Economic Watch

Brazil

Madrid, April 16, 2012
Economic Analysis

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The increasing power of public sector banks in Brazil: back to the past?

- **The market share of public sector banks is now the highest in 10 years**

  Due to an impressive expansion in state-owned commercial and development banks, public credit now represents about 44% of total in Brazil, in comparison to 34% in 2007, right before global turbulences hit the country. This expansion (which follows years of relative stability) puts public banks back to the centre stage.

- **Higher risks: the price public banks have to pay for higher market share**

  Although public banks still display a sound financial situation, their recent fast expansion has generated some deterioration in their balances. Most financial indicators are not as strong as some years ago and, more importantly, do not look as robust as those displayed by domestic private banks.

- **The political use of public banks is an issue to be watched**

  The (political) decisions to use public credit to support the economy and to reduce public banks lending rates to drive Brazil's banking spreads down reinforce the view that the expansion of public banks will continue to be very strong in the coming years. It is not unlikely that in the near future public banks account for more than half of the credit market share, a situation that resembles that of decades ago. More than the expansion per se, the main source of concern is political intervention. Anyway, the excessive growth of public sector banks could end up exposing them -and the whole system- to an economic downturn. It could also add to the concerns about credit and asset bubbles in Brazil.

The market share of public sector banks is now the highest in 10 years

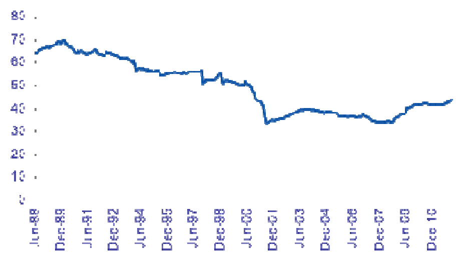
Credit from public banks represented around 70% of total credit in Brazil in the end of the 80's. This was a consequence of both a chaotic macroeconomic environment, characterized among other things by hyper-inflation and fiscal crises, and a set of inadequate incentives which, for example, allowed the political use of public banks and inhibited the expansion of private banks.

From the end of the 80's on, the share of public credit declined significantly, especially after inflation and fiscal problems were reigned in, series of more adequate incentives were set, and some public banks were privatized (see Chart 1).

The share of public credit reached 34% in 2001 and remained practically stable till the end of 2008, when the Lehman Brothers crisis hit the country. At that moment, private credit decelerated due to an increase in risk aversion, liquidity problems, and a significant deterioration of growth perspectives. In sharp contrast, public credit accelerated from the end of 2008 on (see Chart 2).

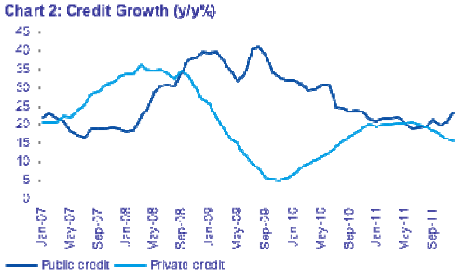
As public loans continued expanding at a more robust pace than private loans after the economy started to recover from the external shock and even after overheating signs emerged in 2010, public banks' market share increased significantly and reached 44% of total credit at the end of 2011, practically 10 p.p. more than its share in the middle of 2008.

Chart 1: Public Credit (% of Total Credit)



Source: BCB

Chart 2: Credit Growth (y/y%)



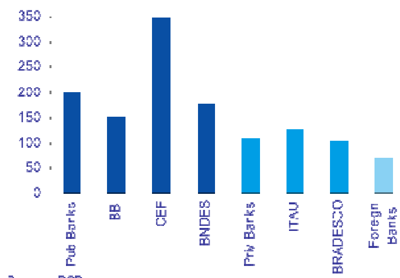
Source: BCB

The expansion of public banks was generalized. It was not only related to the expansion of the BNDES, the National Development Bank, but also to the dynamism of public commercial banks.

In the four years between December of 2007 and December of 2011, the credit extended by public commercial banks grew 199% while BNDES credit grew 178%. This compares to a growth of 109% and 69%, respectively, in total credit extended by domestic private and foreign private banks (see Chart 3).

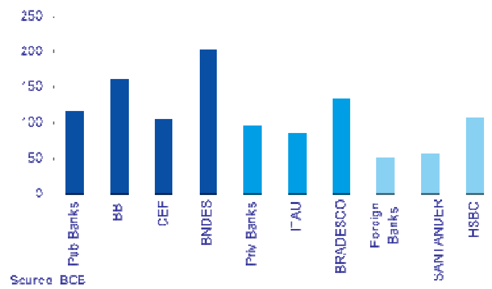
Within public commercial banks, credit from Banco do Brasil (BB) and Caixa Economica Federal (CEF), which together account for 96% of public banks' total assets, grew 152% and 347%, respectively. The credit expansion observed in Banrisul (a public bank owned by the State of Rio Grande do Sul which is the third largest public commercial bank in the country) was equal to 259%, which shows that credit expansion in public banks was not only driven by federal banks but also by smaller, regional institutions.

Chart 3: Credit growth between 2011 and 2007 (%)



Source: BCB

Chart 4: Assets growth between 2011 and 2007 (%)



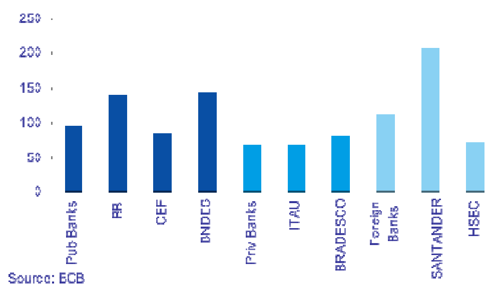
Source: BCB

The over-expansion of public banks is also evident when one looks at other measures such as total assets and capital.

In the last four years, public commercial banks' total assets increased 116% and BNDES' total assets, 204%. Domestic and foreign private banks expansion was not as big: 96% and 51%, respectively (see Chart 4)

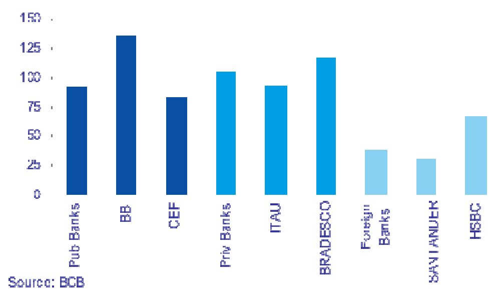
Chart 5 shows that while, on one hand, public commercial banks had their capital increased by 96% between 2007 and 2011 and the BNDES by 144%, on the other hand, domestic and foreign private banks had their capital adjusted 69% and 112% up in the period.

Chart 5: Capital growth between 2011 & 2007 (%)



Source: BCB

Chart 6: Deposits growth between 2011 & 2007 (%)



Source: BCB

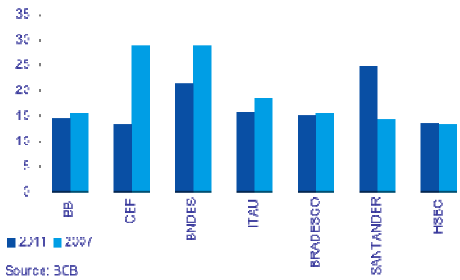
Although the expansion of public banks' capital and assets was also very robust in the last years, it was not as significant as the expansion of public credit, which suggests the balance of public banks deteriorated in comparison to the balance of private banks. The "not-so-significant" growth of public banks' deposits -at least in comparison to domestic private banks- suggests the same (see Chart 6).

Higher risks: the price public banks have to pay for higher market share

The Basel Index for BB, CEF, and BNDES was 14.5, 13.3, and 21.5 in December of 2011, significantly higher than the minimum level required by the domestic regulator (11.0%) and also than levels usually required internationally. These levels, however, are lower than four years ago and also lower than the levels displayed by foreign and domestic private banks (see Chart 7 below).

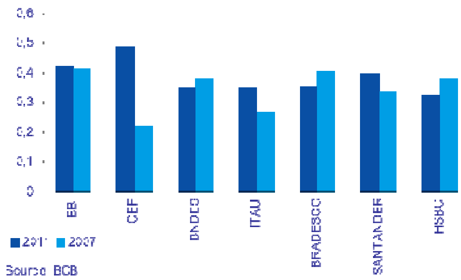
The analysis of other basic ratios, such as credit/assets, credit/capital and credit/deposits, reinforce the claim that the situation of public banks is, in general, not as strong as in 2007 and not as strong as the situation of private banks. This is direct consequence of the very significant growth of public credit in the last years. In other words, the expansion of public credit granted public banks a higher market share, but also more risks due to lower capitalization and higher leverage (see Charts 8, 9, 10 and 11[1]).

Chart 7: Basel Index



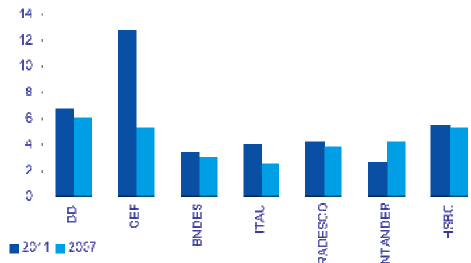
Source: BCB

Chart 8: Credit / Asset Ratio



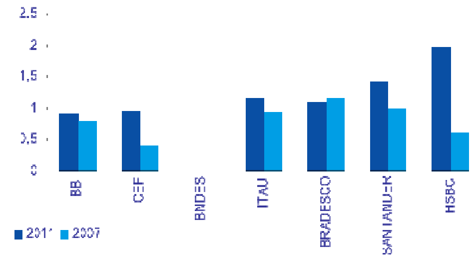
Source: BCB

Chart 9: Credit / Capital Ratio



Source: BCB

Chart 10: Credit / Deposits Ratio

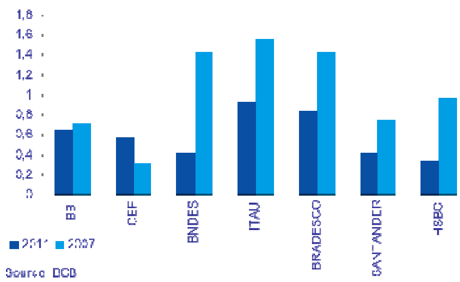


BNDES was not included in the analysis as it does not get demand/time/term deposits. Source: BCB

These facts do not imply that the financial situation of public banks is weak. Rather the opposite. The balances of public banks remain sound, and certainly much sounder than decades ago. In some aspects their financial situation is better than the situation of private banks: the share of non-performing loans (NPL), for example, was equal to 2.1%, in comparison to 5.0% in domestic private banks, and 5.4% in foreign private banks in the end of 2011 (see Chart 12).

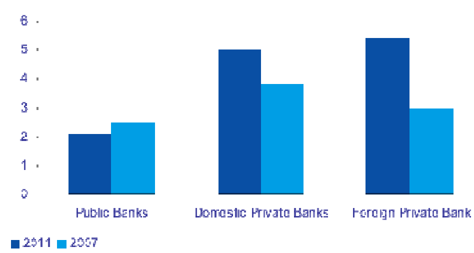
The deterioration pictured above, however, suggests that problems could arise in the medium/long-term if public banks continue growing at the pace observed in the last years, especially if public banks are (politically) used to address macroeconomic distortions as the sections below discuss.

Chart 11: Net Profits / Total Liabilities Ratio



Source: BCB

Chart 12: NPL (%)



Source: BCB

[1] The banks included in these graphs (publics: BB, CEF and BNDES, domestic privates: Itaú and Bradesco, foreign privates: Santander and HSBC) are the largest in the country and account for 80% of the financial system (both in terms of assets and in terms of credit).

The political use of public banks is an issue to be watched

The decision to drive public credit up after the country was negatively affected by global turbulences in 2008 was one of the main counter-cyclical measures that allowed the country to reduce the impact of the external crisis and to start a robust economic recovery already in 2009. In spite of the positive support public credit provided to the economy at that moment, the political use of public banks to revive the economy generated concerns about the long-term performance of the public banking system and, therefore, of the whole banking system.

These concerns were reinforced by i) the fact that public credit remained very dynamic even after overheating signs emerged in 2010; ii) the continuous use of Treasury's (subsidized) resources to capitalize the BNDES (R$235bn -6.5% of GDP- between 2009 and 2011 and R$45bn -1.0% of GDP- in 2012); and, especially, iii), the very recent announcement that the two main public commercial banks (Banco do Brasil and Caixa Economica Federal) will cut their interest rates to force a reduction of banking spreads in Brazil.

The use of public credit to support the economy and the decision to reduce the lending rates charged by public banks (which should not be followed – at least not with the same intensity - by private banks, in spite of increasing political pressures) suggest that the most likely is that public financial institutions will continue expanding at a more dynamic pace than private institutions. It is, therefore, not unlikely that in the near future public banks account for more than half of the credit market in Brazil, a situation that resembles that of decades ago.

As outlined above, we see a risk in the excessive expansion of public banks, especially if it is politically driven. In addition to causing a deterioration of public banks balances and exposing them (and, therefore, the whole system) to an eventual economic downturn, a continued growth of public banks could add to the concerns about the creation of a credit bubble in Brazil. It could also reduce the room for the Central Bank to bring the SELIC rate down to international levels, which is – paradoxically – one of the main objectives of this government.

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