based on reduction in yields to companies. Moreover, even the biggest deals, with very few exceptions, initial prices had been dropped by the substantial changes of behavior on the demand side..

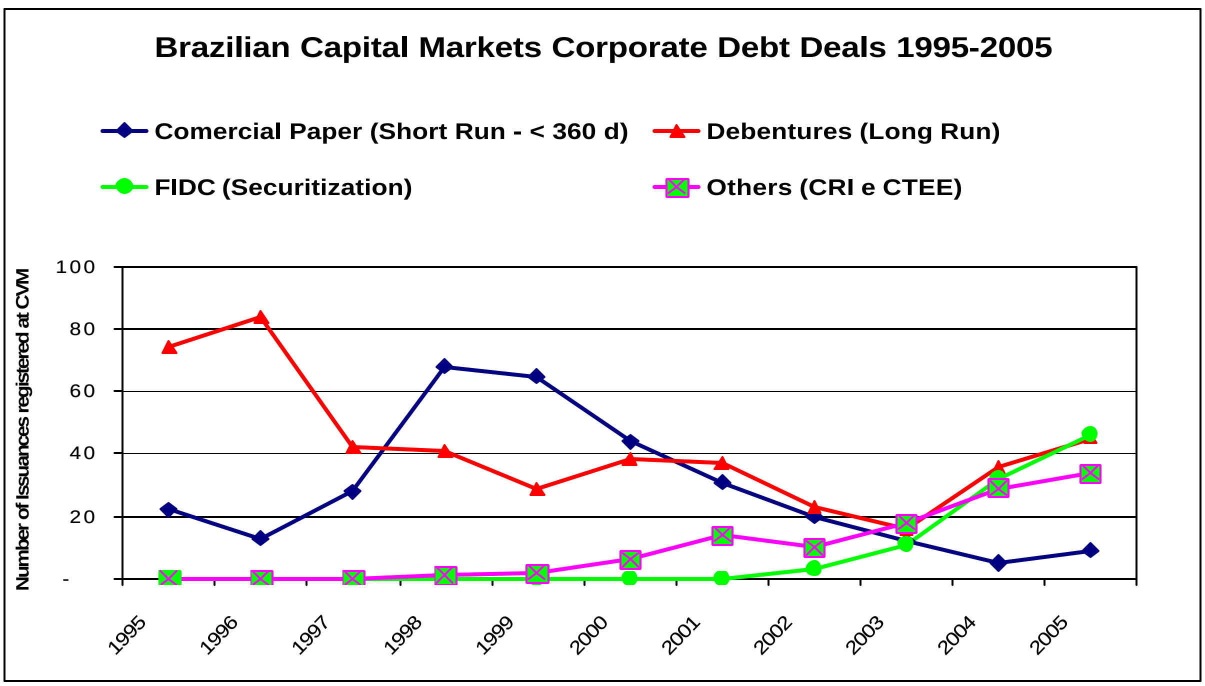
The number of new publicly held companies that realizes Initial Public Offerings – IPO – has been rising. It was 13 in 2005. Compared to 2003, when only two IPOs were realized, it represents huge changes. It shows that the equity side of the Brazilian Capital Market has been becoming stronger as well.

The evolution of short term securities rather than long term ones during the end of 90's can be explained by several crises in a row observed in the International Marketplace (Korea, Indonesia and Thailand- 1997, Russia – 1998 and Brazil its own in the beginning of 1999).

The International Monetary Fund – IMF –, which lent roughly $ 30 billion in support to Brazil, helped the country's swift recovery. Modifications in the Exchange Rate system, as well as implementation of the Inflation Targeting system, had been brought about by the new Brazilian Central Bank Board.

Furthermore, in 2002, it was running presidential elections thus this process brought instability and volatility once again. The asset prices were reflecting the probability of alteration at economic policies' by the Labor Party's new government. The nearer the election date, the worst Brazilian risk was as measured by EMBI Index of J.P.Morgan. So, the exchange rate reflected the highest level of devaluation in history. The recovery started at the second semester of 2003, regarding the maintenance of economic policies.

6.2-) Brazilian Market – Issuances Approach - Quantity Evolution



Source: ANBID

There are some interesting "messages" that can be observed in the graph above. Firstly it shows that FIDC increased sharply in terms of number of deals. It was even higher than the number of debentures deals. It represents the tendency of more and more companies using securitization as a tool to finance its short run needs.

Secondly, despite the Debentures underwriting amounts increasing enormously in 2005, it does moderately in terms of number of deals. It can be explained by higher amounts of money in each deal on average: the motive? Financial Institutions have been using it as a tool to finance its Leasing Companies activities. These deals have reached many billions of Reais. Nevertheless, firms have also been using it to reach higher amounts of capital. The trend shows that debentures will keep growing mainly among the biggest Brazilian companies and/or Financial Institutions.

Thirdly, Cédula de Recebivel Imobiliário – CRI, a recent created Real Estate Securities linked to securitization of cash flows expanded more substantially in terms of quantity. Though it has been higher in terms of amount, it does slightly increase. So, it tends to be less risk concentration in the investment portfolios managed by the Institutional Investors.

The Commercial Paper falls both in terms of quantity and amount; it shows two different aspects: First, companies will prefer use FIDC rather than CP; second, banks are using credit lines in a higher competition to finance short run needs.

So, Commercial Paper tends to be used only linked to structured finance transactions as a bridge loan to be paid with a long term financial instrument.

6.3 -) Brazilian Institutional Investors - Asset Managers

Ranking	Asset Manager	Asset under Management (R$ MM)	Fixed Income (R$ MM)	Equity (R$MM)	%FI	%E
1	BANCO DO BRASIL	148.284,8	130.189,8	18.095,0	88%	12%
2	BRADESCO	100.204,9	96.436,3	3.768,6	96%	4%
3	ITAÚ	97.168,8	89.828,8	7.339,9	92%	8%
4	CEF	39.268,6	34.912,0	4.356,7	89%	11%
5	HSBC	35.760,0	33.822,6	1.937,4	86%	5%
6	UNIBANCO	34.248,1	31.312,2	2.935,8	91%	9%
7	SANTANDER BRASIL	32.491,4	31.313,7	1.177,6	96%	4%
8	CITIBANK	29.856,4	28.039,7	1.816,7	94%	6%
9	ABN AMRO Real	29.840,8	27.388,6	2.452,2	92%	8%
10	PACTUAL	26.558,6	24.115,2	2.443,3	91%	9%
TOP 10		**573.682,4**	**527.358,9**	**46.323,2**	**92%**	**8%**
TOTAL		**708.673,7**	**636.184,4**	**72.489,3**	**90%**	**10%**

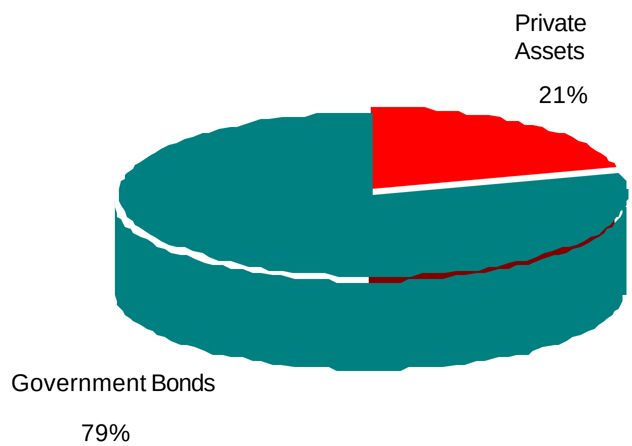
Source: Anbid/Aug-2005

Asset Managers are the most important players on the demand side of securities. In some cases up to 96% of the investment portfolios are composed of fixed income assets. The total amount of fixed income assets reaches roughly US$300 billions[?]. The most important brazilian asset managers are owned by the biggest banks in spite of the fact that independent asset managers has been increasingly growing.

Another noteworthy aspect is the high concentration, approximately 81% of the total amount, of assets under management of the 10 biggest Asset Managers; in the top-five list are two public owned asset managers.

[?] Using Exchange rate US$ 1: R$ 2,15 – Feb/2006

BREAKDOWN OF FIXED INCOME ASSETS



Source: Anbid Aug/2005

The Government Bonds represent the most important asset in the fixed income investment portfolio whereas debentures do not play an important role; approximately 18.2% of Private Assets held by the asset managers, and so, no more than 5% of all portfolios.

As mentioned by Ana Novaes, Professor of Macroeconomics of Pontifícia Universidade Católica of Rio de Janeiro – PUC RJ, – in the paper “Capital Market: Lessons of International Experience”, countries that carry out high levels of public debt crowd out the private sector. It could not be more evident in the brazilian case.

From June 2002[12] on the accounting rules for bonds changed; Mark-to-Market started run for brazilian investment portfolios under management. However, the so-called “exclusive funds” (one-client-funds) were allowed to carry bonds on their balance sheet at historic cost independly of market price development.

[12] Circular BACEN 3086/02 and 3096/02; CVM Instruction 365/02

The Associação Nacional do Mercado Aberto (ANDIMA)[13], another brazilian SRO, played an important role in the implementation of a new Government Bonds price disclosure system.

6.4-) Brazilian Institutional Investors - Pension Funds -

Ranking	Pension Funds	Assets (R$ MM)	% Market Share
1	PREVI	69.972,51	27%
2	PETROS	25.623,28	10%
3	FUNCEF	18.577,79	7%
4	CESP	9.826,40	4%
5	SISTES	6.902,17	3%
6	VALIA	6.294,44	2%
7	ITAUBANCO	6.271,56	2%
8	CENTRUS	5.958,20	2%
9	FORLUZ	4.398,55	2%
10	REAL GRANDEZA	3.497,03	1%
	Top 10	**157.321,93**	**60%**
	Total	**256.466,40**	**100%**

Source: Abrapp Aug/2005

The pension funds are long term investors with little need for liquidity. Their incoming cash receipts are known in advance and with considerable accuracy because a fixed percentage of each employee's salary is usually contributed to the fund, as well as the contribution of employer. As mentioned in the book, The Future of Domestic Capital Markets in Developing Countries (2003), pension fund investments in local markets continue to rise during a period when other investors pull out, suggesting that pension funds contribute to market stability.

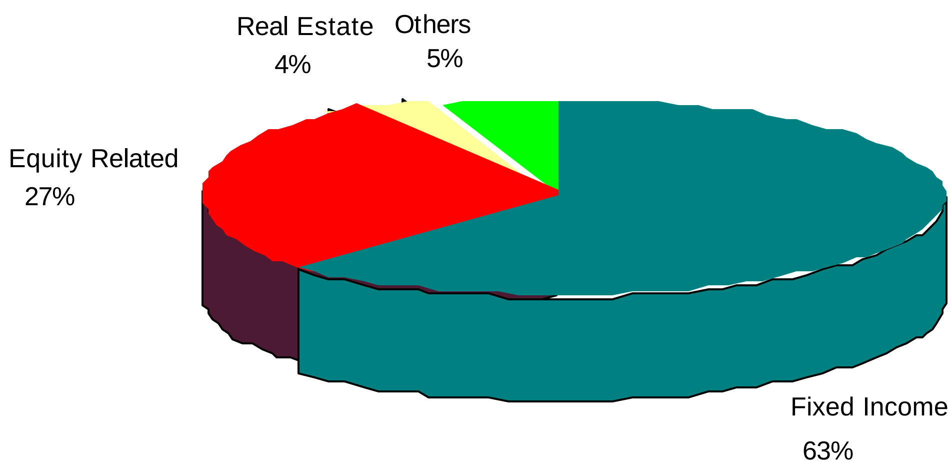
At the same time, cash outflows are not difficult to forecast, because the formula for figuring benefit payments is stipulated in the contract between the fund and its members. This situation encourages pensions to purchase common stock,

[13] See Gestão de Riscos no Brasil (2003) Duarte Jr., Antonio M – p.191

long term bonds, and real estate and to hold these assets on a more permanent basis.

These three different kinds of assets are the most important, in the Brazilian case also, as it can be observed at the graph below.

BREAKDOWN OF PENSION FUNDS INVESTMENT PORTFOLIO



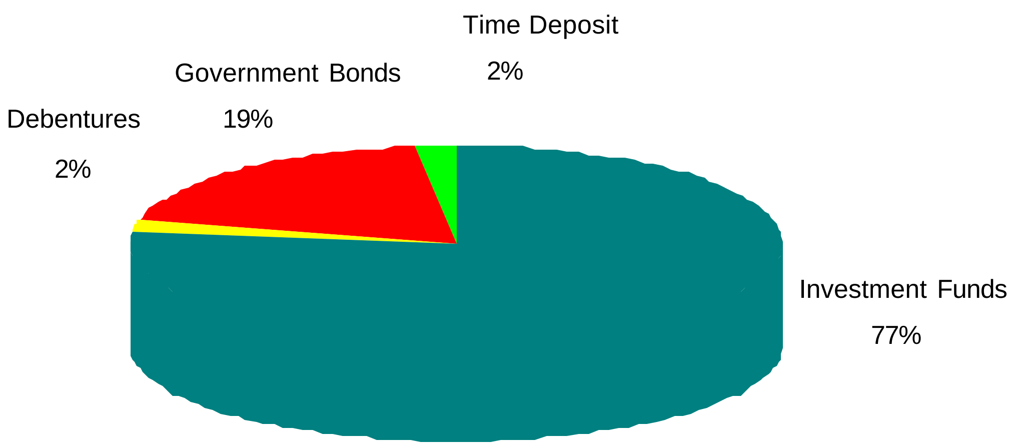
Source: Abrapp Ago/2005

The particular assets held as investments by pension funds depend heavily on whether the fund is government controlled or a private venture. Private funds currently devote the largest percentage of their investments to corporate stock while Government funds tend to allocate more funds in fixed income assets.

In the Brazilian case, pension funds are vastly related to state-owned firms and the Fixed Income are the most important asset in their portfolio. The private sector has been increasing its market share, mainly after modifications in Welfare System, as previously mentioned.

Another characteristic of Brazilian forecast is the increasingly flows of capital into Asset Management. The number of “exclusive funds”, as mentioned before, is a important tool used by Pension Funds to aim the outsourcing of investment management. The graph below shows the majority of investment funds in Pension Fund's portfolio.

BREAKDOWN OF FIXED INCOME INVESTMENT PORFOLIO



Source : Abrapp Aug/2005

Corporate Bond ranked a distant third position, accounting for about 2%; a low number that should increase if the pension funds gradually shifts from sovereign bonds allocation to corporate bonds.

In the paper "Bond Market Development: What are the Policy Issues?" Philip Turner emphasizes the importance of institutional investors' investment rules. In other words, rules forcing institutional investor to hold a high proportion of their assets in government bonds can create a "captive" market. This can undermine the creation of a true market in bonds and in effect deter other investors.

7-) A Developed Capital Market – American Framework

During the lecture at the Securities Exchange Commission Office in Washington D.C., presented in March to Minerva Group – Spring 2006 - the highlights mentioned by Mr. Robert Fisher, Assistant-Director of International Affairs Office, largely illustrated differences in the structure and the specialization of both countries, US and Brazil, as follows:

- 31 Self Regulation Offices;
- 6,500 Brokers Dealers;
- 92,000 Branch Offices;
- 664,000 Registered Representatives;
- 25,000 Investment Advisors;
- 30,000 Investment Companies, and
- 900 Investment Company Complexes.

The many differences between the two countries can be measured in terms of maturity and also in spans of time. Another consideration of importance is related to their regulatory institutions. In the US, the SEC was created in 1934, after the deep crisis of the late 20's. After World War II, the prosperity brought by economic growth in US made the American households considerably better off.

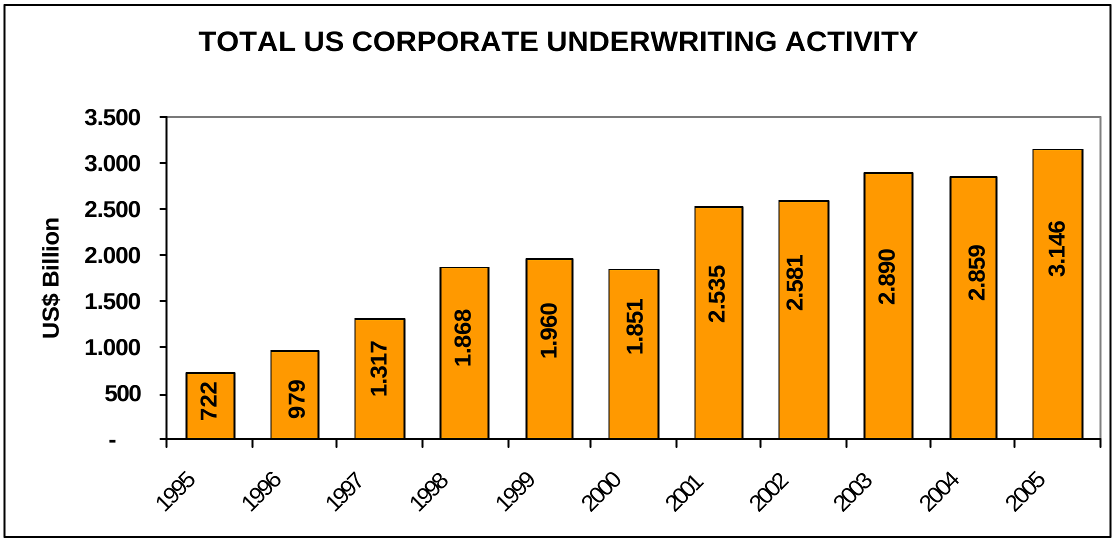
A similar brazilian institution – CVM Comissão de Valores Mobiliários - was created in 1976 only, after a period of high economic growth, during the early 70's, knowned as the "Brazilian Miracle". Afterwards though, the country went through a deep economic crisis that came to represent an entire decade of slow economic growth. That was the "lost decade" as it is known in Brazil. So, contrary to the American households, the Brazilian ones had no economical opportunity to take the advantages of the Capital Market wealth that usually spreads out to society during growth cycles.

The expropriation of savings accounts by the Brazilian Government, in the early 90's as well as the high inflation period since the last 70's affected, and it still does, the society's behavior. The decisions making process of consumption or saving in people's mind take into account not only future trends but also considers bad past experiences.

For a better understanding of the issues that are strongly connected to Corporate Bonds Maturities and Corporate liquidity in secondary market, this section will focus on the most important issues, starting from issuances on the American Capital Market.

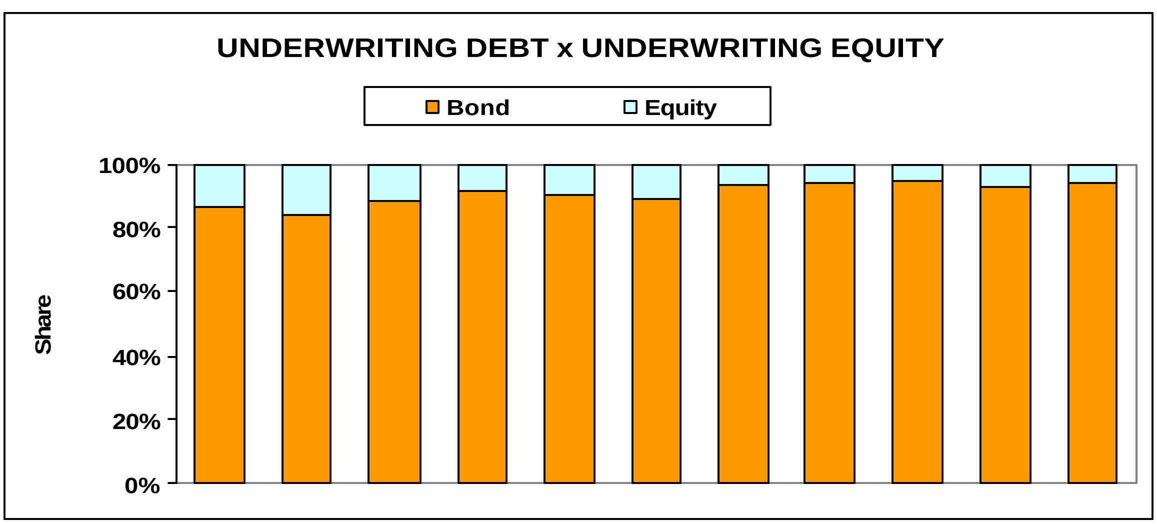
7.1-) American Market – Issuances Approach – General Evolution

As one can see at the bar chart below, the total amount of underwriting has gradually increased since 1995.



Source: Securities Industries Association – SIA Report no.12 – Volume no.12

The American's capital market is several times bigger, broader, and more specialized than the Brazilian's one. Nevertheless, there are some features that are common to both markets. For instance, the new securities' issuances show a concentration in transactions to finance firms with debt, as seen in the graph below, for the same period:



Source: Securities Industries Association– SIA Report no.12 – Volume no.12

According to Thomson Financial Securities Data (www.tfibcm.com), the market can be divided into:

- Debt
  - Straight Corporate Debt
  - Convertible Debt
  - Asset Backed Debt (Securitization)
- Equity
  - Common Stock
  - Preferred Stock
  - IPO

9.1-) Understanding American Corporate Bond Market -

The market for corporate bonds and other corporate debt securities is dominated by giants – leading companies borrowing money and leading investment banking houses assisting them in finding reliable funding at low cost. Most outstanding corporate bonds and notes are not heavily traded – at least compared to the huge daily volume of trading for government securities and many mutual funds.
Among the relatively few corporate debt securities that are actively traded in considerable volume every day, are, for example, AT&T Wireless, Daimler Chrysler, Sprint Capital, Verizon Global, Goldman Sachs e Amerada Haas. The maturity dates reaches 2033 in some cases. The longer the term, the higher yield it tends to be.

Other key factors in shaping investor returns are the issuer's credit rating, the size of the issue, and the specific terms accompanying each bond contract (indenture). The premiums of corporate bond rated as AAA over Treasury yields, in the period within 1997 and 2004, fluctuated in range from 92[14] basis points[15] to 206

[14] See Money and Capital Markets (2006) Rose, Peter - p.600
[15] 1% is equal to 100 basis points.

basis points. During downturns or concern with credit risk the spreads tends to wide over Government Bonds, when the credit risk increases.

The decision to offer new bonds is usually made in consultation with investment banker that who may underwrite all or part of new issue, thus accepting the market risk associate with purchasing and reselling the bonds.

Late[16] in 1990's an intense controversy with strong ethics overtones emerged concerning the pricing practice of dealers. Some dealer firms appeared to be marking up the prices of corporate bonds sold to their customers well above the prevailing open-market price. - Sometimes with markups of 5 to 10 percent; one factor that facilitated these large markups was the delay in getting up-to-date information on actual trading prices. While many stocks are traded on both organized exchanges and through dealers who post new prices almost instantaneously, debt instruments are more frequently traded over counter, where some dealers can quote a range of prices because the buyer may not be able to easily compare the price being offered against recent trades involving the same or similar securities.

Dealers often defend markups by pointing to the risks they face when they purchase blocks of corporate securities; the value of their holdings may drop suddenly when interest rates rise. An added problem is market diversity. Some securities may go for several hours or days without transaction taking place, leaving the dealer with no current price to use as reference point price for a new sale. Still, many investors would like to have a sales receipt that details all of the costs they are paying (including the dealers markups). Borrowers sometimes report a similar information problem- a security may be unable to get precise price quotes on securities sold in order to calculate the true cost of newly raised funds. Clearly, this information would be of great help to a business trying to decide whether to issue new debt or explore other possible source of funding.

[16] See Money and Capital Markets (2006) p.601

In order to make the marketplace more transparent in pricing information, and so fairer to investors, the National Association of Securities Dealers (NASD) launched TRACE (the Trade Reporting and Compliance Engine) in 2002, which is the first intraday consolidated tape in the U.S. OTC fixed-income markets. All broker-dealers that NASD regulates are required to report corporate bond transactions to NASD's TRACE system. TRACE enables individual investors to receive real-time information on the actual sale price of virtually all U.S. corporate bonds.

Despite being highly developed, the American market also faces the problem that is common to many domestic emerging markets; lack of references in pricing at the secondary market; Nevertheless, it is not related to liquidity itself (the United States have the most liquid market in the world) , but to a lack of both transparency and better practices. In order to better understand one should look to the demand side.

9.2-) <u>Consumer Savings approach</u> –

In 1981, as mentioned by Peter Rose, in the book <u>Money and Capital Markets</u> (2006), with the passage of the Economic Recovery Tax Act of 1981, wage earners and salaried individuals were granted the right to make limited contributions each year, tax free, to an individual retirement account (IRA) offered by banks, brokerage firms and other financial institutions or by employers with qualified pension or profit-sharing plans. Similarly, Keogh plan retirement accounts were created to help self-employed persons prepare for retirement and may be offered by the same institutions that sell. Tax favored retirement accounts were supplemented further in the late 1990s when new types of accounts (for example Roth and Education IRAs) were created to give house hold investors new tax-sheltered saving vehicles to prepare for retirement and to help offset the spiraling cost of college education.

The Roth IRA proved to be particularly popular because not only could de consumer invest monies and generate tax-sheltered earnings but, for qualified accounts, withdrawals could be made tax-free (unlike the conventional IRAs and Keogh plans). Legislation in 2001 and 2003 significantly expanded the amount of savings that could be placed in these tax-sheltered accounts.

In the late 1970s, flexible savings plans became popular as many consumers fought to stay ahead of inflation through savings instruments whose rates of return were sensitive to changes in the cost of living as well as to changing interest rates in the money and capital markets. *Money Markets Certificates of Deposit* were authorized by Federal regulation in 1978 with interest rates than changed as market yields on US government securities fluctuated. In 1982, the Garn-St.Germain Depository Institutions Act allowed banks and thrift institutions to offer deposits competitive with shares offered by money market mutual funds, in the form of money market deposit accounts (MMDAs)and Super NOWs[17], each offering flexible interests rates but accessible via check to pay for purchases of goods and services. As the 1990s approached, several banks and savings associations, led by Chase Manhattan Bank (now J.P.Morgan Chase) of New York, introduced *market-index certificates of deposit* with returns linked to stock market performance.

Accompanying the development of more flexible-yield types of deposits, life insurance companies and pension programs began to offer new types of life insurance policy and annuity accounts that builds up cash value and promise either a lump-sum payment or a stream of future income payments. The much older fixed-value insurance and annuity plans were supplanted in many markets by variable-rate annuities and variable-rate insurance plans, whose value depends on the market performance of the assets that make up these savings vehicles. With the right king of investments an individual or family can develop a sizeable reservoir of accumulated savings to protect their standard of living in the later stages of life.

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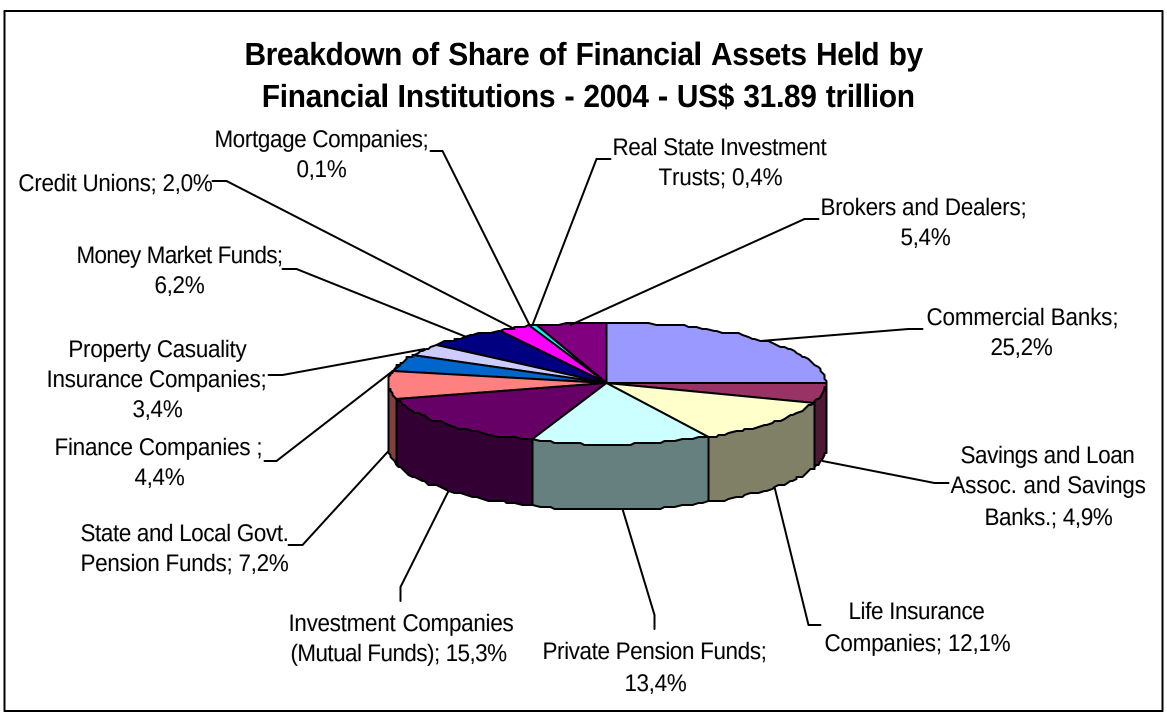
[17] Now Account was introduced in New England in 1970. It was a checkbook account that broke new ground by paying interest rate on checkbook deposits – which Federal law prohibited for regular checking accounts.

During the 1990s, corporate equities, in the form of both individual corporate stocks and pools of shares held in mutual funds, exploded in popularity among house hold savers. Many individuals and families concluded that their long-range savings were not growing fast enough for their future needs (especially in meeting the challenges of saving for retirement, inflation, and future educational costs), particularly if those savings were held in deposits at banks and thrift institutions where promised interest yields were often very low. Equities, on the other hand, seemed to offer his promise of much larger long-term returns. Moreover, the pooling of equities in mutual funds appeared to lower the consumer's risk exposure to help offset the lack of federal insurance. At the same time, the Securities Exchange Commission (SEC) required mutual funds to clarify for the public their method of figuring their rates of return and required these funds to simplify their reports so that consumers could more easily understand what their buying. The market for individual corporate stocks and shares in mutual funds sagged over the 2000-2002 periods under adverse economic pressures, as mentioned before, but it appeared to be stabilizing somewhat as the new century move forward. As it can be observed in the graph below, as much mutual funds as pension fund play important role in American market place and so both will be covered in next sections.



9.3 –) American Institutional Investors – Mutual Funds

One of the most rapidly growing of all financial institutions over the past two decades is the mutual funds, or, as it is more properly called the investment company. Investment companies provide an outlet for the savings of thousands of individual investors, directing their funds into bonds, stocks and money market securities. These companies are especially attractive to the small investor, to whom they offer a continuous management services for a large and varied security portfolio. By purchasing shares offered by an investment company, the small saver gains greater diversification, risk sharing, lower transaction costs opportunities for capital gains, and indirect access to higher-yielding securities that can be purchased only in large blocks. In addition, most investment company stock is highly liquid, because these companies stand ready at all times to repurchase their outstanding shares at current market prices. The majority of mutual funds shares are held by individuals and families rather then by institutional investors.

Investment Companies first developed in Great Britain, made their initial appearance in the United States in the city of Boston in 1924, serving as a vehicle for buying an monitoring subsidiary corporations. Many were unsuccessful in the early years, and the Great Depression of the 1930s forced scores of these firms into bankruptcy. New life was breathed into the industry after World War II, however, when investment companies appealed to a rapid growing middle class of savers. They were also buoyed by rising stock prices that attracted millions of investors, most of whom had only modest amounts to invest and little knowledge of how the financial markets work. The industry launched an aggressive advertisement campaign that attracted more than 40 million shareholders during the 1960s alone.

Then the roof fell in as the long postwar bull market in stocks collapsed in the late 1960s and again during the 1970s. Small investors began to pull out of the stock market in droves. Many investment companies disappeared in this shakeout period, most of them consolidated into larger firms.

The future of the industry seemed in doubt until a new element appeared: innovation. Managers began to developed new types of investment companies designed to appeal to groups of investors with specialized financial needs. By tradition, investment companies had stressed investment in common stock, offering investors capital appreciation as well as current income. With the stock market performing poorly, these firms turned their focus increasingly to bonds and money markets instruments. New bond funds directed the majority of the funds into corporate debt obligations or tax-exempted municipal bonds. Their principal objectives have been to generate current income and, in the case of municipal bond fund, a higher after tax rate of return for the investor. Capital appreciation is normally a secondary consideration to bond funds.

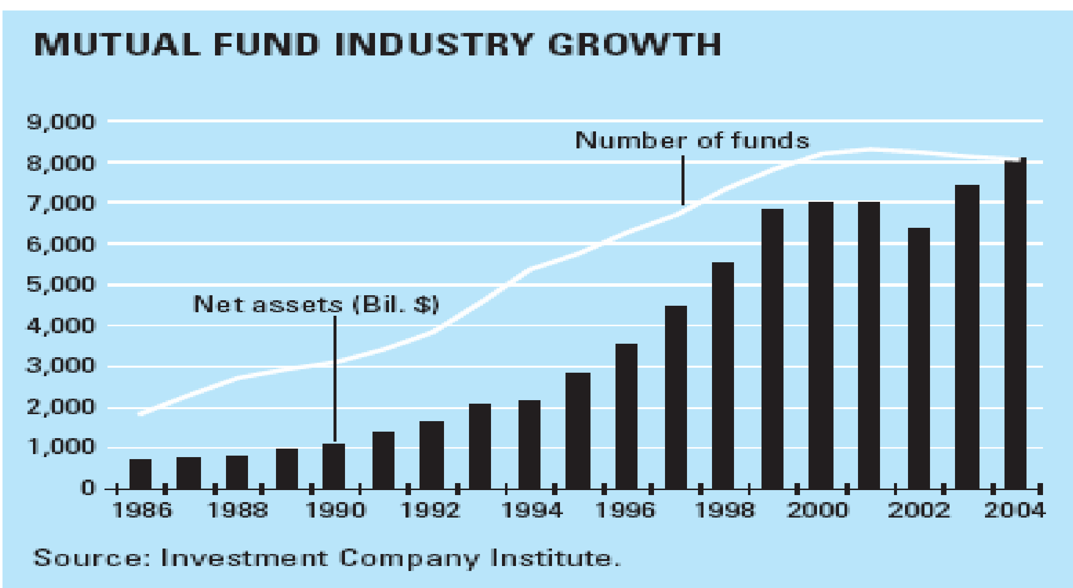
Money market funds emerged in 1974 with the announced intent of holding money market securities, mainly commercial paper and government bills. They were created in response to record high-interest rates due to inflation and the desire of the small investor to skirt around federal interest rate ceilings on savings deposit offered by banks and thrift institutions. In addition, the money funds have offered investors professional management of their liquid funds.

The 1980s and 1990s were marked by the rapid growth of global funds. These are stock and bond funds whose income-earning securities come from all over the world. These funds have access to security trading 24 hours a day through active exchanges in London, Tokyo, Singapore, Hong Kong and other financial center around the globe. Manager of these funds believe that the higher returns are attainable with a balanced international portfolio, as opposed to a portfolio of a domestic securities alone.

Finally, during the 1990s and early into new century hedge funds become prominent. These mutual funds are really private partnership that sell shares to only a limited number of investors in the hope of reaping large returns from pursuing a high-risk investments. In this case, the word “hedge”, refers to an investment strategy that splits the money being invested between those assets expected to increase in value if the market goes up and those assets believed to benefit if market goes down. Many hedge funds gamble on the market's direction by betting that they know better than the market as whole which way interest rates and security prices are likely to go.

There also exist other mutual funds related to stock activities as such as Exchange-Traded Funds, Small-Cap, Mid-Cap and Large Cap Funds and so on.

Investment companies have also been a source of controversy among regulators and the public. These mutual funds provide savers with multiple benefits – easy access to the financial market place, professional asset management services, greater liquidity and ready marketability. One of the most significant fees paid by customers are advisory fees. Furthermore, many funds started charging a front-end or back-end load, comparable to a brokerage fee or sales commissions, which may range upwards of 5 to 8 percent of funds contributed. And there may be administrative costs and trading fees on top of that. In any event, knowing what fees and expenses a mutual fund charges is one of the wisest things an investor can do



Extracted from S & P – Industry Surveys – Investment Companies 11/10/2005

The mutual fund industry has experienced spectacular growth in assets under management over the past several decades, driven by market appreciation and consistent net inflows. Total assets under management grew to $7.98 trillion at year-end 2004, up from $7.41 trillion at the end of 2003 and $448 million at the end of 1940, according to the Investment Company Institute (ICI), a trade group representing US investment firms. The expansion in Assets Under Management was driven in part by increased household ownership, positive retirement savings flows, ongoing reinvestment of dividends and interest, and the introduction of several new types of funds.

By investment objective, investors poured money into equity funds in 2003 and 2004, with net inflows of $177.5 billion and $152 billion respectively. This was in sharp contrast to 2001 and 2002; net inflows totaled only $32 billion in 2001, and outflows totaled $28 billion in 2002. Inflows in 2000 totaled $309.4 billion.
Bond funds suffered net outflows of $10.3 billion in 2004, their first since 1999, as stronger economic growth prompted the Federal Reserve to begin raising interest rates. Inflows were $31 billion in 2003, $140 billion in 2002, and $88 billion in 2001.

9.3 –) Pension Funds

Pension Funds protect individuals and families against loss of income in their retirement years by allowing workers to set aside and invest a portion of their current income. A pension plan places current savings in portfolio of stocks, bonds or other assets, as previously mentioned, in the expectation of building even larger pool of funds in the future, transferring wealthy temporally. In this way, the pension plan member can balance planned consumption after retirement with the amount of savings set aside today.

Two main types of pension plans exist in US today. *Defined benefit* plans promise specific monthly or annual payments to workers when they retire based upon the size of their salary during the working years and their length of employment. In contrast, *defined contribution* plans (as mentioned before) such as 401 K specify how much must be contributed each year in the name of each worker but the amount to be received when retirement is reached will vary depending upon the amount saved and the returns earned on accumulated savings.

Defined benefit pension programs have the advantage of guaranteed income if the employee remains with the particular employer for a relatively long period of time, but an employee who leaves or is dismissed before retirement may get little or nothing.

Under the defined contribution approach, however, the funds saved belong to the employee and are portable if the program is vested, provided the employee stays on the job long enough for the savings to be vested in his or her name. Defined benefit plans are declining as a percentage of all pension programs, while defined contribution plans are rising and now account to the majority of private pension funds.

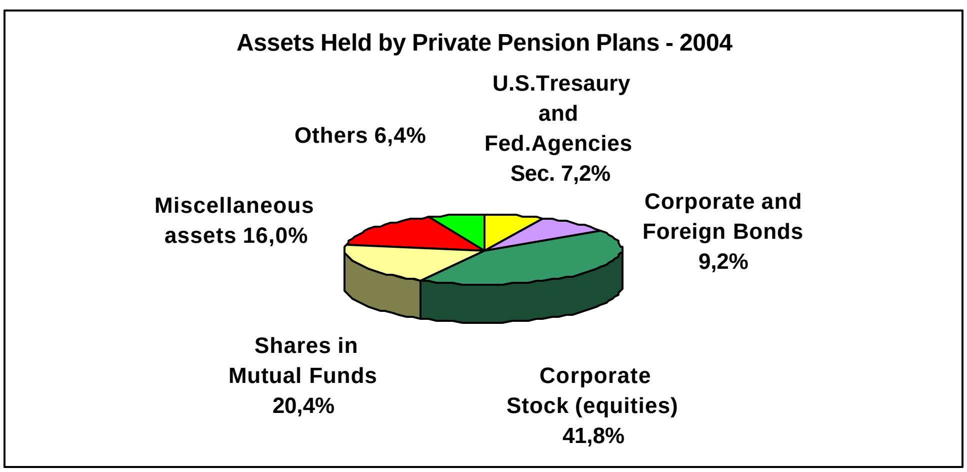
Pension funds have been among the most rapidly growing of all financial intermediaries. Between 1980 and 2000, the assets of all private and public pension funds multiplied more than 10 times over, reaching close to US$8 trillion in the United States. Approximately half of full-time workers in private business and three-quarters of all civilian government employees are protected by pension plans other than the U.S. Social Security Program (OASDI). About 200 million persons are insured by or are direct or indirect beneficiaries of the Social Security program.

Competition among employers for skilled management personnel has also spurred pension growth, as firms have tried to attract top-notch employees fringe benefits. This growth factor is likely to persists into the future due to a possible shortage of skilled entry-level workers as the population ages. Some experts foresee a real problem in this area stemming from recent difficulties pensions plans have had in keeping up with inflation and with the increasing number of retires.

Workers in the future are likely to demand better performance from their retirement plans and greater control over how their long-term savings are invested.

The present ratio of working adults to retired persons in U.S. population is about 3:1. This ratio is projected to shrink about 2:1 within a little more than a generation. In 1935, when the U.S. Social Security act was passed, there were 11 working adults for each retired individual. Nowadays, individuals over 65 years of age are one of the fastest growing segments of the world's population. The growing proportion of retired individuals will threaten the solvency of many private pension funds and has already created significant future funding problems for various government programs designed primarily to aid the elderly. It is not only in United States that this issue has been increasingly concerning many authorities in the Governments' staff.

The US$ 4.17 trillion held by the private pension plans in 2004 were distributed as follows in the graph below:

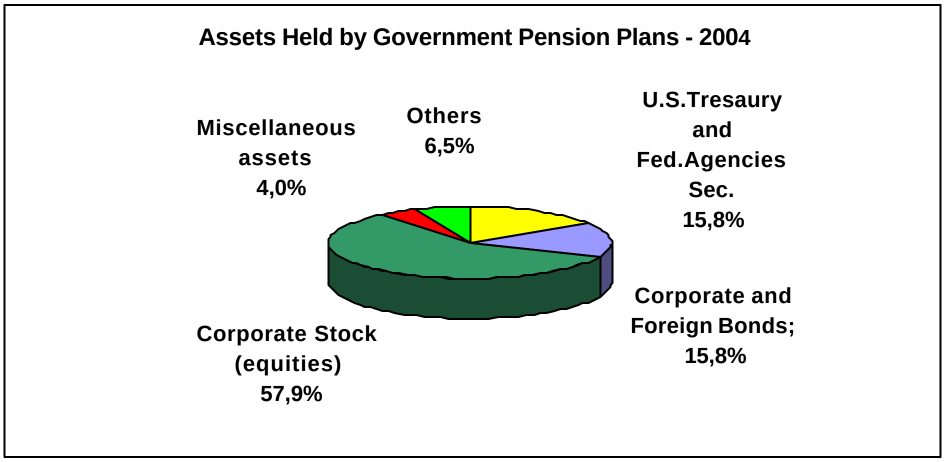


Source: Money and Capital Market (2005) 9th Ed. (Rose, Peter S) p. 485

As mentioned before, the private pension plans has less Government Bonds into its investment portfolio. The Corporate Bonds, jointed to Foreign Bonds, altogether corresponds to US$ 382 billion. Other feature is the relevant share of

Mutual Funds Shares in the Pension Funds Investment portfolios, the second highest level.

The Governments' pension plans, in the other hand, have double of Government Bonds compared to private plans assets, as the graph below:



Source: Money and Capital Market (2005) 9th Ed. (Rose, Peter S) p. 485

8-) Final Considerations

A country with a small investors base and few market traders will face many problems to develop a competitive market for bonds. The dominance of a few large players in a small market would inevitably require the government to deal with manipulation practices, because there will not be enough competition in the marketplace.

The developments in information technology can decrease transaction costs, spread information flows easily, create incentives to increase the uses of specialized techniques, and increase the number of active participants, making the market competitive and liquid

The Brazilian Investors held more fixed income assets than stocks; the more players in the market (individuals or investment companies), the more turnover in assets tends to happen. The number of transactions will depend obviously on the investor's confidence in the market.

The money market is the foundation of all financial and capital markets. In many countries the extreme volatility of money market rates adds to the risks of bondholders: the daily carrying cost of long term paper becomes much more uncertain and the absence of a relatively stable and complete money market yield curve can hamper hedging strategies.

One notion is that, while the existence of indexed instruments and derivatives can help to lengthen maturities and deepen liquidity in the fixed income market, these financial innovations require careful monitoring to prevent excessively leveraged positions and undesirable mismatches in the maturities of assets and liabilities.

Stock markets and bond markets affect each other; The Stock market reforms aimed at improving the conditions under which corporations issue and trade shares are desirable, governments, in general, should not protect local exchanges or the domestic brokerage industry from local or foreign competition.

Foreign investors should be welcomed into domestic capital markets since they can deepen liquidity in those markets, even if they add more volatility to the process. They can accelerate the convergence

The issuance of bonds simply to sterilize excess reserves can influence the development of local bond markets. In particular, governments that issue bonds against these reserves can further the development of their own local bond market. Mexico and Singapore are considered the most developed markets among emerging-market countries. Somewhat less advanced, but still well ahead of many developing countries, are the markets in Brazil, Colombia, Korea, Morocco, and Turkey. Government markets differ not only in their depth, but along other dimensions as well. Government securities in East Asia are primarily long term in maturity, with fixed interest rates; those in Latin America tend toward shorter- and medium-term maturities, often with variable interest rates.

The decisions must then be made about who issues the bonds (governments or Central Banks) and at what maturities. These decisions can affect the liquidity and depth of the markets and depending on its amount compared to fiscal policy, GDP and economic growth, can affect risk over in the long run. Central Banks and Treasury Departments have different targets. Difference is the reason the Central Bank should be independent, as demonstrated by the high inflation levels during the 80s and the 90s in Brazil. The high inflation can be much more harmful than lack of coordination between actions of Central Bank and Treasury Department to the market.

The danger that local debt markets run into when local currency debt is too short term is the need for constant rollovers – a problem that exists in countries with a history of high and volatile inflation, as such Brazil. The transition to long term, fixed rate debt must, however, be gradual. Part of the transition may entail some indexing of debt to inflation and adoption of variable rates during some period. The shape of Brazilian debt structure in local currency has been changing. However, the most difficult task is to lengthen LFT's duration. There are some different ideas, as mentioned recently by a former president of the Brazilian Central Bank, Francisco Lopes, in the paper "As LFTs e o Alongamento da Divida Publica". It can be a good procedure to follow.

Another very important point is Banks vs. Capital Markets. There are some important issues here, mostly in the brazilian case, where the banking system is strong but still does not have enough competition. The Debt Capital Market gives corporations an alternative source of financing that often places (welcome) competitive pressure on banks. This competition not only stimulates greater operational efficiency in the banking industry (so that costs fall), but also forces banks to improve their processes for monitoring risks, which they are forced to price more keenly. In this way, a significant contribution can be made to the soundness of the banking system.[18] The bond market, it is often claimed, takes away the safest business and leaves banks with the riskier loans. If the banks are forced by regulation to hold excessive capital against loans to low risk borrowers, this pressure can force a migration of "good" borrowers from banks to markets. It is an Adverse Selection problem. This distortion can be inefficient. Indeed, the Basel Committee's proposed revision of the Capital Accord explicitly seeks to put this right and aims to align capital requirements more closely with actual risks. In practice, the relationship between banks and Capital Markets is more symbiotic than the old adversarial model would allow.

First, banks are the biggest holders of bonds. Bonds constitute not only a significant proportion of bank balance sheets (mostly in Asia), but business related to the issuance of bonds has become a more important element of earnings. Many have argued that banks can flourish only if they learn to play a major role in capital markets. According to this view, banks need to be fully involved in bank the underwriting and in the sale of capital market products to households.

It is a major challenge, particularly in those countries with only a limited investment banking culture. The need to educate commercial banks in the skills - and pitfalls – of investment banking is a common theme. Worries about relying exclusively on foreign institutions whose activities are imperfectly understood by local entities (public as much as private) have also surfaced from time to time. Three important issues require attention:

The first relate to the price of loans; the basis of valuations of the loans tends to be more and more questionable compared to bond market-based prices. This means that banks and regulators must develop mechanisms that incorporate such new information.

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[18] "Structural Change in the Corporate Bond Market in Korea after the Currency Crisis" In the Bank for International Settlements , The Development of Bond Markets in Emerging Economies, pp.130-147.BIS Papers 11.Basel, June.

The second issue is securitization: banks in emerging markets will have to become more adept at bundling bank loans into packages to be sold in the market. This process can work best for home mortgages and consumer credit, two areas that recently developed hugely in Asia. The pricing trend observes objective criteria (such income, valuation of the collateralized asset, and so on) and is not related to special knowledge or relationship. As this process develops, as seems to be happening in Brazil now, new debt instruments come onto the market.

The third issue is the unhedged interest risk on the balance sheet of a bank. Under earlier, highly-regulated regimes, interest rates typically did not serve a major allocative function and tended to be rather stable over time. Long term rates were frequently kept above short-term rates, so that banks could safely finance long-term assets with short liabilities. Exchange controls often insulated domestic rates from international capital markets. Under the more liberal regimes prevailing nowadays, however, interest rate risk has become more volatile. This volatility means that banks are becoming much more exposed to interest rate risk, which they are not always equipped to manage.

Derivative instruments are very important to hedge positions, manage risks and so increase liquidity in markets.

The regulator, at the same time, must focus on market failures, mostly on insider trading and situations of conflict of interest; SROs must play an important role in strengthening investor's confidence; Mark-to-Market practices have to be increasingly used, aiming risk disclosures measured by market prices but dealing carefully with volatility that affect investors expectations, and regulation has to promote increasing use of electronic commerce of bonds, as used in stock markets.

Special consideration has to be given to a recently published paper, presented to the Minerva Group – Spring 2006 in March 12th by Francisco H.G. Ferreira, Lead Economist of The World Bank: "Understanding Differences Between Income

Distributions: A Comparison of Brazil and the United States in 1999”. The conclusions are pointed out as follows:

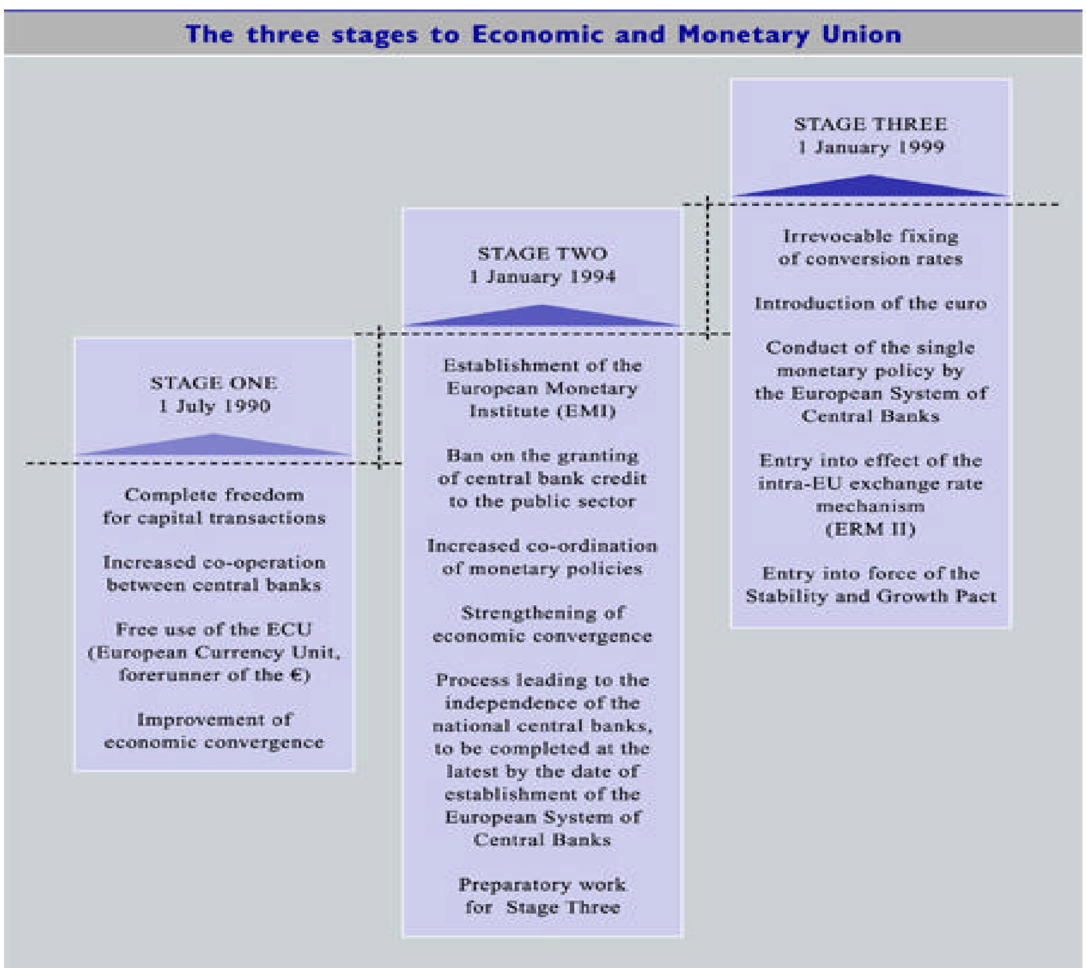
> *“Overall, the bottom line seems to be that differences in income inequality between Brazil and United States (13 Gini points difference) are predominantly due to differences in underlying distributions of “endowments” in two countries, including entitlements to retire income. […]Among endowments, almost equally important roles are played by the distribution of human capital (proxied by years of schooling) and the distribution of non-labor incomes, chiefly pensions.”*

The most important point is that the players have to know that the improvement process will come gradually, step by step, and it takes a long time; first target: macroeconomic stability; second target: integration of national economy into global economy; third target: government setting rules efficiently and providing better environment to business, making the institutions strong enough to support pressures of the changing world. The European convergence is a good example that illustrates the complexity of whole process.

After the Second World War politicians in several countries in Europe were convinced that the only way to prevent another war in Europe is to unite the countries economically and politically. After years of negotiation, several European Countries with different interests signed in 1957, The Treaties of Rome, creating the European Atomic Energy Community (EURATOM) and the European Economic Community (EEC). The objective of the Member States at that time (Italy, German, France, Netherlands, Belgium and Luxemburg) was to remove trade and tariff barriers between them and to form a common market. In 1973, Denmark, Ireland, and the United Kingdom joined to the European Economic Community (EEC). Then EEC was composed by nine Member States.

. In June 1988, after Greece, Spain and Portugal jointed into the Community, the European Council confirmed the objective of the progressive realization of Economic and Monetary Union (EMU). Their new tasks included holding consultations on, and promoting the coordination of, the monetary policies of the Member States, with the aim of achieving price stability. It mandated a committee chaired by Jacques Delors, the then President of the European Commission, to study and propose concrete stages leading to this union.

The committee of experts, chaired by the then President of the European Commission, Jacques Delors, examined ways of achieving EMU. Its report (the Delors Report) proposes a transition in three stages, which was decided by the European Council in June 1989.



Extracted from the European Central Bank home page

Under Article 121 of the treaty that established the European Community, the convergence of long-term interest rates is one of the criteria for assessing the achievement of a high degree of sustainable convergence for Economic and Monetary Union (EMU). Article 4 of the Protocol on the convergence criteria annexed to the Treaty states that interest rates should be measured on the basis of long-term government bonds or comparable securities. The statistical framework for the acceding countries follows the same principles that were applied to the current EU Member States in the run-up to Stage Three of EMU.

The Brazilian promising forecast is a result of improvements in many different areas, including regulation; Brazilian investors will be better off if national regulators figure out how to keep improving regulation and surveillance procedures based on facts that happened in developed countries. Definitely, the risk management is the must important point to consider; bond maturities' length and liquidity will gradually expand as a result of increasing competition in the market.

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