

Atualidades

BRAZIL'S SURVIVAL OF THE 2008 GLOBAL FINANCIAL CRISIS: WERE WE THAT GOOD?

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FIRST WORDS

It's for me a great honor to be at this so important university, to discuss with you a subject that concerns to all the world these days. After all the great question is the *trillion dollar* one: our world how we know it, will survive the financial crises that started in 2008? Just because, as all of you here certainly know, as somebody said once, that all the things concern to the economy: "*it's the economy, stupid*", was the famous expression created by James Carville during the elections for president in United States in 1992. I just read this morning that he gave an advice to President Obama by CNN: "*be in panic, fire a lot of people of your staff!*".

I am very grateful to Professor Guy Hormans, for this opportunity, and, please be kind with my bad English.

INTRODUCTION

As it's widely known, in 2008 a financial crisis was deflagrated with its remote roots in the subprime mortgage market of the United States of America, and spilled over to all the financial system (including banks, capital market and the insurance market).

As it's also known, that major financial institutions in the United States and Europe went bankrupt, among which Lehman Brothers and AIG's cases are notorious. The central banks of several countries, their governments, and financial institutions had to take drastic measures in order to impede the crisis effects from going down on a catastrophic road. Even so, the losses reached billions and billions of dollars.

Brazil was affected by the crisis, up to a certain point. In that occasion, no banks broke, only few had some difficulties that were overcome with the aid from the Brazilian Central Bank measures. Some com-

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panies that had speculated in the derivatives market (for example, Aracruz Celulose and Sadia) suffered significant losses that sharply affected their survival in the market. Sadia (frozen food field) was the object of a reversal in an acquisition process by its competitor: Perdigão. It turned out that Perdigão acquired Sadia.

Some small-size and medium-size banks showed some problems of liquidity, which were overcome by resorting to the emergency measures issued by the Brazilian Central Bank.

At that time, the Brazilian President, Luiz Inácio Lula da Silva, boasted that the country would suffer only a “*marolinha*” (in our colloquial language, *marolinha* is a small wave that softly breaks on the beach). There was an overstatement of optimism, though. However, compared to what other nations were going through during the crisis, the Brazilian situation appeared to be quite favorable, having the financial operations carried out in an almost normal pace within a relatively short time.

The protection of the financial market in Brazil was a result of several historic factors, all of which were rooted in both old and more recent institutional reforms aiming at an effective action against inflation, connected to the creation of our National Financial System (NFS), with the uprising of the Brazilian Central Bank (BCB).

SUMMARY OF THE PROTECTIVE FACTORS OF THE BRAZILIAN FINANCIAL SYSTEM

1. Centralization – The NFS structure;
2. Previous improvement of NFS;
3. Actual autonomy of the BCB;
4. Institution of the Brazilian Payment System – BPS;
5. Focus on the battle against inflation. Effective monetary policy instruments;
6. Legal regime of exchange rates and foreign capital;

7. Prudential measures. Adhesion to Basel Agreements I and II (ICCMCS – International Convergence of Capital Measurement and Capital Standards). Anticipation of Basel III;

8. Emergency measures taken during the crisis.

1. Centralization – The NFS structure

Our centralized and systemic organization has its origin in the Superintendence of Currency and Credit – SUMOC (acronym in Portuguese) in 1945. It was the late beginning of a movement that happened in Latin America, result of the effects of the American recession in the 30's of last century. In this sense, a mission led by Edwin W. Kemmerer, professor of Economics and Finance at University of Princeton visited the region to promote the fundamental principles of central banks, which resulted the foundation of several institutions of this nature in our area, beginning with the Colombian Central Bank in 1923 until the Brazilian Central Bank in 1964, which experienced the previous creation of the SUMOC.

It has been affirmed that a centralized model as the Brazilian, endowed with a sole body in charge of both the financial and capital markets, might have been one of the reasons why Brazil was not sharply affected by the 2008 financial crisis. Acting as shield over all the institutions from both markets, its prudential regulation might have been able to hinder the irregularities in the subprime operations in the United States of America.

Let us look to the structure of our National Financial System – NFS as set forth by the Law 4.595 from December, 31st, 1964.

At the top, there is the National Monetary Board – NMB which has competence to regulate all the financial system (financial market formed by the banks) and capital market (stock exchange market,

public limited companies and brokers partners to distributors that operate in the stock market and in the Over Trade Counter OTC²).

The National System of Private Insurances acts separately, being instituted by the National Private Insurances Board, as a regulatory body and by the Private Insurances Superintendence – SUSEP (acronym in Portuguese) as an executor body of the first-order policies and as a regulatory body of the second-order policies.

However, the NMB may also directly interfere with the insurance sector since it establishes the indexes of the technical reserves of insurance companies and the bonds, in which they must be mandatorily applied. In this sense, our insurance companies cannot operate speculatively in a regulatory and limitless hollow, as it happened in the United States of America (as it seems), which might have been one of the reasons for the bankruptcy of AIG.

Below the NMB is the Brazilian Central Bank – BCB and the Securities and Exchange Commission of Brazil (CVM), the former acts in the financial market, the latter in the capital market.

Conveniently enough, in our original regulatory structure, the BCB had functions in both markets: the financial and the capital markets. The lack of experience in the latter, besides other reasons, caused this market to crash in Brazil in the years of 1969 and 1970, which postponed significantly its consolidation in the country. Following the promulgation of the Law 6.385 from 1976, the competence of the BCB was segmented with the institution of the CVM in accordance with the model of the American Stock and Exchange Commission – SEC.

In doing so, all the Brazilian financial institutions depend on prior and mandatory consent by the BCB to work and since their formation, they are frequently inspected.

2. Over-the-counter.

There is no financial institution out of this system, not taking into account the existence of any marginal market that may be of any relevance.

2. *Previous improvement of FNS* and 3. *Actual autonomy of BCB*

As a result of an intense improvement work carried out by the BCB in the past decades, the market was very stable at the time of the crisis. This process comprehended the creation of two different programs, the first aimed at the public financial institutions (PROES), and the second at private financial institutions (PROER). For this reason, public resources were used by the BCB in the actions taken in order to save the insolvent banks, which were partially returned once the privatization of the institutions were saved.

Operating banks in Brazil had been for long controlled by State Governments. Practically, no one of them met the basic principles of good banking technique, having been widely used for political purposes by their State Governors, exchanging money for votes. It's known that a significant part of the resources of these banks was effectively and fraudulently embezzled. Every state bank was broken and was unduly supported by public resources that gnawed at local finances.

One of the main reasons for the abusive freedom of state banks was the fact that the legislation has never granted the BCB the full autonomy and independence in its function; as a result, there were major political disputes for inspection in state banks and for punishments for embezzlements. The power granted to the BCB to fight against such banks did not come from the law modification, but from an informal agreement with the central government due to the need of taking deep and restrictive measures, under penalty of systemic risk incident. Since Fernando Henrique's mandate and both Lula's mandates, the BCB has actually been granted its auto-

nomy, which has been until now kept in Dilma Rousseff's mandate. As a result, a policy of winding-up state banks that had not gone bankrupt yet was introduced with resources from the PROES.

Some people are afraid that Dilma Rousseff will not maintain the status of independence that BCB had during the last mandates, according to what had recently happened about Brazilian basic economic rate (SELIC), that was strongly decreased in value by BCB (and it was a completely surprise for the market). That measure was interpreted as a real interference done by the federal government, that needed to adopt the preference for increasing the economy instead of take care about the inflation.

Coming back to our subject, there were two major bankruptcies in the public sector: the State Bank of Rio de Janeiro and the State Bank of São Paulo, which wasted hundreds of millions of dollars from PROES. After saved, both banks were sold to the private sector. Santander group acquired BANESPA, which made it penetrate the Brazilian market with a large number of agencies.

In the private banks side, the resources from PROER allowed them to save institutions with serious problems, winding them up or giving their control to other banks. A sorting out mechanism was used in order to sort the "*bad part*" out of the "*good part*". The PROER rescued the former and the latter was sold to other banks.

At the time, the left-side political parties were strongly against both programs, having made its implementation troublesome. After President Lula reached the power, he acknowledged – against his will and never openly declared – that such programs had effectively saved the Brazilian financial system from a deep systemic crisis.

4. Institution of the Brazilian Payment System – BPS

After having good results from the fight against inflation, the BCB carried out a

reform in 2001 and 2002 in the payments system for the purpose of permitting the settlements of interbank funds transfers as soon as possible with irrevocable and unconditional terms.

These measures permitted the reduction of risks in the settlements of interbank operations, consequently reducing the systemic risk. The mechanism turned to impede the domino effect before the bankruptcy of any bank.

At the same time, from June 24th, 2002, after a transition period, any funds transfer between bank reserves accounts became subject to the existence of enough balance in the account of the participant drawer in the correspondent order. As a result, there was a significant reduction in the risk of credit incurred by the Brazilian Central Bank.

The real-time settlements, operation by operation, from April, 22nd, became to be used in operations with federal bonds run through the Special System for Settlement and Custody – SELIC (acronym in Portuguese), which was possible due to the interconnection between this system and the Reserve Transfer System – STR (acronym in Portuguese). The settlements of these operations follow the Delivery Versus Payment (DVP) requisite.

Besides that, all the multilateral clearing system deemed systematically important that the operator entity started to act as a central counterparty and assure the settlement of all operations.

Therefore, the financial institutions should find resources in the interbank market to meet their daily necessities, as needed. At difficult moments when accessing this market is not possible, they may request emergency loans to the BCB. However, if they cannot provide enough guarantees and their bank reserves accounts is on the verge of being over drafted, the BCB may immediately interfere and impede the problem from spreading.

There is a gap of opportunities for only a few hours when the BCB is not totally aware of the situation of turmoil in a financial institution, given that it is when the BPS shows a high rate of systemic security.

5. Focus on the battle against inflation. *Effective monetary policy instruments*

A fifth factor of the security of the National Financial System can be identified by the historical battle faced by successive Brazilian governments against inflation. This wound has made our nation struggle for decades affecting, mainly, low-income people and the small and medium size businesses that did not have structure to use the measures taken to soften the effects of inflation.

The institution of the monetary correction was one of the elements that contributed to create both survival conditions in the inflation and a malefic instrument for its endurance and oppression of the economically weaker people. It dealt mainly with the monetary correction of balances and financial operations. The monetary correction allowed the creditors to maintain their credits monetarily updated, which did not happen to the debtor, especially those without a bank account – the “bankless ones”.

The perversity of the monetary correction climbed to a peak where it was applied on the balances from the night of one day to the morning of the other – the so-called “over-night operations”. During José Sarney’s government, when the inflation reached the plateau of 90% monthly, the “over-night” monetary correction provided great profit to the banks and depositors, going against the general interest of the economy.

Some plans against inflation were made in Brazil; all of them failed due to a lack of appropriate economic grounds. What left the worst memories was the Collor Regime. It started by confiscating

all the financial opportunities in the banks, creating immeasurable distortions in the economy.

Finally the *Plano Real* (Real Plan) almost finished off the inflation (which still lingers partially due to political factors and economic structure). Precisely, for the fact that the BCB does not have full autonomy, its fight against inflation suffers resistance in some sectors of the government. There are left-side politicians supported by “development” economists who believe that some inflation might be healthy for the economy, whereas the orthodox-oriented economists defend that there’s no such thing as “a little inflation” as there is no “half pregnant”.

Since Plano Real, the Brazilian Central Bank has been working on an inflation-goal platform and its activities use monetary policy mechanisms to either irrigate or shrink the money market, according to the needs of the goals. One of the most widely used instruments is the mandatory collection of part of the bank balance from the Central Bank. The direct effect is the reduction of the operational leverage of banks, for being very excessive; it was precisely one of the causes of the bankruptcy of financial institutions in 2008, as we know, in USA and Europe.

During the crisis, the balance of compulsory deposits was at R\$ 272 bn. Considering that in January, 2007 it was at R\$ 170 bn. It means that the settlement rate in the market shrank. Note that the monetary base expanded very little, having increased from R\$ 164 bn. to R\$ 193 bn. in the same period. That is, while the compulsory deposits increased 62.5%, the monetary base increased only 17.68%.

6. Legal regime of exchange *rates and foreign capital*

As Brazil has historically been a weak-currency country and with problems resulting from a negative balance trade, a

strict legislation on exchange rates and foreign capital was passed.

In the same exchange rate field, besides having had a very sensitive evolution in the plan of freedom in the international operations, the banks, for instance, are still forbidden to apply the internally raised resources overseas. This sanction impeded our financial institutions from operating in the subprime derivatives market, where the crisis emerged.

On the other side, the foreign capital, both loans and investments, depend on prior registration in the BCB, in order to return to its origin country with the profits it makes. The BCB refuses operations that come from and go to tax havens, which restricts the excessive flexibility in the financial institutions that operate internationally.

7. Prudential Measures. Adhesion to the Basel Agreements I and II (ICCMCS – International Convergence of Capital Measurement and Capital Standards). Anticipation of Basel III

The improvement made in the NFS by the PROER and PROES programs and the prevention against insolvency cases in financial institutions, demanded the implementation of the principles set forth by the Basel Agreement on its both versions: I and II, as well as the incorporation of principles of Basel III. As a result, Brazil was already on a more advanced level than those other signing countries of the Agreement.

Certainly you know very well this subject, but it's important to remember them now.

• *First Pillar: "Minimum Capital Requirement"*

The levels of minimum capital were established at very high degrees having mechanisms created in order to maintain its integrity.

A new methodology was adopted in order to measure, analyze and manage credit risk (the risk for the bank not receiving) and operational risk (risk of losses resulting from employees mistakes, computer failures or fraud).

The market risk remained unchanged.

• *Second Pillar: "Review of the Supervision Process"*

The Central Banks would be responsible for assessing the way banks estimate the adjustment of its capital needs in relation to the risks taken.

The banks managers should develop an efficient risk management and internal measurement of capitals in accordance with the risk and control profile of their institutions. In Brazil, progressive provisions were made to the mutual operations, rated by the risks classified as A – H. In the latter, the provision required is of 100% over the operation value.

The internal processes were submitted to BCB's approval, being subject to interferences if needed.

The interest rates test was established in bank records.

The BCB began to examine the internal interest rates risk measurement systems and control whether the institutions are keeping capital at the interest rates risk level.

The quality of bank supervisors in Brazil has been quite good, being a consensus that the employees of the BCB represented the finest of the public service in Brazil.

• *Third Pillar: "Market Discipline"*

A better discipline in the market has been stimulated, increasing the transparency in the banks regarding available information endowed of high control level.

As there is no such thing as a perfect system, some insignificant failures were

spotted and readily resolved, such as the bankruptcy of Santos Bank and, more recently, Panamericano Bank, both involved in fraudulent operations. There was no significant systemic danger to the market.

8. *Emergency Measures taken during the crisis*

As soon as the crisis broke out, some emergency measures were taken by BCB in order to lessen the problems caused by the spread of the international financial crisis, targeting at the rediscount operations. In this case, some special criteria and conditions were established for the assessment and acceptance of assets received by the BCB in discount operations, either in national currency or as a loan guaranty in foreign currency. For a period of time, the requirements predicted in law were disregarded.

Two banks controlled by the federal government were authorized to form subsidiary partnerships for the purchase of shares of financial institutions headquartered in Brazil (Banco do Brasil and Caixa Econômica Federal). This mechanism allowed the fact of neutralizing the effects of banks that showed bankruptcy risks.

In financial aid operations, the chief officers of bankrupted financial institutions had to provide personal guaranties or through companies in their groups for permission. In the event of breach, the BCB has the power to sell the guaranties received through public offering.

The bank intervention and liquidation instruments were kept at the BCB's disposal.

A resolution by the National Monetary Board (n. 3.621 from October, 10th, 2008) permitted the formation of swap contracts between the BCB and FED from NY.

CONCLUSION

All in all, either because of the use of instruments that had already been constitut-

ed for prevention during the past years or because of the adoption of efficient emergency measures, it is possible to say that the Brazilian banks were not at a risky situation and that Brazil had effective instruments to face a systemic international financial crisis. There was no bank bankruptcy resulting from risk exposure, but only a few of them suffered some crisis effect without contaminating the market.

Note that Lula's government, conversely to what he has always affirmed, received from the two previous mandates, expressly from Fernando Henrique Cardoso's, *a blessed inheritance*.

As it has been concluded, the first exchange rates protective laws which are currently valid came from the first half of the last century. The foreign capital laws, the ones for the NFS and the ones for the capital market are from the 1960's. The laws for business corporations and for the Securities and Exchange Commission of Brazil (CVM) are from the 1970's. The *Plano Real* was edited when Fernando Henrique Cardoso was Ministry of the Treasury Department and was completely instituted when he became president.

President Lula played an important role in his government when he kept the game rules and granted full autonomy to Henrique Meirelles, President of the BCB at the time.

Two major companies and some small and medium size banks had to bear the price of their speculation in derivatives. The economy as a whole had its activities level reduced, with some areas being more affected than others.

However, it was possible to bring businesses back to normal, until the 2011 financial crisis broke out. But this is a different story. I may come back next year to tell you about.

Certainly this is not a financial crisis. It is much more than that, as all you know.

Thank you very much.

