MAYER • BROWN
TAUIL • CHEQUER

Banking
Newsletter

December, 2017

Rethinking Infrastructure in Brazil | The New BNDES Benchmark Lending Rate

On September 21, 2017, the Brazilian Government finally converted into law the Executive Act No. 777/2017, which created the new market-based rate (TLP) that will replace the long-term corporate lending rate (TJLP) as a benchmark for loans granted by the Brazilian Development Bank (BNDES). By adopting this measure, BNDES is trying to reduce subsidized lending, apply stricter criteria for financing and achieve a steep increase in the benchmark interest rate it has long used.

The new approach of BNDES presents challenges for future infrastructure projects in Brazil. But the hope is that the changes promoted by BNDES will encourage a deeper and more competitive project finance market.

The purpose of BNDES.

BNDES was established on June 20, 1952, under Law No. 1,628, as a government agency, with the main purpose of developing and carrying out national policy for economic development. Over time, BNDES was converted into a state-owned company according to Law No. 5,662/1971. Since its foundation, BNDES has played an essential role in boosting the expansion of industry and infrastructure projects in Brazil, offering several financial facilities to Brazilian companies of all sizes as well as public administration entities, enabling investments in all sectors of the economy. Not by coincidence, BNDES became the major source of long-term financing in Brazil, mainly because of the low interest rate linked to such financings (i.e. TJLP).

What is the TJLP?

TJLP (Long Term Interest Rate) was created in 1994 by the Executive Act No. 684 (subsequently converted into Law No. 9,365/1996) as a benchmark interest rate to be charged in long-term financing transactions, including the ones performed by BNDES. The idea behind the creation of the TJLP was to translate to the Brazilian environment the long-term interest rates prevailing in the international markets. With that in mind, the National Monetary Council (Conselho Monetário Nacional) was to establish the TJLP on a quarterly basis, based on long-term international real interest rate, domestic inflation, and Brazil's country risk.

Over time, however, the lack of hard parameters for the establishment of the TJLP left the door open for a high degree of discretion. And as time passed, the TJLP was normally fixed at a percentage lower than what the regulation originally predicted, resulting in an increasing gap between TJLP and the Selic rate (the "Special Clearance and Escrow System" is the main instrument used by the Central Bank of Brazil to control official inflation and that represents the average rate weighted by the volume of one-day operations guaranteed by Federal Government securities). As an answer to such a gap, the Brazilian Government cited the necessity to improve investments through cheaper long-term credit facilities (especially investments in the infrastructure sector).

As a result of the implementation of the TJLP, Brazil saw BNDES' loans portfolio grow exponentially in the last couple of decades. However, this inevitably led to difficulties, as the low interest rate charged by BNDES had a severe impact on the Brazilian lending market.

First, the disassociation between the Selic rate and the TJLP represented an implicit subsidy on the transactions performed by BNDES, the cost of which is supported by the National Treasury. It is important to keep in mind that BNDES is only able to charge such low interest rates because its funding cost is also very low thanks to specific sources of financing, including the National Treasury. In recent years, the National Treasury has not only transferred amounts to enhance the capital of BNDES, but also to cover the fiscal cost of the loan transactions, as the National Treasury itself has a funding cost close to the Selic rate, well above the TJLP.

Second, the efficiency of the Brazilian monetary policy was also heavily affected by the huge number of loans granted by BNDES under a very low interest rate. When almost all of the long-term financing is performed with funds from BNDES, the basic interest rate (Selic) fluctuation policy, used by the Brazilian Government to control the credit and the economy, does not fulfill its role. Therefore, when there is a need to increase the Selic rate in order to slow down the economy and control the inflation but a great portion of the credit is not affected, the increase has to be higher to compensate such lack of efficiency.

Finally, the large quantity of subsidized financing from BNDES was disadvantageous to the local market for long-term loans (via private sector banks or capital market transactions). The private banks, when acting as on-lenders to BNDES (resellers), had a much reduced spread and, therefore, tried to compensate such loss by increasing their spread in other banking transactions. In addition, as the banks could not compete with the lower rates charged by BNDES, the long-term market was completely dominated by BNDES.

What is the TLP?

TLP will be calculated monthly by the Brazilian Central Bank and will be comprised of: (a) IPCA inflation index (*National Consumer Price Index*); and (b) a fixed rate (spread) based on the yields on five-year inflation-linked government bonds known as NTN-B (*National Treasury Notes - Series B*).

At first sight, TLP and TJLP may have similar parameters. But, on closer inspection, these two interest rates are fundamentally different. First, while the TJLP was created to reflect the long-term interest rates prevailing in the international markets and adjusted to the country-specific risk, the TLP is calculated based on a domestic interest rate projected for a longer period. Second, while the TJLP is established by the National Monetary Council on a quarterly basis, the TLP shall be calculated monthly by the Central Bank of Brazil, reflecting the current market conditions. Combined, such aspects grant TLP a much more transparent and market-based reference rate.

It is import to note, however, that TLP will not come into effect until January 2018 – which means that all loans granted by BNDES up to December 31, 2017, will continue to be benchmarked by TJLP. In addition, in order to avoid any disruption in the market, the implementation of the TLP will occur gradually, transitioning over a five-year period.

How will TLP affect the Brazilian lending market?

Although it is too early to measure the impacts of the replacement of the TJLP by the TLP, the hope is that the changes will encourage a deeper and more competitive project finance market in Brazil and bring several benefits to the Brazilian market, as follows:

- <u>Brazilian Monetary Policy</u>. Taking into consideration that the TLP will be much closer to the Selic rate (at least in theory), the efficiency of the Brazilian monetary policy will tend to increase, both stimulating and tightening the economy, and decreasing the volatility of the interest structure in Brazil.

- <u>Local Market</u>. As BNDES' loans become more expensive, difference sources of financing tend to arise, especially the ones provided by private sector banks or by capital market transactions, strengthening the Brazilian local market.

- <u>Implicit Subsidies</u>. As mentioned before, the National Treasury has been covering the fiscal cost of BNDES' loan transactions for quite a while (difference between the National Treasury funding and the TJLP charged by BNDES). As TLP gets closer to the National Treasury cost of funding, the so-called "implicit subsidy" in BNDES' financings will eventually disappear at the end of the five-year transition period. It was inexplicable how certain economic groups could finance themselves with interest rates lower than the government itself.

It is important to note that the reform does not exclude, in any way, the possibility for the Brazilian Government to provide subsidized credit. It only disassociates the offer of subsidies associated with BNDES credit from the decision to provide the credit itself. The current implicit subsidies in BNDES credit are quite unclear, as they do not appear in the budget, but still increase the public debt. Therefore, we believe the new regulation may bring several benefits in this regard, in particular that: (i) it maintains full flexibility for the Brazilian Government to offer subsidized credits; (ii) it should make these subsidies transparent and included in the budget, which is necessary in a fiscally constrained environment; and (iii) it should make easier to distribute any subsidies where they have the greatest impact.

Will the private sector still show demand for funding long-term infrastructure projects?

The question that remains is: how to create institutional and market conditions capable of attracting private capital?

Brazil has a large, local institutional investors' base and the local debt capital markets and private sector banks have the potential (and demand) to fund long-term infrastructure projects. In addition, several sources of external debt financing are available to fund projects in Brazil. But in order for such institutions to enter the long-term market and assume BNDES' former role, certain challenges will have to be overcome and the Brazilian lending market itself should become much more sophisticated.

- Sponsors of projects may be willing to accept higher levels of risk in exchange for higher expected returns on their equity, but lenders typically have a lower tolerance for risk. The Brazilian Government will be forced to implement clear and more stable regulations, efficient bidding and awarding procedures, solid rule of laws and the absence of political interference in the infrastructure sector. Improved contract arrangements would be an important step forward. In particular, only those risks that the private sector can actually control should be allocated to it.

- Currency risk has been a critical feature for foreign investments. On top of that, hedging contracts are usually limited to short-term transactions. The Brazilian Government must develop mechanisms to mitigate such risk.

- Tax incentives have always been a key issue for infrastructure financing and in this sense a wide variety of tax incentives must be implemented to stimulate the private financing market.

- Multilaterals institutions need to expand their current offering of loans and guarantees in the Brazilian market, including local currency lending and liquidity backstopping to mitigate exchange-devaluation risk.

Conclusion

By stepping aside, BNDES is seeking to open the space for private capital to help stimulate investment, which is seen as the key to paving the way for sustainable growth in the long run, and companies will have to look for alternate sources for new projects. It is proving to be a new phase of Brazil's long-term credit market.

For more information regarding this newsletter and to receive our previous issues please contact:

Eduardo Lima
+55 (11) 2504-4238
elima@mayerbrown.com

Priscilla Santos
+55 (11) 2504-4269
ppsantos@mayerbrown.com