

## **A note on Brazilian financial regulation and governance**

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The question posed by Theme 4 of this workshop is indeed a very broad one and would demand a thorough research on the topics involved. I am afraid I did not have the proper time to think it over and I would not be able to provide a wide ranging answer to this question. Thus, I will be selective and I will present the following issues that need to be addressed to support Brazilian development: i) competition among banks; ii) high rate of interest on liquidity; iii) approval by the Congress of a Complementary Law to regulate the financial sector as required by the 1988 Brazilian Constitution; iv) exploitation of workers through the governance of the Job Time Guarantee Fund (FGTS) and v) state-owned versus government owned enterprises.

### **FINANCIAL REGULATION**

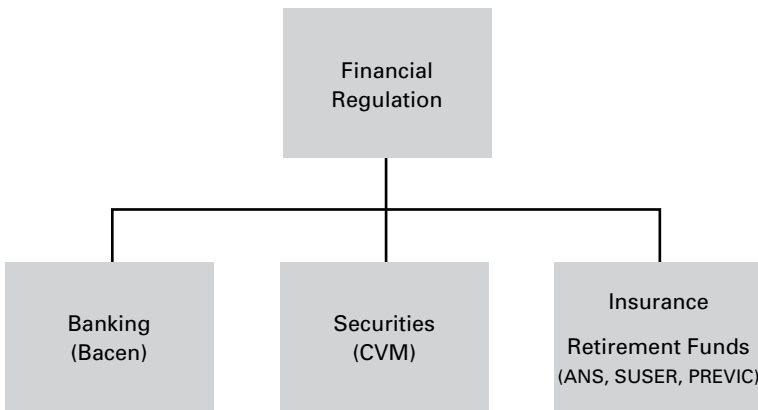
The Brazilian institutional structure of financial regulation is based on specialist agencies. The Central Bank is the banking sector regulator and supervisor, the Securities Commission (CVM) takes care of securities and several agencies are in charge of insurance and retirement funds [ANS (Health Care), SUSEP (Insurance), PREVIC (Retirement Funds)]<sup>1</sup>. Figure 1 shows this institutional structure.

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<sup>1</sup> The acronyms are as follows: ANS (Agência Nacional de Saúde Suplementar); SUSEP (Superintendência de Seguros Privados); PREVIC (Superintendência Nacional de Previdência Complementar).

Figure 1



There are some countries that have opted for a different institutional structure. Instead of specialized agencies they have a single mega regulator. One major drawback of the Brazilian institutional framework is that it lacks coordination because there is no official entity to take care of this activity, at least to prevent systemic risk, as in the case of the Financial Stability Oversight Council created in the United States by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

The bank regulation comprises at least the following activities: i) capital adequacy; ii) liquidity; iii) deposit insurance; iv) lender of last resort; v) intervention and resolution and vi) competition. Most of these activities have been well handled by the Brazilian central bank. For example, the Brazilian central bank follows the guidelines of the Basel Committee on Banking Supervision, as stated in the International Convergence of Capital Measurement and Capital Standards report. This framework is based on three pillars: i) minimum capital requirements; ii) supervisory review and iii) market discipline. There is a time table to implement this framework which should be completed by the end of 2012.

In the case of competition the basic regulatory issue is how to induce banks to behave in the public interest and at the same time to have a reasonable rate of return. In many countries the banking sector is highly concentrated. The argument used to explain why banks are large is based on economies of scale and scope. It is also the case that in many countries banks have market power. The argument here is that either markets are not contestable or there are barriers to entry. I must acknowledge that I am not familiar with the Brazilian empirical evidence on these two hypotheses. However, the spread charged by the Brazilian banks points out that something is wrong with our banking sector.

The Brazilian banking system is dominated by a small number of large institutions either state-owned [Banco do Brasil and Caixa Econômica Federal] or private-owned [Itaú, Bradesco, Santander, HSBC and CityBank]. Concentration of the banking sector has increased during the latest years. Banco do Brasil acquired

Nossa Caixa, a bank owned by the state of Sao Paulo; Itau and Unibanco merged and Santander bought Banco Real. There is no empirical evidence that this concentration has benefited bank customers.

The Brazilian central bank has not given due attention to the competition regulation of the banking sector. This is an issue that deserves careful analysis and changes in the regulatory framework to improve the efficiency of the banking sector.

It is common knowledge that the Brazilian interbank real interest rate is the highest in the world. Thus, bank liquidity is overpaid and earns much more than it is required in a normal environment. How to explain this anomalous situation? This is part of our hyperinflation heritage. During hyperinflation, liquidity in domestic currency paid a premium in real terms. The end result of this mechanism was to avoid the dollarization of the Brazilian economy, a very well established phenomenon in Latin-American economies that have had a hyperinflation experience. This mechanism was not dismantled by the Real Plan, as it should have been, and goes on as if it were an essential tool of our monetary policy. This mechanism works through a contagion effect of public debt on monetary policy due to a treasury bill indexed to the interbank interest rate fixed by the central bank. This Treasury bill amounts to one third of the stock of Brazilian public debt. Thus, it is not an easy task to dismantle this anomaly, but a time table should be framed to correct this problem.

## FINANCIAL GOVERNANCE

An article (192) of the 1988 Brazilian Constitution states that a Complementary Law should be enacted by Congress to regulate the financial sector<sup>2</sup>. More than twenty years have elapsed since its promulgation and no decision was taken by the Congress on this law. Why hasn't the Brazilian Congress come to an agreement and set forth the rules of the game? One easy answer is to say that there is no need for such a law since the rules in place are good enough as a playing field for the financial sector. A second explanation is to use political economy arguments and to recognize that the Brazilian society is divided into several topics regarding financial regulation and those topics yields a lot of controversy. One of these topics is central bank independence. Should the Central Bank be independent of the government executive branch in order to avoid political interference in its decisions? What kind of independence? Goal independence and (or) operational independence? It seems to me that the operational independence in the latest sixteen years, during the tenures of both President FHC and Lula, has been successful compared with previous Brazilian experience. It is very likely that the operational independence by law would bring a decrease in the long run rate of interest as it happened in England

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<sup>2</sup> A Complementary Law has to be approved by the majority of the Congress. An Ordinary Law is approved by the majority of the Congress members present when the vote is casting.

in the 1980s when the Labor Party decided to give independence to the English central bank.

A very good application of the principal agent theory is the governance of the Job Time Guarantee Fund (FGTS), a compulsory fund created in the 1960s by the Castello Branco Government. This fund belongs to the workers but most of the time it yields a negative rate of return. How come? This fund was captured by the politicians who do not behave as an agent of the worker (the principal). Thus, new governance has to be drawn to establish a true relationship between the agent and the principal.

State-owned enterprises (Banco do Brasil, Caixa Econômica Federal, BNDES, Banco do Nordeste do Brasil, Banco da Amazônia) play an important role in the Brazilian financial sector. As other state-owned enterprises, the governance of these enterprises should be reviewed due to the experience of the latest thirty years. Instead of state-owned enterprises they are indeed government-owned enterprises, because the Chief Executive Officer as well as other management positions became assets to be exchanged by political support by the executive branch of the government. The basic question is to define who the principal is: the state or the government? This situation has to be given a precise answer by the Brazilian society. If the Brazilian society wants to correct this problem, the appointment of executives for the state-owned enterprises has to be based not on political grounds but on technical expertise and previous experience in similar positions.

The fact that someone has a very good CV does not mean that he is fit to run any enterprise. Recently, in the United States, Senator Richard C. Shelby, rejected Professor Peter Diamond, a Nobel Prize Winner, from MIT, to be a FED Governor, and he stated in his Opening Statement: “Dr. Diamond is, of course, a very accomplished academic and economist. Nevertheless, a reasonable comparison of the qualities of a FED Governor should possess and Mr. Diamond background clearly demonstrates that he is not the right person for this particular job”. [Committee on Banking, Housing and Urban Affairs, March 8, 2011].