In Good Times or Bad, Brazil Banks Profit

By DAN HORCHAUG, **New York Times**, 13/08/2015

A Banco do Brasil branch in Rio de Janeiro. Even as the economy has stagnated, banks have performed impressively. Credit Pilar Olivares/Reuters

SÃO PAULO, Brazil — Political parties whose symbol is a red star tend to be unfavorable for bankers, but Brazil's ruling party has been a lucrative exception.

When the Workers' Party of former President Luiz Inácio Lula da Silva and current President Dilma Rousseff took power in 2003, it promised, and for many years delivered, a rising standard of living for the country's poor and working classes.

Yet the gains have been much more impressive for the nation's banking industry, even as the manufacturing sector has stagnated and the broader economy has ridden the ups and downs of global commodity prices. The combined annual profits of Brazil's four biggest banks have grown more than 850 percent to just over $20 billion, from $2.1 billion, in the 12 years of Workers' Party rule.

Even as a corruption scandal centered in the government-owned petroleum giant Petrobras has paralyzed important sectors of the economy, bank profits have kept growing. Bank earnings made up more than half of the total profits for companies on the São Paulo stock exchange in both 2013 and 2014, according to the consulting firm

Economatica. While the stock market is a poor reflection of Brazil's economy — agribusiness and carmakers are barely represented — bank profits were never above a quarter of the total all through the previous decade.

Brazil's largest and third-largest banks, Banco do Brasil and Caixa Econômica Federal, do not even have profit as their sole mandate. The government, which controls both, often obliges them to engage in less profitable operations as a public service.

The two giant private sector banks, Itaú and Bradesco, consistently earn returns on equity — a measure of the earnings a company can squeeze out of each dollar invested — of around 20 percent. Big banks in the United States usually manage only about half as much.

Government policies and economic trends have helped the banks here.

One is interest rates at levels so high that they would leave borrowers in most other countries speechless.

In the so-called non-earmarked or free credit market, which excludes government-subsidized loans for housing and infrastructure, Brazilian consumers pay on average 58.6 percent interest, and businesses pay 27.5 percent to borrow money.

Brazilian academics argue over the reasons for such high rates, but a history of high inflation, sharp currency fluctuations and large government budget deficits mean that the government itself must pay a steep price to borrow money.

The central bank's basic rate, which it pays on the local equivalent of Treasury bills, is 14.25 percent.

Since banks can make good money by just buying government bonds, to take the effort and risk of actually making loans, they need an even greater profit.

They can often find it. The average spread — the difference between what banks pay to gain access to capital and what they charge to lend it out — is 30.7 percentage points in the free credit market.

Not all of that is profit. Taxes and regulatory costs are high, and the government just announced a plan to further increase taxes on bank profits. And default is a serious risk. Nearly 56 million Brazilians, more than a quarter of the country's population, have missed enough debt payments to be on the blacklist of Serasa Experian, a credit reporting bureau.

But the spreads are easily wide enough to compensate, especially when the economy is growing.

And when times are bad, the banks can look to the government.

Brazil's Treasury not only sells bonds that protect investors against inflation, as certain United States Treasury bonds do; it also offers bonds that increase their payouts when interest rates rise or the currency devalues.

When banks sense that the economy is about to deteriorate, they scale back their loans and migrate into these government-backed investments.

As a result, many of Brazil's recent economic troubles, like inflation of nearly 9 percent, a plunging currency and rising interest rates, have actually bolstered banks' bottom lines.

"Banks here are experts at navigating economic instability," said Luiz Fernando de Paula, an economics professor at Rio de Janeiro State University. "Because of government bonds that offer protection, currency crises and interest rate shocks do not become banking crises. The government pays the price instead."

In a sign of just how intertwined the government and banks are, Brazil's banking industry owns nearly 27 percent of the national debt.

A lack of competition may also be helping profits.

Ever since a banking crisis in the 1990s threatened scores of financial institutions with insolvency, the authorities have encouraged a string of mergers and acquisitions.

"No government official ever made a statement on the subject, but we have seen a regulatory bias that favors fewer but more solid banks," said Roberto Luis Troster, a former chief economist for the Brazilian Federation of Banks.

By one measure, this policy has been a success. The way that many United States and European banks were rocked in the 2008 financial crisis is nearly unimaginable in Brazil.

"With such high spreads on loans, traditional banking operations are so profitable that the banks here don't need to assume much risk," said Luis Miguel Santacreu, financial sector analyst at the Brazilian credit ratings agency Austin Rating. "It is very unlikely that any big bank would need a capital injection to survive."

But borrowers also have few options to shop for better prices.

When President da Silva took office in 2003, the four biggest banks had 53 percent of the banking system's total assets, according to Brazil's central bank. They now have over 70 percent, and many of the smaller banks operate only in limited segments of the market.

"There is some evidence that the banks have oligopoly pricing power," Professor de Paula said.

Not only has the market share of the biggest banks risen, but the credit market itself boomed after first President da Silva, then President Rousseff changed regulations to make it easier for consumers and small businesses to borrow.

Both groups responded enthusiastically. Many low- and middle-income consumers borrowed heavily to buy their first household appliances or cars.

Private sector debt has risen to nearly 70 percent of the economy from 30 percent when President da Silva took office.

That is still low by global standards. In the United States, the ratio is closer to 200 percent, and even the Germans have more private sector debt relative to their economy's size than Brazilians do.

But high interest rates make even modest debt a heavy burden. The average Brazilian household spends 22 percent of its monthly income on debt payments, according to the central bank. The National Confederation of Commerce puts the number even higher, at 31 percent.

The average American household spends under 10 percent of its income on debt payments.

With borrowers overstretched, the banks' days of rapid growth may be coming to a close. Growth through acquisitions is also nearing its limit.

With Bradesco reaching a deal last week to acquire HSBC's operations in Brazil for $5.2 billion, the top four banks' control of the system's total assets will be near the 75 percent maximum that the central bank established in 2012. As a result, the authorities may block further acquisitions.

And if Brazil's recession drags on much longer, default rates will rise. But even if earnings no longer grow as quickly as in the past, they will probably remain strong, even while the broader economy does poorly.

"The banks are reducing their volume of loans, but interest rates are higher than before, spreads are also rising, and they're making money on government bonds," Mr. Santacreu said.

"There's no way that they won't make a good profit."

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