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LONG TERM CORPORATE FINANCING IN BRAZIL: IS BRAZIL BECOMING "NORMAL"?

FINANCIAMENTO EMPRESARIAL DE LONGO PRAZO NO BRASIL: BRASIL ESTÁ SE TORNANDO "NORMAL"?

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Contents

Introduction

The Brazilian long term credit market wasregarded as small and shallow for many decades after the World War II. These characteristics were considered two of the main hurdles of the Brazilian economic development. Other emerging countries in Asia and in Latin America also shared these same limitations at that time. This was different from how financial markets already worked in industrialized countries, where private credit for longer periods was abundant, intermediated by capital markets in the US or by banks in Europe or Japan.

Since the 1990's, the profile of the credit markets in many of the most important emerging markets (Agnoli and Vilan, 2008; IADB, 2005; Borensztein, 2008) has rapidly changed. National treasuries as well as large local companies started issuing long term bonds denominated in local currency. This was a consequence of important macroeconomic and institutional changes and, particularly in Latin America, of the reintegration of the region to the international financial system after the external debt crisis of the 1980s and 1990s.

In this scenario, Brazil was a laggard country. Those reforms took place later than in other countries of the region, such as Colombia, Peru or Chile. High inflation came to a halt only in 1994. Fiscal and exchange rate stability had to wait until the initial years of the next decade to become a reality. Only then, local financial markets started to grow steady and at high rates at the same time as the real interest rates declined and the average maturity of the corporate debt rose.

The Brazilian long term credit market was positively affected by the financial reforms introduced from 1994 on. The public debt decreased when compared to GDP and was dedollarized as the Brazilian government became a net creditor in foreign exchange. The average maturity of the public offers of treasury bonds was extended from 2.8 years in 2002 to 4.2 years in 2013 (Tesouro Nacional, 2014). The public bond and the exchange markets were restructured in order to provide more liquidity and more confidence to investors along with the creation of a term structure of the interest rate.

After 2004, the banks began providing mortgage loans for families for maturities up to 15 years or more and loans for the acquisition of automobiles reached 8 years. The bond corporate market [1] also grew, following the modernization of the public debt market. Private funds, although still scarce and costly, became more and more available.

The long term corporate credit market is supplied by three sources of funds. The main source is the loans provided with funds from the development bank – Banco Nacional do Desenvolvimento Econômico e Social (BNDES). Half of them is loans which are extended directly by BNDES' and the rest – indirect operations - is long term credits extended by commercial banks and refinanced with the development bank. This funding is earmarked by the government. It is long-term – average maturity is over seven years – and priced according to the TJLP rate – Long Term Interest Rate or "Taxa de Juros de Longo Prazo" – which is fixed every quarter by the government.

The second source is the funds of the banks used for the acquisition of non financial corporate bonds, debentures. They are a special form of loan extended by the commercial banks with their own funds (treasury operations). The third source is the money invested by families and institutional investors in debentures. Those funds are both priced according to the Central Bank basic interest rate (SELIC), although indexation to the main price consumer index (IPCA) has increased in the last few years. Their maturity ranges from two to seven years but may reach over ten years.

Those three sources of funds, although its singularities, operate in a harmonized way. They have different focus, transactional costs and tax incentives. They are combined to provide the most efficient options for the banks and their clients. The commercial banks have a leading role in the market. However, the BNDES is a decisive agent when the credit is related to fixed investments and involves a large amount of money or needs very long-term maturities.

[1] Financial Corporations issue Financial Bills ("Letras Financeiras") as only non financial corporations are allowed to issue debentures in Brazil.

In this paper, the Brazilian long term corporate financial markets will be assessed by three different perspectives. The first is comparing its size with other relevant countries. This dimension illustrates the aspects of the local financial development as part of a global integrated system. The second is following the evolution of the long term corporate market in the Brazilian and of the financial system as a whole. This will allows us to examine the recent evolution of corporate debt with the other components of the domestic credit market. The third shows light on the sources of long tern funds for corporations and on their main providers and managers. This is a way to identify the role of different investors on the decision making process.

This paper is organized as follows. Its first part gives an overview of the bank credit market after the 2000s. This was a period in which the Brazilian market has grown at very fast rates and, differently from the past decades, has not shown any real signs of instability. The private banks took a leading position in the beginning of cycle but lost ground to the state owned banks after the 2008 Financial Crisis because of their countercyclical role.

The second part deals with role the development bank, BNDES, in the long term market. It is a very large bank which is mainly funded by the National Treasury directly or by means of government Special Funds. Its loans are long term and indexed to a special rate, the TJLP, which is fixed by the government independently from the basic rate of the Central Bank. BNDES loans are earmarked to fixed investment projects of non financial corporations. Half of them are lent by BNDES directly and the rest is lent by the commercial banks and later refinanced with the development bank. There is a long tradition of information and risk sharing between BNDES and the other banks.

The third part analyses the corporate bond market, which has rapidly grown after 2004. This was not a result of a traditional disintermediation process, as was seen in many other countries. It was part of a strategy of the commercial banks to lend more efficiently in terms of cost and regulations by means of acquiring debentures from their clients instead of holding their long term loans on their own books. After 2008, families and institutional investors started buying a small part of the offers, particularly those which were exempted of income tax.

The fourth part gives a picture of the long term corporate credit market in Brazil. It has reached 16% of GDP in 2013. BNDES is the main source of funding, with 70% all credits outstanding. However, the commercial banks command 70% of the market as they manage their own funds plus half of BNDES credits and almost all of the funds of households and institutional investors which are allocated in debentures.

Policy recommendations and conclusions are the main issues of the last two parts of the paper. They focus on the regulatory changes that should be implemented in order to boost the access of households and institutional investors and the offers that are open to all investors, the registered ones. Families will be the basis of investors of a secondary market in the future. They, along with pension funds, will increase competition and the size of the market, while lowering the spreads. BNDES will hold an important position in the market in the long run but commercial banks and other private investors will have a larger share of the market in the future. The speed of these changes will depend heavily on the course of the Central Bank interest rate (Selic) and the BNDES rate. Whenever the Selic will be set on a low basis - under two digits - for a long period and its difference to the BNDES rate is minimum, the companies will be encouraged to issue directly to the families and the institutional investors, which will be willing to increase the yield of their portfolios.

1. The Bank Loan Market: An Overview

Until the beginning of the 2000´s, Brazilian credit market was characterized by five salient features. The first two were scarcity and high volatility. The evolution of the bank loans and the corporate bonds illustrates those two aspects. Between the beginning of 1996 and the end of 2004, the total bank loans to GDP fluctuated between a minimum of 24.3% and a maximum of 33.3%. The average was 27.5%. This was a low level compared with the figures of other countries, particularly industrialized nations.

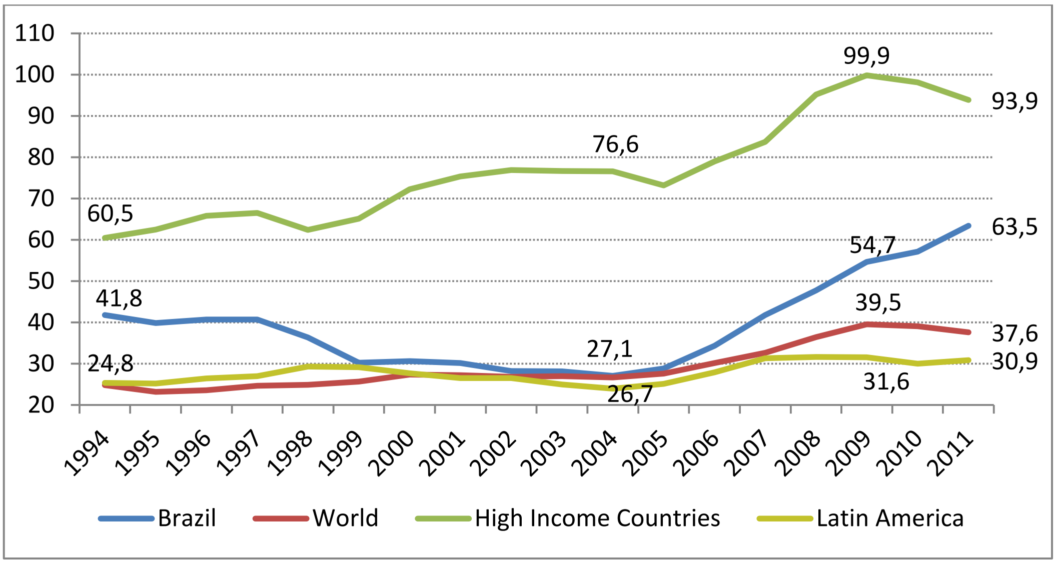
The third striking feature of the Brazilian credit was the high cost. Throughout the 1990s and 2000s, interest rates were maintained at very high levels in nominal as well as real terms. For example, the Brazilian Central Bank's basic rate (Selic) accumulated in 12 months held, from 1995 to 2008, a difference of 12 percentage points ahead of inflation, on average.

The fourth characteristic was the high concentration on a small number of financial institutions and the large participation of state-owned banks. From 1995 to 2014, the participation of the 10 largest banks in the total assets of the banking industry increased from 71% to 86%, as a result of consolidation and concentration. After the 2008 Crisis, the share of state-owned commercial banks in the total loans grew from 34% at the beginning of 2008 to 54% by the end of 2014 (Banco Central do Brasil, 2015)

Finally, the last major feature was tight regulation. Credit operations financed with funds raised through the classic market instruments - time and savings deposits, for instance- were severely controlled by the Central Bank through traditional instruments of liquidity management. Reserve requirements are 45% for demand deposits and 20% for time deposits. Banks have to follow capital to loans requirements that are higher (11%) than the levels of the Basel Accords (8%). The maturities of the loans were also affected by banking regulation and by tax incentives. Thus, the average term of these operations was always short and volatile, since they used to vary according to anti-inflation policies or to domestic adjustment to external shocks (Torres and Macahyba, 2014).

Since 2004, some of those striking features are no longer present. According to the World Bank (2015), Bank credit to the private sector reached 63.5% of GDP in 2011. This figure was much above the world average of 37.6%. This is a higher level than seen in other major economies in Latin America (Mexico, Argentina and Colombia). The exception was Chile with 65.5%. It is, however, well below the percentage observed in higher-income countries (93%), and even in emerging nations such China (121.5%). Credit to the private sector in Brazil was 27.1% of GDP in 2004, and since then has grown by 16.4 % per year in real terms. This trajectory did not give in, not even during the International Financial Crisis of 2008, having supported both by demand from companies and households. As a result, scarcity is no longer a dominant phenomenon, although there are still some supply constraints in specific segments. Volatility has disappeared (Figure 1)

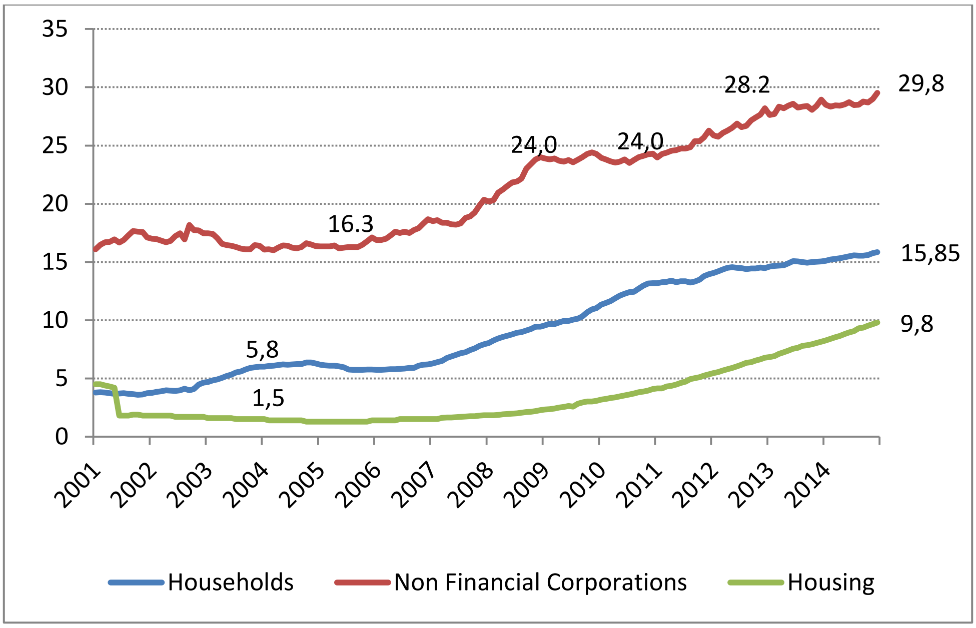
Figure 1: Private Credit by Deposit Money Banks to GDP (%)



Source: World Bank (2015)

The rapid expansion of bank lending in recent years was mainly sustained by strong decompression in the household sector. Families debt initiated the expansionary credit cycle and had grown quickly and steadily since 2004. The indebtedness of Brazilian families would not budge even during the global financial crisis. As a result, one can see in Figure 2 that the ratio of credit to households compared with the GDP increased from 5.8% to 15.9% between 2004 and 2014. The same phenomenon can be seen in the housing market. Despite being a very small portion of the market, around 1.5% of the GDP by 2004, loans for properties grew in leaps and bounds. Since then, it has increased six fold, reaching 9.8% of GDP at the end of 2014.

Figure 2. Outstanding Bank Loans for Corporations, Households and Housing (in % of GDP)



Source: Banco Central do Brasil, 2015

The decompression of the households and the housing sectors were stimulated by different factors. From the supply side, the main reason was that the banks were low leveraged and well capitalized. This rapid growth would not have been achieved if the banks had not fully recovered from the years of economic crisis of the 1980s and 1990s and if the new regulatory framework was not robust enough to avoid the deterioration of credit standards or the start of financial bubbles. Since 2004, the banks introduced many new financial products for families.

From the demand side, as real wages increased and the unemployment rate reached very low levels, consumers become more confident about increasing their indebtedness. At the same time, the Central Bank cut interest rates, which made installments more affordable to families, many of which were accessing bank credit for the first time. Institutional innovations like payroll loans also helped to decrease the risk aversion of banks.

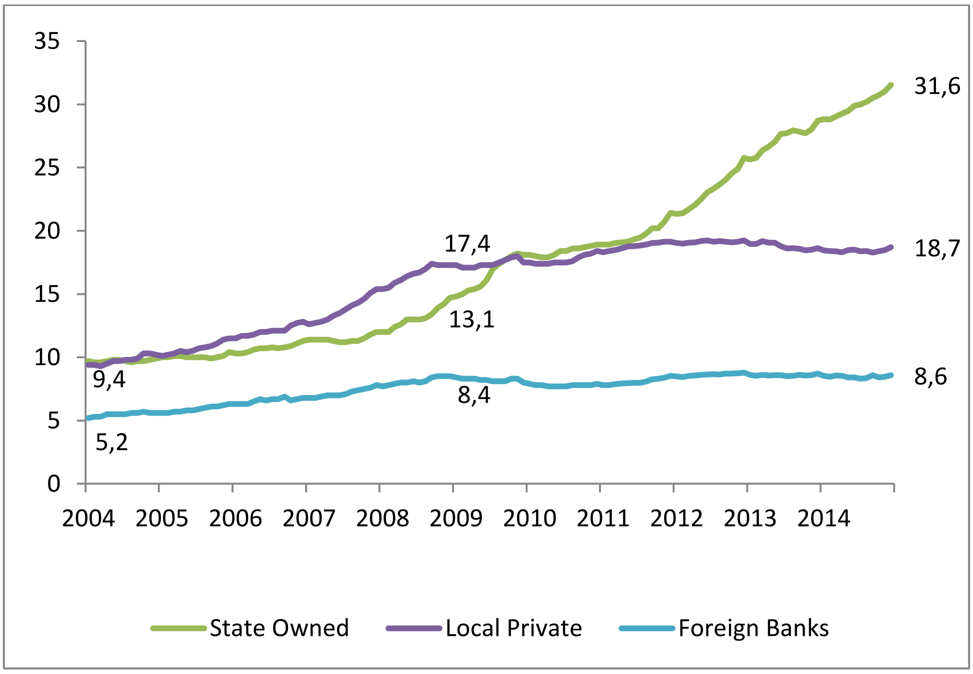
Corporate loans also grew fast, but at a slower pace. The expansion of the corporate loans started later, in 2006. The total corporate loans increased from 15.4% of the GDP in January 2006 to a peak of 30.8% in December 2014. Differently from the household or the housings sectors, there was no strong "diffusion of new financial products" and growth was concentrated in two periods: from August 2005 to December 2008 - from 16.3% to 24% of GDP - and from January 2011 to December 2012 – from 24% to 28.2% of GDP (Figure 2)

The first surge had three main motivations. The first one was the rapid increase in economic activity starting in 2005. The sharp recovery and subsequent devaluation of the exchange rate - the second factor - explains the behavior of export related operations. Finally, the most important reason was the liquidity preference of corporations as a response to the uncertainty generated by the international scene. The experience accumulated by Brazilian companies over two decades of economic instability showed that high levels of cash was the best way to face any turbulence if the crisis deepened (Torres and Macahyba, 2012).

This behavior is demonstrated by the liquidity and debt indicators of non financial corporations. According to the consolidated balance sheet data for 311 public companies, in the period extending from the third quarter of 2007 - when the surge stated - until the third quarter of 2008 - when financial crisis hit the markets - these companies increased their cash holdings by 50%. Their total debt increased but not the net debt. Thus, while the net balances of these companies increased from R$ 122 billion to R$ 189 billion, net debt remained stable at around R$ 75 billion.

From the supply point of view, the rapid growth of the credit market in the first surge was led by the local private banks (figure 3). They were liquid and capitalized enough to match the demand. The state-owned banks lagged behind. They were financially healthy but too slow to introduce new financial products in time to compete with the private sector. State-owned banks and their local private competitors held almost the same market share in 2004. In September 2008, the difference for the private banks reached four percentages point of GDP.

Figure 3: Outstanding Loans by Ownership of Commercial Banks (In % of GDP)

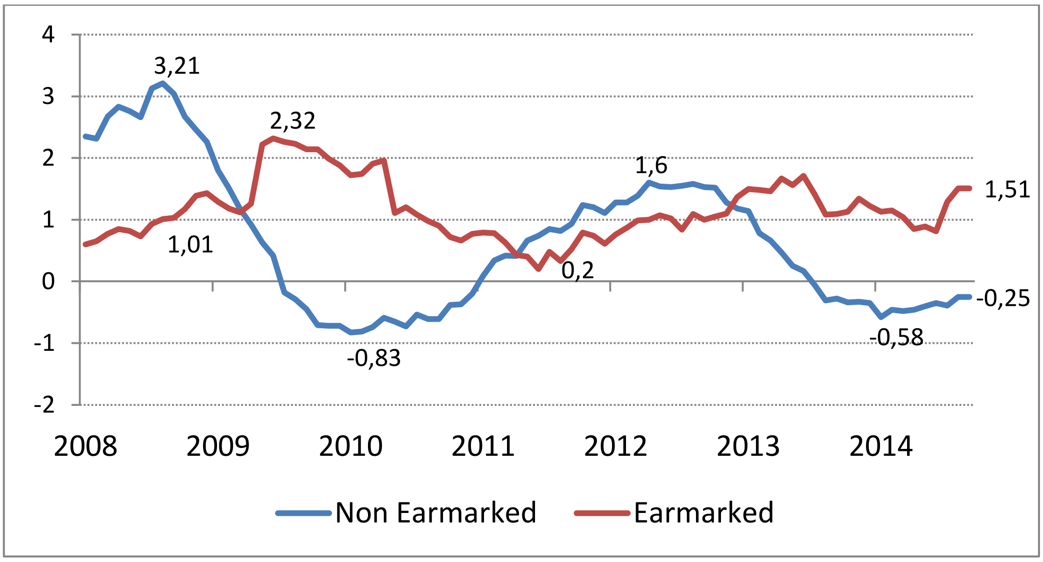


Source: Banco Central do Brasil, 2015

Lehman's bankruptcy had an important impact in the domestic credit market. Although the Brazilian private banks were not exposed to foreign assets, they became more cautious and decided to curb the rate of expansion of their loans. Actually, the rate of growth of non-earmarked credit fell from 46.5% per annum in October 2008 to just 1.0% at the end of 2009. (Banco Central do Brasil, 2015). In the beginning, this was led by uncertainty related to the derivative and credit operations of some large export oriented companies. Due to the sharp devaluation of the Brazilian currency, no bank knew for sure how much the loss of their clients would amount to and how that would impact its own balance sheet. Liquidity in the interbank market dried up and the Central Bank had to intervene to save the smaller banks from a severe liquidity shortage. Export credit lines became scarce and had to be substituted by new lines from the Central Bank and from BNDES.

In the last quarter of 2008, the state-owned banks began to compensate the "sudden stop" of their private competitors and expanded their operations aggressively. They saw the crisis as an opportunity to recover part of the market share they have lost along the last five years. They increased their loans in the markets they were already relevant as well as started offering new financial products in new areas, like auto loans. In the corporate sector, BNDES had a particular role compensating the shortage of short and long term funds from the local banks as well as from the international market. This reversed the trend of the credit market in favor of the state-owned banks (Figure 3). Different from the first surge, the second one was led by the state-owned banks with the support of earmarked funds (Figure 4).

Figure 4. Growth of Corporate Bank Loans by Source of Funding in 12 Months (In percentage points of GDP)



Source: Banco Central do Brasil, 2015.

2. The Role of the Development Bank (BNDES)

The Brazilian Development Bank (BNDES) is a state-owned bank which manages the long term earmarked credit system for investments in industry and infrastructure. It is one of the largest development banks in the world. In 2013, the loans disbursed by BNDES amounted more than four times World Bank´s, even though total assets for both banks were similar (Table 1).

Table 1: Main Financial Indicators of BNDES, Inter-American Development Bank and World Bank (In US$ million)

Items	BNDES 2013	IADB 2013	World Bank 2013
Total Assets	333,835	97,007	324,367
Equity	25,880	23,550	39,523
Net Income	3,479	1,307	218
Disbursement	81,285	10,558	16,030
Capitalization (%)	7.8	24.3	12.2
ROA(%)	1.1	1.4	0.1
ROE(%)	14.5	5.9	0.6

Source: BNDES, 2014b.

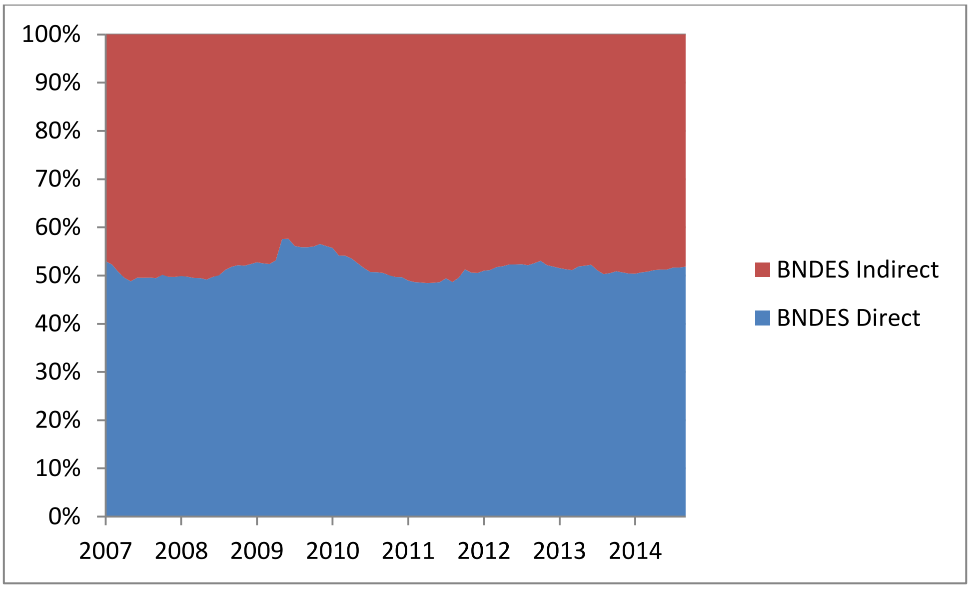
BNDES is the largest provider of long term funds for the corporate sector in Brazil. The development bank lends through two different channels[2]. The most important one is directly. These loans are extended by BNDES and the risk is held in its books. The second channel is indirectly. A financial intermediary – usually a commercial bank - structures a loan to one of its clients, hold the risk it in its books and refinance it with BNDES. Most of these loans has to be related to specific fixed investments and must have the same financial terms in the asset and in the liability side of the intermediary, except for a markup over the cost of the funds.

[2] BNDES may also buy debentures of non financial corporations on public placements, but the scale of these operations is small compared to loans.

According to Figure 5, direct operations hold a larger proportion of BNDES' outstanding loans, but the difference from the indirect operations in very narrow, around 1.5% on average, and the market shares are quite stable. The two channels, however, rarely compete with each other. There is a rule that fixes a boundary between them. Loans that amount under R$ 20 million (US$ 7.5 million) are extended by the commercial banks. The rest is extended by BNDES[3].

Because of this "division of labor", the volume and the maturities of the loans of the two modalities are quite different. The number of indirect operations was close to 1 million in 2013 and their maturity usually is set from 5 to 7 years. The number of direct operations was estimated in 50.000 in 2013 and may reach 25 years of maturity, although usually ranges from 7 to 15 years.

Figure 5. Outstanding BNDES Loans: Direct and Indirect Finance (%)



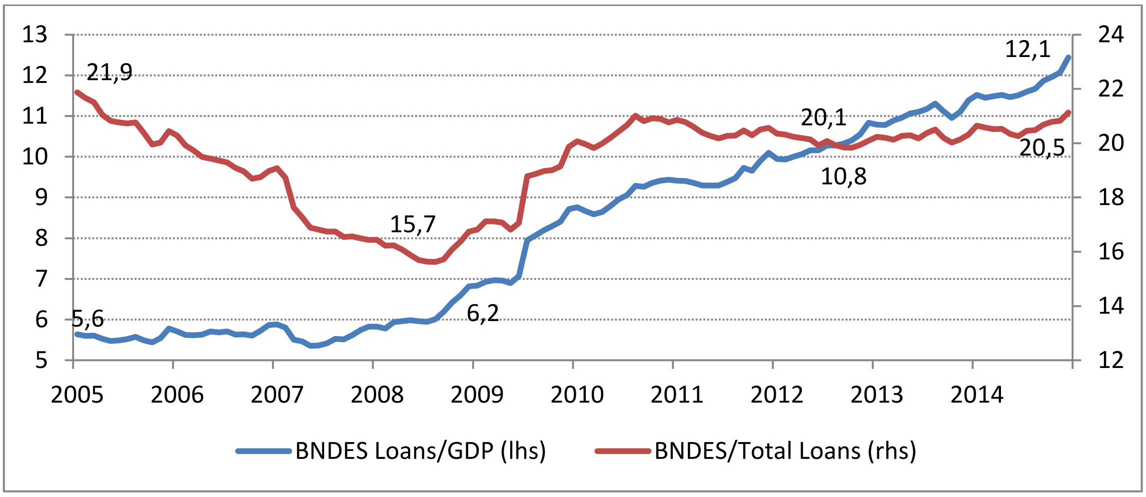
Source: Banco Central do Brasil, 2015

BNDES has always been the leading bank of long term lending in local currency in almost all the major sectors, except housing. According to Torres and Macahyba 2012, the development bank concentrated in 2009 more than two-thirds of all bank loans over

[3] Commercial banks also play an important role in the BNDES direct loans as guarantors.

5 years. In July 2014, more than 20% of all the bank loans in Brazil were funded by BNDES. This participation, however, had not been stable over time. For example, BNDES's share in the total credit fell sharply between late 2004 and mid-2008, a period of rapid growth of the credit market. It dropped from 21.9% at the beginning of 2005 to 15.7% at the end of the first half of 2008 (Figure 6).

Figure 6: BNDES Loans to Total Bank Loans and to GDP (In %)

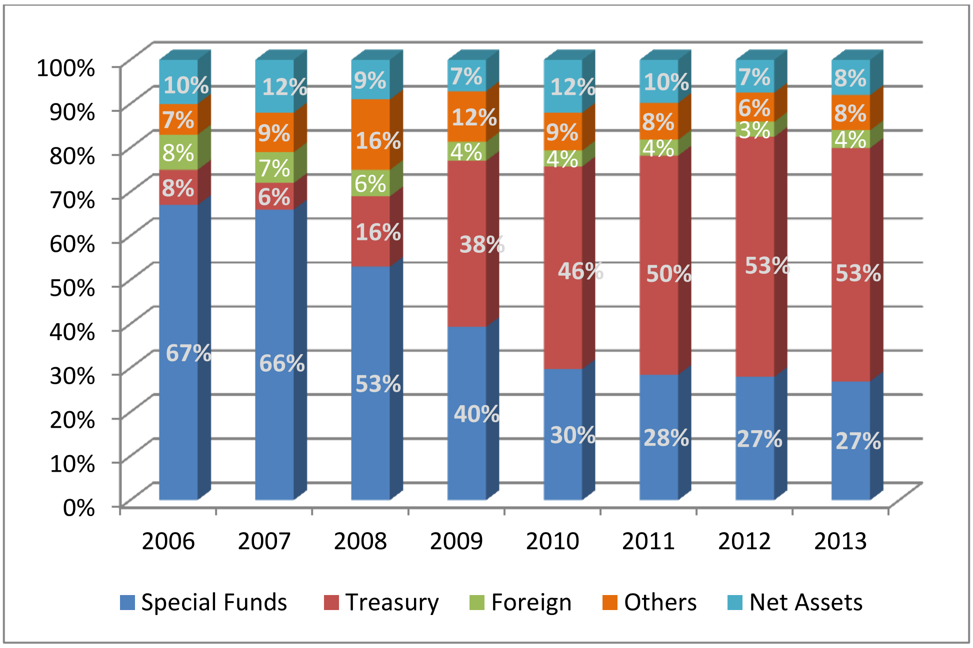


Source: Banco Central do Brasil, 2015

However, BNDES's loss of market share was not due to competitive pressure from other banks. It was mainly a consequence of the slower pace of demand to finance productive investments while household and housing credit were booming. The funds that are managed by the development bank are earmarked for the acquisition or the exporting of machinery and equipment, for the construction of new plants, or for the building of infrastructure works. Thus, the boom in household and housing demand for credit in recent years had no direct impact on the performance of BNDES.

Another factor that affected the growth of credit from BNDES in recent years was the role this bank played in the countercyclical policies. As witnessed during the crisis of 2008, BNDES helped to sustain investment and to offset the credit crunch from the domestic and foreign private banks. As can be seen in Figure 6, the participation of BNDES in the total bank credit increased at a fast rate, from 15.6% in August 2008 to 21.1% in the same month of 2010. In this period, the total of its loans to the GDP jumped from 6.0% to almost 9.3%. Special Funds from the National Treasury (SF), such as PIS–Pasep and the Workers' Assistance Fund (FAT), used to be the main sources of funds for BNDES until 2008 (Figure 7). They supply loans to the development bank on a concessional basis: very long periods and charge TJLP, an interest rates that is lower than the Central Bank rate (Selic). The SFs are supplied by compulsory contributions from corporations, which are very stable.

Figure 7: BNDES's Main Sources of Funds (in %)



Source: BNDES, 2014b.

Since 2008, the Treasury took the position of leading supplier from the SFs.In order to compensate the impact of the international financial crisis of 2008, BNDES needed large amounts of money in a very short period of time in order to play a relevant countercyclical role in the credit market. However, as the supply of the SFs is very inelastic, the National Treasury had to step in and issue large volumes of debt in order to give massive new loans to the development bank.

BNDES could have instead sold its own bonds to private investors, but this market was not large and deep enough to supply the large amounts needed at the appropriate time.

The Central Bank could have been another possible buyer for those bonds, but that would have had a negative impact on monetary policy and in the expectations of the financial market. The public debt was the only local financial market that, after the 2008 crisis, was large and deep enough to supply the large amount of money needed by the development bank[4]. Due to this strategy, the National Treasury, as early as 2010, became BNDES's main supplier of funds. From 2007 to 2010, the federal government participation of the total sources of the development bank increased from 6% to 46%. In 2012 and 2013, they reached 53%. In the meantime, the share of the SFs decreased to 27%.[5] Therefore, the strategy to fund BNDES with Treasury loans was also a response to structural limitations of the domestic bond market.

As the development bank is 100% state-owned, there was no legal impediment to make direct loans from the Treasury. This mechanism had already existed since the 1970s. The difference was that until 2008 it was not used on a regular basis and the amounts of money involved were much smaller.

[4]Another possible way to finance BNDES needs in 2008 was to increase taxation or compulsory funding, but those measures would have had a negative impact on the economy

[5]Other sources of funds for BNDES have always accounted for a relatively small part of its budget. External funds have supplied less than 10% of the total funding. Most of these loans are very stable and are lentby multilateral agencies or export credit agencies. In 2012, foreign loans had dropped to 3% of the total liabilities. The same applies to bonds (corporate bonds) in the local market. In this case, participation is even lower.

3.TheLong Term Corporate Bond Market

Until the 1980s, the United States was the only country to have a relevant private bond market. This was mainly due to the characteristics of the financial regulation adopted in that country from the 1930's on: a strict segregation between the activities carried out by commercial banks - short-term loans - and by other financial institutions - long-term credit, intermediated by the capital markets. This regulatory framework was very different from the models adopted in other advanced countries. In Europe and in Japan, for instance, long term credit was intermediated by universal banks[6]. Their capital markets were not as important as in the US.

Table 2. Outstanding domestic private debt securities to GDP (%)

Country	1990	1995	2000	2005	2011
United States	68.2	77.2	94.6	105.7	91.9
South Korea	27.9	37.0	50.7	53.0	59.3
Malasia	18.2	30.5	32.8	47.4	58.1
France	49.4	45.6	34.2	38.3	56.3
Japan	38.5	41.9	48.1	41.0	37.2
Germany	..	52.5	57.1	34.9	24.0
China	3.3	2.5	7.1	10.7	23.1
Brazil	..	8.3	8.4	12.7	21.7
Mexico	1.3	1.2	9.8	13.9	15.7
Chile	..	..	..	..	14.8
U.K.	12.8	12.9	18.3	15.1	12.3
India	0.3	1.0	0.4	0.9	4.9

Source: World Bank, 2015

The globalization of the financial markets had a deep impact in financial markets. One of the most important changes was the disintermediation of credit as capital market operations became more accessible and less costly for corporations. In Japan, some important reforms were adopted after the 1970s in order to develop the local bond market. Japanese government and financial institutions wanted to bring back to Tokyo

[6]In addition, there was also the facilities offered by the American bankruptcy law

brokering bonds in yen that large companies and banks were already issuing abroad. Europe had a later development due to the importance that banks have always had in financing services in that continent. Corporate bond markets had grown faster since the start of the euro in 1999. The process of financial liberalization, that followed the introduction of the single currency, led to more competition and flattened intermediation spreads.

In Asia, local corporate bond market expanded more rapidly from the mid-1990s on in countries like Malaysia and South Korea. In both cases, the Asian Crisis of 1997 deeply affected the ability of local banks to extend credit. As a reaction, companies started issuing bonds in the local financial market. In India and China, this trend became more visible in recent years.

The development of corporate bond markets in Latin America has in general been later and slower than in the advanced countries and in Asia[7]. Only in the 2000s the region completely recovered from the long period of high inflation and scarcity of external liquidity. The crisis of 2008 gave new impetus to the Latin American corporate bond market. The bankruptcy of Lehman Brothers closed the access of the large companies in the region to the global financial market. However, despite the crisis, some Latin American capital markets remained open for new placements in local currency by companies which were well rated. Institutional investors, particularly pension funds, played an important role in sustaining the demand for private papers Latin Americans. In the middle of the last decade, these institutions held 80% of all such emissions in countries like Chile, Colombia and Peru.

Differently from what happened in industrialized and in some emerging countries, Brazil still has a very shallow and limited long term credit market. This specificity can no longer be easily explained by "structural factors inherent to developing economies" or by "particular economic conditions that are shared by Latin American countries". The reasons why Brazil is still a late comer have to be searched in the characteristics of the development of its own local financial markets.

[7]Themajor exception to this picture was Chile.

According to Table 3, the Brazilian non-financial corporate bond market only grew fast after the second half of the 2000s. It increased from 6.6% in 2006 to 13.1% of GDP in 2014. The data also shows that this trend was not followed by proportional issuance from financial corporations or the Treasury. This picture could indicate that Brazil was, at last, following the international trend. Corporate private debt was rising at fast rates and banks were losing ground for capital market operations.

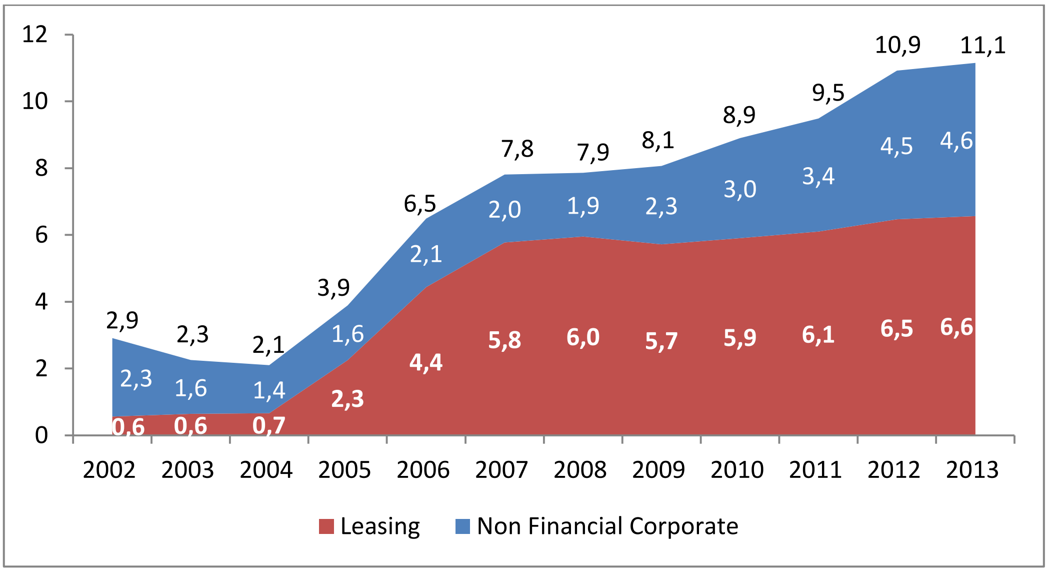
Table 3.Brazil: Outstanding Domestic Financial Assets (In % of GDP)

Financial Assets		2006	2007	2008	2009	2010	2011	2012	2013	2014*
Non Financial Corporate Bonds	**Debentures**	6.6	7.9	8.2	8.7	9.0	9.6	11.6	12.0	12.8
	Others	0.1	0.1	0.6	0.5	0.3	0.3	0.2	0.3	0.2
	Total (a)	6.6	8.0	8.8	9.2	9.3	9.9	11.8	12.2	13.1
Financial Corporate Bonds	**CDs**	14.5	14.9	24.1	25.6	22.6	18.2	14.8	13.2	11.0
	Bonds	0.0	0.0	0.0	0.0	0.8	3.6	5.4	7.0	6.8
	Others	0.1	0.3	0.2	0.6	1.5	0.7	0.7	0.6	0.6
	Total(b)	14.6	15.2	24.3	26.2	24.1	22.5	20.9	20.8	18.4
Corporate Bonds (a+b)		21.2	23.2	33.1	35.7	33.4	32.4	32.7	33.0	31.5
Covered Bonds(c)		1.2	1.0	1.4	2.3	2.6	3.3	4.6	6.1	8.1
Private Bonds (a+b+c)		26.3	22.3	24.6	35.4	38.0	36.6	37.0	38.8	41.1
Public Bonds (d)		54.5	46.1	46.0	41.7	43.2	42.5	43.0	43.6	41.9
Total (a+b+c+d)		80.8	68.4	70.6	77.1	81.1	79.2	80.0	82.4	82.9

Source: ANBIMA, 2014
(*) Figures for September 2014,

However, the aggregate data tends to underestimate the role that the banks have had on the expansion of the corporate bond market. According to Figure 8, between 2005 and 2008, the rapid expansion of debentures was mainly due to the issuances of the leasing industry. These companies, which at large belong to financial conglomerates, were only a way for their owners - the banks - to access the debenture market as financial institutions are forbidden to issue debentures in Brazil.

Figure 8.Outstanding Debentures (In % GDP)



Source: ANBIMA, 2014

Almost all of the debentures issued by leasing companies were bought by the banks of the same conglomerate. After receiving these funds, the leasing company relent them back to their owner's bank through the interbank market. In fact, it was only a booking operation within the same financial conglomerate with the only purpose to originate a security that could be used to carrying out reppo operations between the banks and their clients. The debenture of the leasing company replaced the traditional Certificate of Deposit issued by the banks. The reason for that was to avoid the taxes and the reserve requirements that affected CDs but not the reppos of debentures, which were supposed to be “long term securities”. Therefore, the fast growth of the corporate bond market in Brazil in the second half of the 2000s was not a real development of the non-financial corporate bond market, but just a way for the banks to intermediate funds on a more efficiently.

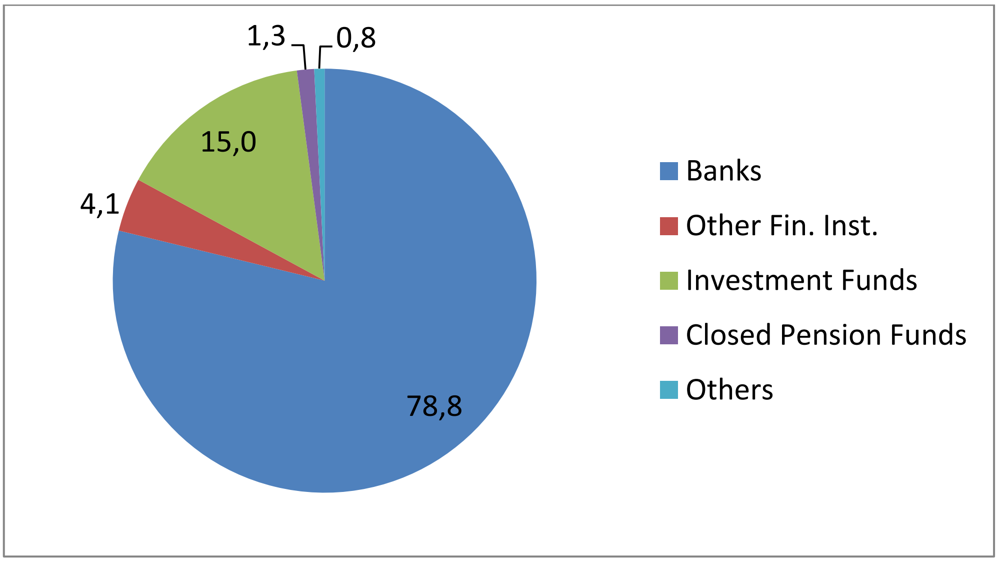
From 2008 on, the outstanding of leasing debentures to GDP has been almost flat. The reason was that the tax and regulatory arbitrage between CDs and debentures almost disappeared for two reasons. First, repurchase agreements with debentures of leasing companies became subject to reserve requirements. Second, long-term bond of the banks – called "Letras Financeiras" - were exempted from reserve requirements by the Central Bank. The aim of those measures taken by the government was to make the banks stop using the debenture market as a way to fund themselves.

Since then, the expansion of the debentures market was driven by non financial corporate issues. The stock of securities of these companies rose from 1.9% of GDP to 4.6% in 2013. In order to access this market the companies have to hire the service of the banks to structure and distribute their bonds. However, instead of simply copying the model adopted in the international markets Brazilian banks also provide firm guarantee, acquiremost of the bonds issued and hold them to maturity. The money from the sale of the debentures is used to repay the short-term debt of companies with the bank which at the same time releases new short term credit lines on the same amount.

The main reason for this behavior is again arbitrage. The acquisition of debentures is the best way for banks to lend large amounts of money for corporations for longer periods. It avoids the payment of IOF, a transaction tax, which is only applied on bank loans. Besides that, a corporate bonds are also more flexible to allocate than loans. They can be easily sold an bought and therefore can be easily transferred within different portfolios managed by the financial conglomerates - investments funds, treasury operations etc. Therefore, the recent boom of the non-leasing debenture market in Brazil, as the one before, is not a real disintermediation process. It is just a more efficient way to extend longer term bank loans using a security instead of a contract. It is different from the earlier one because it has not been driven by arbitrage between the different ways the banks can fund their own operations. However, it is still mostly a consequence of tax incentives which affect the way banks extend credit to corporations.

The importance of the banks in the debenture market has a large impact on the composition of the demand for this asset. In Brazil, differently from other countries, the banks are the main holders of long term corporate bonds. In August 2013, they had 79% of the outstanding of debentures in their portfolios (Figure 9). In the rest of the world, this position is taken by institutional investors, such as pension funds and insurance companies.

Figure 9 - Demand for Debentures in August 8, 2013 (In %)



Source: ANBIMA, 2014

In 2010 and 2011, the government again tried to reform the debenture market. This time, the aim was to stimulate private long term funding from local families and foreigners for investment projects in infrastructure. A new law created the "infrastructure debentures" or "debentures 12431" [8] and guarantees income tax exemption if this asset is held by families or foreign investors. To be eligible for this tax benefit, these debentures must have different financial characteristics from the bonds that are usually sold or bought by banks. Interest rates cannot be indexed to the interbank market rate (DI), the minimum average maturity is four years and repurchased agreements are forbidden within 24 months following the launch. Moreover, the issuer has to allocate these funds in specific investment, mostly energy infrastructure projects, already approved by the government.

[8] This is the number of the law that created the tax incentive for this debentures

By December 2014, there were 14 of these “infrastructure debentures” totaling R$ 14.8 billion. Of this amount, US $ 5.0 billion was allocated exclusively to non-residents and were privately placed. In fact, they were just a way for foreigners to avoid paying the income tax on interest which is applied to any kind of loan from overseas except if intermediated by “debentures 12.431”.

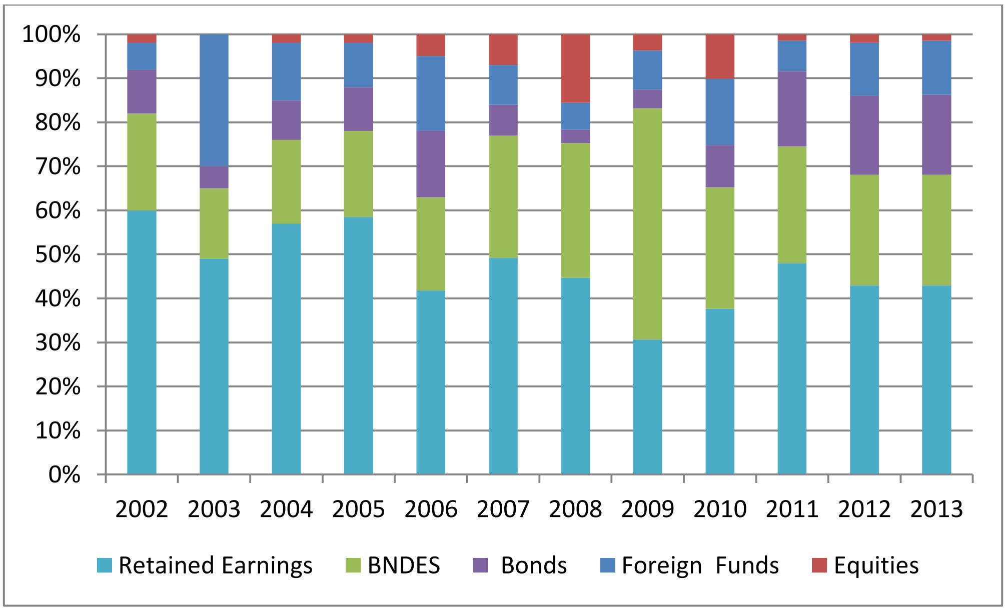
There were also 46 issuances, totaling R$ 9.8 billion, for local investors. The power sector originated most of these operations, followed by highways. The maturity of the operations reached up to 17 years, which shows that these bonds have more suitable to funding investment projects.

4. Long Term Corporate Financing in Brazil: What are the news?

Brazilian credit market has grown very fast in the last few years. The long term corporate credit market is one of the dimensions of this process. As a late comer, the Brazilian experience is not just a copy of the more advanced countries. As usual, this process has many singularities because of the actions and interests of the different local agents that operate on it.

From the demand point of view, Brazilian corporations seems to have a behavior which is similar to what is observed in other developed and emerging countries. According to Figure 10, Brazilian non-financial corporations follow a very stable pattern in terms of long term funding.

Figure 10. Source of long-term funding for corporate investments in industry and infrastructure (%)



Source: BNDES, 2014b.

The retained earnings are their main source and had supplied on average 45% of their demand for long term funds along the period 2002-2013. The only exception was in 2009 because of the global financial crisis. The second main source of long term funding is BNDES with 27%. This figure includes both the development bank's direct loans as well as the ones refinanced by the commercial banks. Cross-Border funding holds the third position with 12% along with corporate bonds. The issuance of shares is the least important source of funding with 4%.

This means that the Brazilian long-term credit market is led by the banks and not by the capital markets. Therefore, it is more similar to the models adopted in Europe and Japan. What is specific in the Brazilian experience is the large size of the development bank (Zysman, 1983).

Another interesting picture of the Brazilian long term credit market comes out of the combination of the data of Figures 9 and 11 for the different source of funds of long term credit for corporations[9]. Unfortunately, this is only available for the year 2013. The results are shown in Table 4.

Table 4: Sources of Long Term Credit in 2013 (In %)

Sources	GDP	Total
BNDES Direct Op.	5.8	36.1
BNDES Indirect Op.	5.6	34.9
Banks ex Leasing	2.3	14.1
InvestmentFunds	1.7	10.5
Others	0.7	4.3
Total	16.0	100.0

Source: BNDES and ANBIMA

In 2013, the size of long term credit market in Brazil reached 16% of GDP. From this amount, 71% was funded by BNDES, half of which were on its own books. The other

[9]All debentures of leasing companies were purged from this sample.

banks held the other half of BNDES loans plus a portfolio of debentures which amounted 14% of all long term credits for non financial corporations. Investment funds held 10%. These vehicles gather the savings of families, non-financial corporation and institutional investors[10] but are mostly managed by banks. The rest (4%) includes the debentures which are owned directly mostly by pension funds and families. Therefore, from the funding point of view BNDES is the central pillar of the corporate long term credit market in Brazil. However, its almost monopolistic position of the past is little by little being challenged by two new groups of investors, the commercial banks and the large investors such as pension funds and rich families.

This same data could be rearranged to make clear the structure of the long term credit market in Brazil from a different perspective: what amount of funding is commanded by the different agents (Table 5). We estimated that 70% of the total portfolio of the investment funds are managed by the banks and 30% by independent managers.

Table 5. Commanding Agent over long term funds

Commanding Agent	In % of GDP	In %
BNDES	5.8	36.2
Other banks	8.8	55.0
Non Banks	1.4	8.8
Total	16.0	100.0

Source: BNDES and ANBIMA

Table 5 shows that although BNDES is the largest provider of long term funds, the commercial banks are much more important in commanding the extension of these credits than the development bank. The commercial banks manage their own funds, the resources from the investment funds and half of the portfolio of the earmarked operations of BNDES.

These results also indicate that in fact the leadership in the long term corporate market in Brazil is a condominium between BNDES and the commercial banks. They dominate

[10] Mostly pension funds

different areas and have a long tradition of risk and information sharing in large credit loans. BNDES has an important say in very large investment projects for industry and infrastructure and in consumer credit for capital goods with high local content. This is due to the long maturity, low cost and large annual of its budget (R$ 190 billion or US$ 70 billion). The development bank also plays a very important countercyclical role that helped to stabilize the corporate credit market in moments of crisis, as in the 2008-2009 episode.

The commercial banks long term credit for corporations is a byproduct of their normal short term (up to 2 years) lending activities. When the credit lines to large companies are full, because of demand or changes in the regulatory framework, the banks ask their clients to issue debentures because it is a more efficient and less costly way to provide large amounts of credit, due to tax and regulatory incentives, if the clientcan access the capital markets and if the amount of the credit is large (over R$ 250 million or US$ 100 million).

This business model does not compete with BNDES loans, which follow a different tax and regulatory framework. As a matter of fact, the two sub-systems are mostly complementary. The commercial banks deal with the "long term working capital" of the companies and they complement BNDES on the funding of the long maturity investment operations of the corporations. Sometimes, there are frictions between them when a large client is involved. For example, when BNDES extended a large loan to Petrobras during the 2008-2009 crisis, the commercial banks complained that they were not allowed to take part in this credit operation, because they wanted to increase their exposure to the well rated state oil company.

Despite this division of labor, the two sub-systems compete for the global demand of credit of the corporations. There is a Ricardian price structure in the market. BNDES usually offers the cheapest loans. Therefore, when investment projects are structured, the companies try to maximize the access to BNDES loans and use the commercial bank market as a complement. Therefore, there is some substitution between the two subsystem depending mostly on the difference between BNDES rates (TJLP) and the rest of the markets' (Selic).

A second kind of competition started recently between the commercial banks and some of their largest clients. Those companies have long experience of issuing overseas and want to be more independent from the banks and access directly the non bank investors. They want to build an interest rate term structure of their own as well as a secondary market. The most important barrier they face at this stage is regulatory. There are two ways to make a public offer in Brazil. The usual one called "restricted" [11] because the bond can only be sold up to 50 investors. There is no need to be pre-approved by the regulatory body (Comissão de Valores Imobiliários - CVM) and, therefore, transaction costs are very low. The second way is by means of a "registered" offer[12] . There is no limitation of the number of buyers but it has to be pre-approved by CVM. This can take a long and unpredictable time and is very costly. The growing preference for "restricted" offers is illustrated on Figure 11. It shows that after the possibility of Restricted Offers was enacted in 2009, the volume of "registered" offers diminished severely.

Figure 11: Public Offers of Debentures by Distribution

[11] It is based in CVM Resolution 476
[12] It is based in CVM Resolution 400

Source: ANBIMA, 2014

Finally, the households and institutional investors are newcomers to this market. They prefer to operate through investment funds managed by banks and concentrate their direct operations on public bonds. However, whenever the Central Bank brings the nominal Selic rate under 10% a year, they are encouraged to carry on more private risk buying debentures directly on public offers. This was a clear phenomenon in 2012 when the Selic rate fell to its lower ever level, 7,5% a year. There was a run for yield both from the closed pension funds and the rich families. At the same time, some well rated companies started issuing in the domestic market and tried to access those non-bank investors.

A more "normal" market started to develop but its pace will always be tied, on one side, to the difference between the Selic rate and the expectation of inflation and, on the other side, to the difference between the TJLP and the Selic rate. The higher the real rate paid by the public bonds the less the rich families and pension funds will be willing to diversify their portfolio towards private bonds. At the same time, the higher the Selic rate the less stimulated the corporations will be to issue in the domestic market. Also if TJLP is much lower than the Selic rate and BNDES has a lot of funds, the corporations will try to maximize the borrowing with the development bank and there will be less demand for the rest of the market.

5. Policy Recommendations

Brazil has a small corporate long term bond market. The relative size and depth of the Brazilian market is still behind those of developed countries but also of developing nations from Asia and even from Latin America. The main reason for this "relative backwardness" is that interest rates have been kept high for a very long period. This, on the one hand, inhibited the corporations to issue bonds and, on the other hand, concentrated the demand for long term assets of investors on the public debt, which also guarantees very low risk and high liquidity. In addition, the regulatory bylaws still discourages the issuance of corporate bonds for non financial investors.

Given this situation, we suggest that the government changes the emphasis of their work. So far, their efforts have focused in creating a fiscal and regulatory framework that encourages the release of private securities long-term oriented for fixed investments. In the next future, despite the perspective that the Central Bank will maintain the base rate at levels over two digits, the government should initiate a program to foster the issuance of "infrastructure bonds". This program should have the goal of R$ 50 billion of this debentures until the end of 2018, the last year of the administration of President Dilma Rousseff.

In order to encourage the market, the state-owned banks - BNDES, Banco do Brasil and Caixa Econômica - would offer a firm commitment to a substantial portion of the offers of "infrastructure bonds", which would only be exercised if emissions were not fully distributed to investors. Besides that, all financial institutions would have a tax benefit of 10 percentage points if they have to hold them in their portfolio up to two years.

The infrastructure debentures purchased by the public financial institutions should be financed by borrowing from the market, through the instruments already available, such as Financial Bills ("Letras Financeiras"). There would be no need for additional supply of scarce fiscal and quasi-fiscal funds for meeting this goal.

At the same time, these portfolios of the public banks would be subject to periodic auctions, through electronic platforms. This mechanism would allow portfolio managers other than the banks to buy such securities at any time and, therefore, to establish sales strategies to its clients, particularly abroad, without being dependent on the primary market.

Regarding the liquidity of the bonds with income tax benefit, the most important measure would be to extend the exemption from income tax to foreign investors portfolios which holds assets that have the same incentive in any proportion. Currently, there is a legal requirement that such funds, to be tax free, have a very high percentage of government bonds or, alternatively, private papers.

The "infrastructure bonds" faces competition from other securities backed in real estate and agricultural receivables that offer the same benefit to investors and are not subject to the same restrictions as the "12431 debentures". They can offer shorter maturities, indexation to the Selic rate and be issued by the banks. We suggest that the regulatory framework of the tax benefits for long term securities should be consolidated in one only level playing field for any issuer of any sector. This new regulation should be based on the rules for "infrastructure debentures". At the same time, the banks would not be allowed to issue bonds with tax benefits.

The approval process for registered bonds under CVM Resolution 400 should be liberalized and this kind of offer should be stimulated. The program of the companies should be pre-approved by CVM so that when a market window opens, the company only supplements the information with the final financial conditions, without having to undergo the approval process again. Also, the advertising material would not have to be approved in advance by CVM anymore. This Authority, instead, would set strict penalties for issuers who failed to meet a number of obligations previously determined. Among them, the responsibility to disclose to investors if any relevant information is changed during the registration and distribution process.

6. Final Remarks

Over the last decade, the long-term credit market in Brazil has undergone a major transformation in terms of scale and structure. Long term credit supply for non financial corporations still remains segmented and dominated by BNDES, with the support of special public funds and loans from the National Treasury. However, the funds intermediated by the private sector, virtually nonexistent before, have had a more important role.

The commercial banks have been the leading actors of this structural change. They have been extending large amounts of long term credit to non financial corporations through the acquisition of debentures, instead of using its own balance sheet. Financial institutions linked to the distribution processes acquired most of the public offers. This strategy is completely in line with the legal apparatus. Buying debentures instead of offering traditional credit operations is cost efficient for their clients and gives the banks more flexibility to deal with credit limits, and to diversify risks.However, these transactions cannot be considered as typical capital market operations, as the underwriters in most cases did not make any sales effort. It is, in fact, a traditional bank loan transaction extended by means of a debenture.

Thus, to understand the actual role of banks in the long term of credit market it is not enough to analyze their balance sheets where traditional credit operations are booked. One must also follow their role as capital market investors and managers of investment funds for institutional investors and families

Alongside the banks, the relevance of these other local investors has grown in the last few years. They were attracted by the higher yield offered by corporate bonds, phenomenon which intensified during the period in which nominal interest rates fell below two digits. Private bankers, family offices, wealth management firms are becoming important players in the debentures market.

However, it´s important to note that the development of this market will essentially depend on the evolution of interest rates. There is no doubt that high interest rates retracts away investors who prefers to buy and hold public bonds that in this circumstances offers a better risk-return benefit. Similarly, when BNDES rates are kept well below to those applied in the private market, there is a natural tendency of the companies not to consider other sources of funding and to try to finance most part of their projects with funds from the development bank.

In this context, the adequacy of investment financing mechanisms in Brazil remains on the top of the agenda of Brazilian policy makers as a way to sustain a reasonable growth path without depending too much on BNDES funds. In this scenario, is the capital market prepared to supply, even partially, these funds for fixed investment? From the point of view of regulatory, tax apparatus and market infrastructure the answer to this question is positive, although there are regulatory framework cam be improved.

Therefore, it seen that the financing structure for investment in Brazil will face in a medium-term horizon two important changes. First, it is expected that the public banks loans portfolios will not continue to grow at the path observed in recent years. Rather, it is likely to suffer some contraction relatively to the private sources of financing. Second, another phenomenon to be confirmed that private agents will be able to compensate that structuring, distributing and even investing in corporate debt securities, with characteristics that are favorable to companies in terms of maturities and indexation. However, It seems that these two phenomena will not occur at the same speed and intensity what could hurt the level of fixed investments. The government has to act quickly to foster the development of the long term market in order to accommodate the lack of BNDES funds. The response of the corporate bond market, however, will depend mainly on the levels of interest rates and on the expectations of economic agents about the trajectory of the Brazilian economy in the coming years.

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