Credit Markets

Improving the efficiency of credit markets

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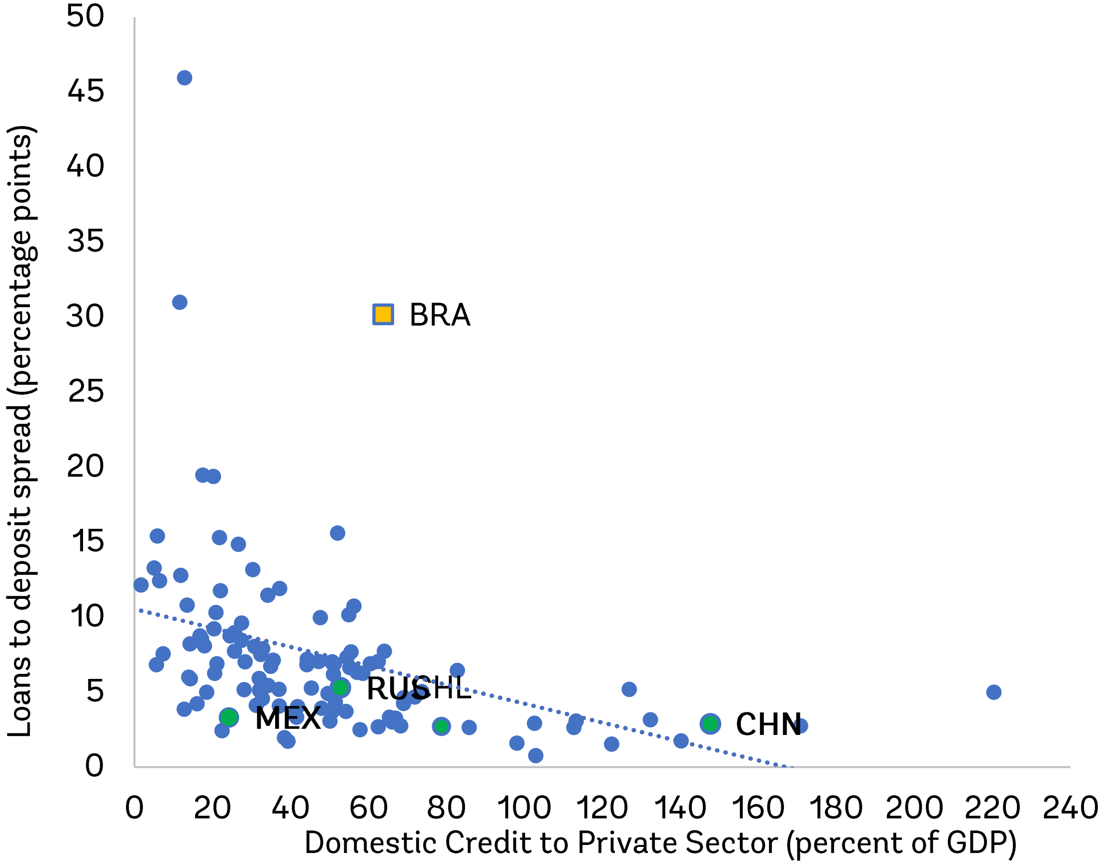
I. Key Sectoral Challenges

Credit market is characterized by high interest rates and short maturities

Figure 1: Brazil’s Spread Credit, Average 2013-2017



Source: International Financial Statisitics.

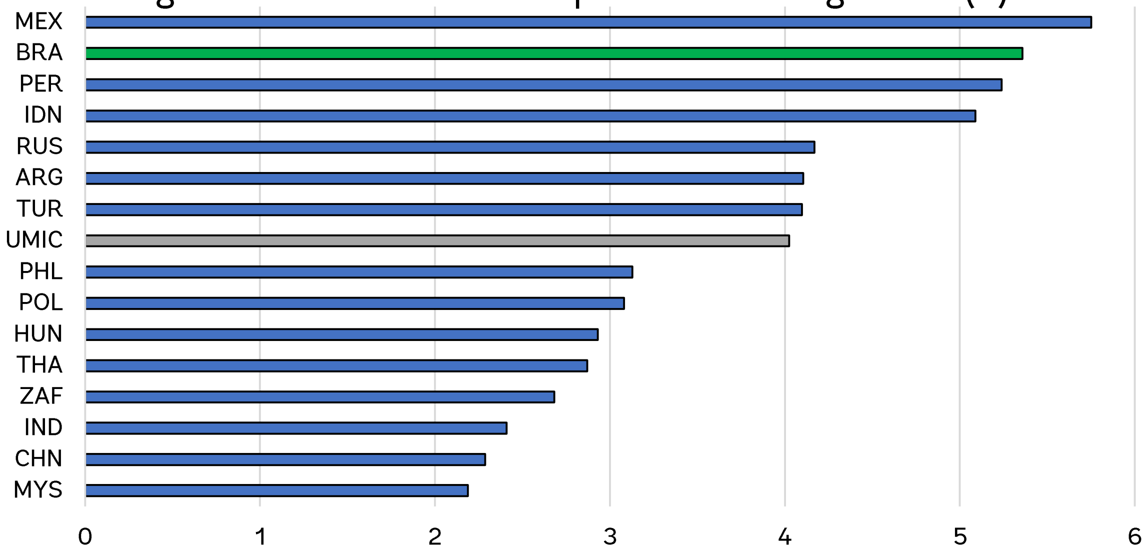
Note: 11 countries with a negative spread have been excluded.

- Low level of savings, fiscal deficits, inflation, and elevated and volatile interest rates have held back the evolution of a well functioning credit market.
- Thus, financial intermediation remains below international peers, at 60% of GDP in 2017 (compared to a median of 72% of similar economies, or 115% for upper MICs.)
- Financing is mostly short term, constraining financing for longer-term capital investment…
- …and very costly, with very high loan-to-deposit spreads at about 30%, making Brazil an international outlier.

Banks' net interest margins (NIMs) are higher than in peer countries

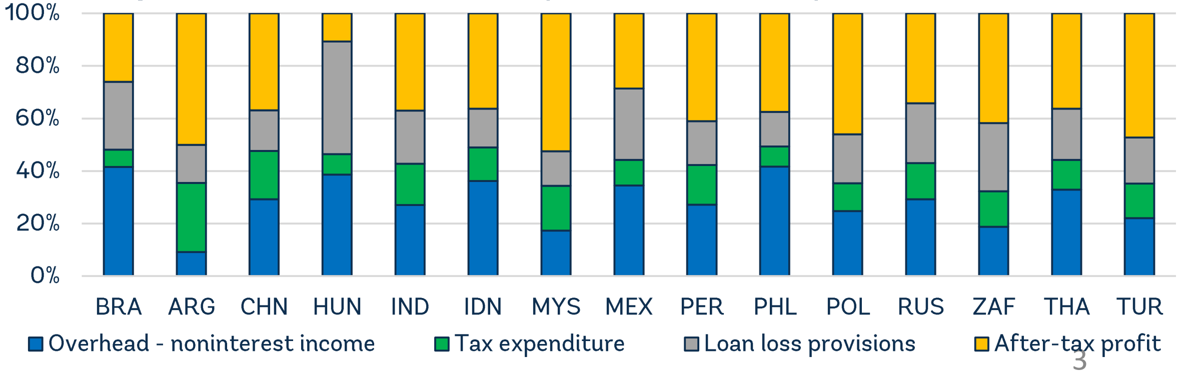
- Weighted average of NIMs in Brazil was 5.4% over 2005-2014, the 2nd highest of its peers.
- Data from a 179 countries over 2005-2015 finds negative association of net interest margins with private credit/GDP. Countries with lower NIMs have higher financial development and savings intermediation.
- Overhead costs and loan loss provisioning are the most important components of net interest margins in Brazil. Labor costs, taxes, credit risks, poor enforcement all likely to contribute.
- Brazilian banks' profitability was 4.4% higher when compared to other industries and much higher than other emerging markets. Could point to a lack of competition.

Figure 2: International Comparison – Average NIMs (%)



Source:: Bankscope; World Bank analysis

Figure 3: International comparison - Decomposition of NIMs

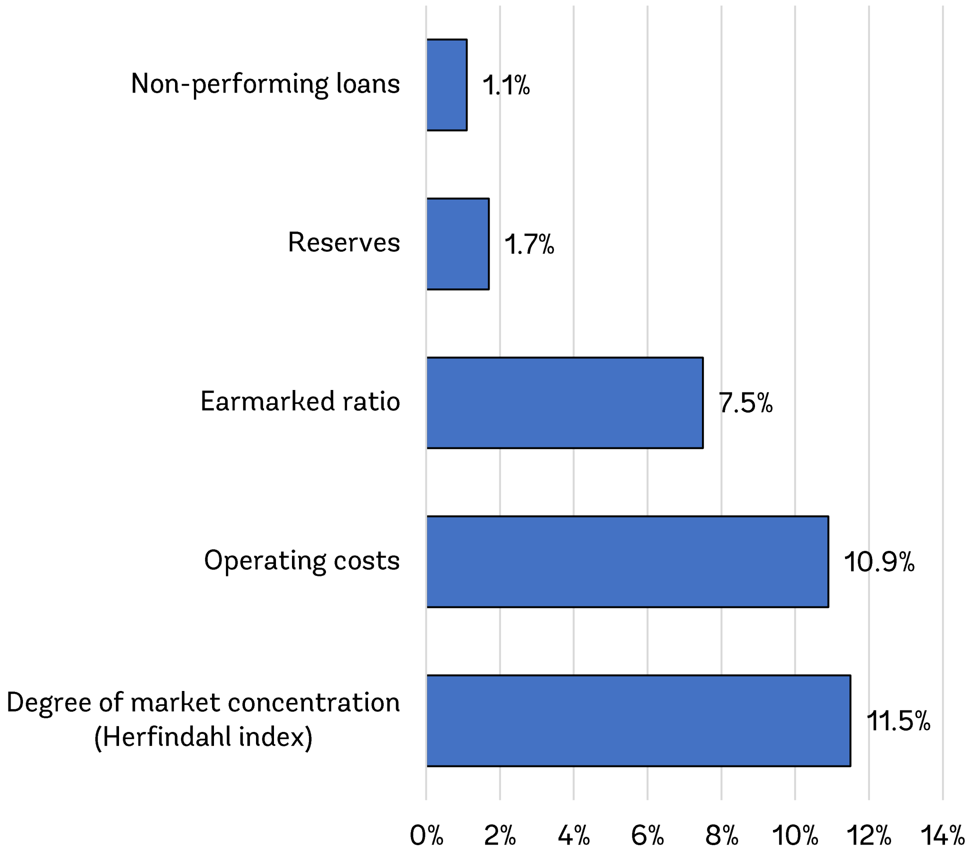


Source:: Bankscope; World Bank analysis

Market concentration is associated with higher spreads

- **Market concentration is associated with higher spreads (particularly at the product level) – but link to competition needs further investigation**
- **Almost half of the banking system is state-owned and concentrated**
    - Largest 6 banks account for 81% of system assets.
    - The 3 largest private banks account for 69% of private banks' assets.
    - High concentration of branches: 90% by the top 5.
    - Market concentration is especially severe in the credit market.
- **Average interest spreads are significantly higher for the largest 3 private banks, which are also vertically integrated with other businesses, allowing for bundling, cross-selling, and cross-subsidization of products.**
- **High switching costs may contribute to interest rate spreads.**
    - Banks impose high administrative burden to discourage customers from switching.

Figure 4: Marginal effect on the net interest spread from a one-standard deviation increase in each driver



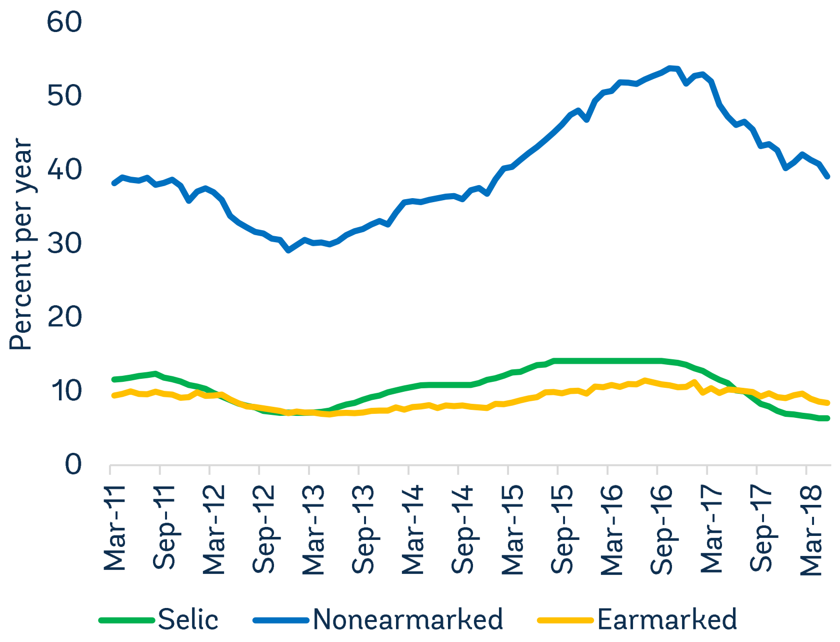
A segmented financial sector: half the credit is earmarked and subsidized

- To mitigate the lack of well-functioning private credit markets, the government introduced significant intervention to foster longer-term finance at regulated interest rates—most notably through various programs to earmark credit targeted to infrastructure, agriculture, and housing.
- Earmarked credit is funded with constitutional funds, federal government lending, tax exempt financial instruments, and demand deposits.
- Earmarked rates have been below market rates (and often below government's borrowing costs).
    - Until 2018, earmarked financing for enterprises was priced at a regulated rate, the TJLP (Taxa de Juros de Longo Prazo); Now there is a new long term lending rate, the TLP.
    - Housing finance market has been based on another regulated rate, the TR (Taxa Referencial).
    - Agricultural credit market has been subsidized at specific rates set for different segments.
- Earmarked credit is mostly intermediated through public banks.
- Subsidized earmarked credit expanded rapidly after the global financial crisis and today accounts for almost half of credit in the economy.

Public intervention has negatively impacted the free market

- The fiscal cost of credit market interventions peaked at an estimated 2.1% of GDP in 2015.
- Regulated interest rates that do not respond to monetary policy present challenges to monetary transmission.
- WB analysis indicates that cross-subsidies from earmarked to non-earmarked loans are an important driver of spreads.
  - Banks may enter in markets with subsidized spreads, and cross sell free market products.
  - Amongst private banks, those with a higher share of lending in earmarked credit, charge higher interest rates in free market loans.
- The earmarked lending requirements associated with demand deposits along with large reserve requirements (only recently reduced) make it expensive to finance free market credit through deposits.

Figure 5: Earmarked and Free Spreads in Brazil



Financial infrastructure gaps in reporting, collateral and insolvency

Financial infrastructure gaps in the credit reporting, and insolvency and collateral regimes have also presented challenges for an effective functioning of the credit markets.

- Credit Reporting System
  - Comprehensive credit reporting systems associated with enhanced access to finance and improved terms of financing.
  - Underdeveloped credit reporting system in Brazil -sharing mostly negative information.
  - A critical reform measure is the changes to the rules governing the Cadastro Positivo—with mandatory contribution of positive and negative data, on an opt out basis.
- Collateral Registries
  - Introduction of centralized, modern registries for movable assets improve firms' access to finance.
  - The legal and registry framework for secured lending in Brazil through movable collateral is fragmented, creating barriers for financing, especially SMEs.
  - Reform of "duplicata electronica" will eliminate paper-based documents and (i) reduce forgery and fraud; (ii) improve the legal and transactional certainty; (iii) reduce costs; and (iv) enable discounting, securitization, trading through electronic platforms.

Financial infrastructure gaps in reporting, collateral and insolvency

- **Insolvency framework**
  - Effective insolvency framework can address judicial inefficiencies, especially collateral execution, and contribute to reduced cost of financing.
  - Creditor rights, proxied by DB's legal rights index, compare unfavorably (2 compared to 5 in LAC).
  - Contract enforcement is weak: A recovery rate of 13 cents on the dollar (31 cents in LAC).
  - The judicial system is inefficient: Reorganization and liquidation procedures take 4 years on average (2.9 in LAC).
  - Brazil has embarked on an ambitious process of insolvency law reform.

Policy directions should focus on three main areas

In order to improve the functioning of the credit markets in Brazil, policy directions should focus on:

Reforms	Difficulty	Impact
Evaluate and promote competition	High	High
Optimize public interventions	High	High
Address financial infrastructure gaps	Medium	High

Evaluating and promoting competitive conduct in the financial sector
- Interoperability
- Competition in retail payments
- Role of alternative providers (credit cooperatives)

Reviewing and optimizing public interventions
- Review Objectives in a Coordinated Effort
- Evaluate and reform housing and rural finance programs
- Evaluate and streamline credit guarantee programs

Addressing gaps in financial infrastructure
- Cadastro Positivo-regulatory framework
- Secured transactions framework
- Insolvency Framework

Evaluate and promote competitive conduct in the financial sector

1. Conduct in-depth analysis of competitive conduct and institutional framework of competition policy.

2. Promote competition in the payments market
   - Enforce interoperability between MNOs, bank card issuers, acquirers;
   - Improve transparency, unbundling of services, and cost reduction (interchange fees);
   - Develop a specific Fintech framework to encourage innovations;
   - Promote open-banking – authorize third parties to develop services for customers;
   - Review agency regulation - ease minimum requirements for agents; Impose restrictions on agent exclusivity; and
   - Standardize disclosure forms for key financial products and comparators of basic fees and charges.

3. Promote role of credit cooperatives as alternative credit providers.

Reviewing and optimizing public interventions

1. **Objectives for earmarked credit interventions must be reviewed in a coordinated manner.**

2. **Clearly evaluate housing and rural finance programs for impact and distribution of subsidies—reforms needed in both sectors:**
   - Agriculture – Reduce earmarked lending requirements; make subsidies explicit and focused on segments that need the most (i.e. small farmers) or to finance smart agriculture; expand space for private banks to enter the agrifinance business;
   - Housing - System relies on savings deposit collection at the regulated rates, creating exposure to increasing interest rates. Offer up-front subsidies to targeted beneficiaries to help with a down payment; and
   - Disconnect subsidies from credit decisions to improve transparency – Similar reforms to the TLP needed in the housing and rural sectors – tying the cost of finance in the earmarked credit to the Government's cost of funds.

3. **Evaluate and streamline credit guarantee programs.**
   - Overlap, operational differences as the agriculture sector is not benefitting.

Addressing gaps in financial infrastructure

1. **Develop regulatory and oversight framework for Cadastro Positivo:**
   - Licensing process, impact of new entrants (FinTechs), competition, oversight framework defining role of authorities.

2. **Secured transactions:**
   - Legal deficiencies in secured transactions;
   - Interoperability of movable asset registries;
   - Speedy and effective enforcement remedies—extra judicial methods; and
   - Infrastructure for "duplicatas" should be replicated for other types of movable assets.

3. **Adopt insolvency legislation:**
   - Improved creditor rights, strengthened extrajudicial recovery, a more agile judicial recovery for MSEs, quicker fresh start for individual entrepreneurs.

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Main challenges:

1. **Financial intermediation is costly and with high spreads, making Brazil an international outlier with higher net interest margins than in peer countries.**
   - Very high loan-to-deposit spreads at about 30%.
   - Overhead costs and loan loss provisioning are the main components of net interest margins.
   - Market concentration in the credit market has the strongest association with the spreads.

2. **High public interventions create distortions—present high fiscal costs, challenges for monetary policy transmission, and contribute to increased spreads in the free market.**
   - Half of credit to economy is earmarked, mostly at regulated interest rates.
   - Banks' cross—subsidies from earmarked to non-earmarked loans are an important driver of spreads.

3. **Financial infrastructure gaps in the credit reporting, and insolvency and collateral regimes present inefficiencies, resulting in higher costs for banks.**
   - Poor creditor rights – Doing Business Legal Index of 2 in Brazil (5 in LAC)
   - Weak contract enforcement – Recovery rate of 13 cents on the US$ (31 cents in LAC)

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Key recommendations:

1. **Evaluate and promote competitive conduct in the financial sector.**
    - Conduct in-depth analysis of competitive conduct and institutional framework of competition policy;
    - Promote competition in the payments market – payments interoperability, transparency, open-banking, bank agents regulation; and
    - Promote role of credit cooperatives as alternative credit providers.
2. **Review and optimize public interventions**
    - Review objectives for earmarked credit interventions in a coordinated manner;
    - Clearly evaluate housing and rural finance programs for impact and distribution of subsidies-similar TLP like reforms; and
    - Evaluate and streamline credit guarantee programs.
3. **Address gaps in financial infrastructure**
    - Develop regulatory and oversight framework for credit bureaus;
    - Address legal and enforcement deficiencies for secured transactions; ensure interoperability of movable asset registries; and
    - Adopt strengthened insolvency legislation.

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