Policy Innovations to Improve Access to Financial Services: The Case of Brazil

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Abstract

This paper has two parts. In Part I, we present an overview of the recent evolution of the banking sector in Brazil and relate it to some of the 10 Principles laid out in the CGD task force report Policy Principles for Expanding Financial Access. In Part II, we study some specific initiatives for improving financial access in Brazil, namely: (i) correspondent banking, (ii) simplified bank accounts, and (iii) payroll bank loans.

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Policy Innovations to Improve Access to Financial Services: The Case of Brazil

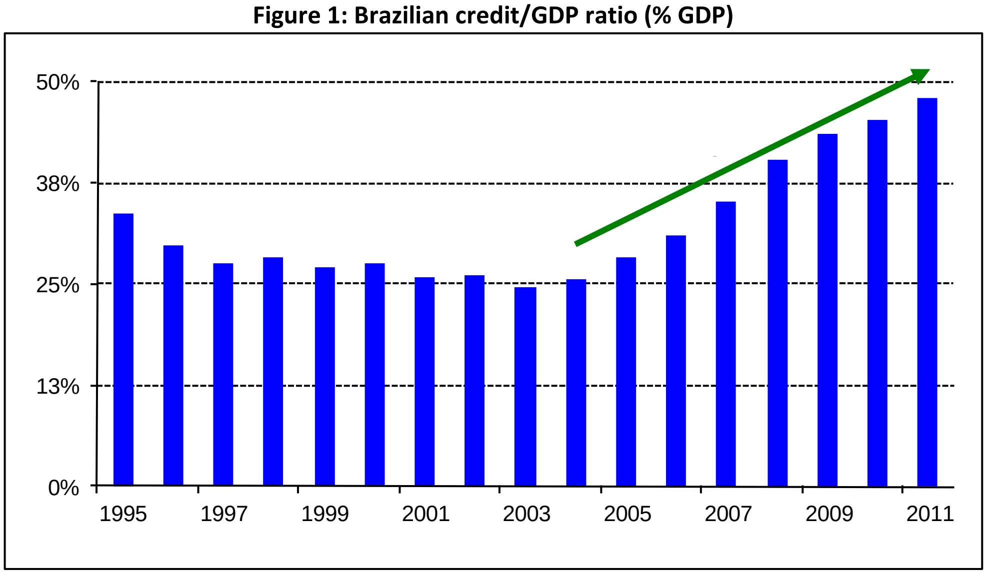
The case study for Brazil follows the overall approach for the project and is divided in two parts. In Part 1, an evaluation of the Brazilian situation against some of the ten task force Principles is performed. In Part 2, some exemplary innovations and initiatives to improve financial access in Brazil will be presented and further discussed.

Access to Finance in Brazil: case study, Part I

1. Financial access in Brazil

In recent years the Brazilian economy has undergone a robust process of financial deepening. Based on a strong banking system and favorable macroeconomic conditions, the proportion of total credit to GDP rose from an average of 27 percent between 1998 and 2003 to 48 percent in 2011. Not only has the size of the credit market increased significantly, the speed of this increase has been equally impressive, with total loans growing at an average annual rate of 21 percent between 2003 and 2011 (Figure 1).

Figure 1: Brazilian credit/GDP ratio (% GDP)

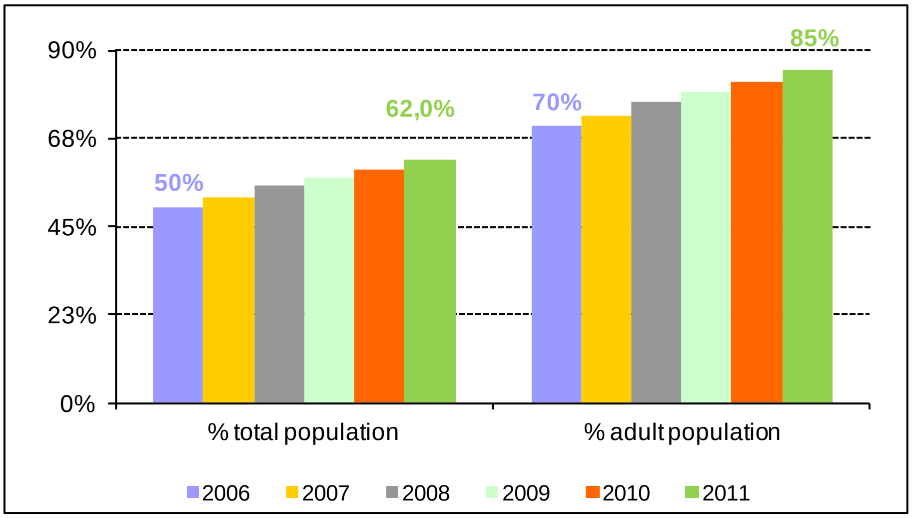


Notes: 2011 data are only until November.
Source: Central Bank of Brazil.

This financial deepening is characteristic of developing countries. In Brazil, this process has been accompanied by an effective improvement in people's access to financial services.

According to the Central Bank of Brazil (BCB) data, the banked population increased from 50 percent of the total population in 2006[2] to 62 percent of the total population in 2011. When considering only the adult population (over 15 years of age), this percentage rose from 70 percent in 2006 to 85 percent in 2011(Figure 2).

Figure 2: Total financial system customers in Brazil (% population)



2011 data only until November.
Source: Central Bank of Brazil and IBGE.

This growing portion of the population is served by a denser network of financial service providers. In Brazil, the number of bank branches per 100,000 adults rose from 13.7 to 14.7 between 2006 and 2011. Similarly, the number of service outposts[3] increased from 30 to 35 establishments per 100,000 adults between 2006 and 2011.

Another noteworthy observation is the increase in the number of bank correspondent units. Bank correspondent units are financial and non-financial firms contracted by financial institutions to provide certain types of financial services. The number of correspondents has grown greatly, with a network of 113 establishments per 100,000 adults in 2011 compared to 55.4 points per 100,000 adults in 2006

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[2] According to the Central Bank CCS (*Cadastro de Clientes do SFN*) system, a bank customer is someone who has a relationship with a bank that requires registration. This definition includes account holders, investors and borrowers.

[3] In Brazil, financial services provision is complemented by service outposts. These establishments have their own regulation and generally offer a more limited range of services than the traditional bank branches. The main types of service outposts are the PAA, PAB, PAC and PAE. PAAs (Posto de Atendimento Avançado) have the range of services defined by the financial institution and can be opened only in municipalities in which the respective institution does not have a PAA or a bank branch in operation. PABs (Posto de Atendimento Bancário) are posts located inside public and private institutions and provide all the services authorized for the respective financial institution. PAC (Posto de Atendimento Cooperativo) is a credit union establishment authorized to provide all the services of the respective financial institution. Finally, PAEs (Posto de Atendimento Eletrônico) are posts served exclusively by ATMs (Automated Teller Machine).

(Table 1). This type of financial intermediary is very important for the recent expansion in the financial access in Brazil and will be discussed in greater detail in the second part of this paper.

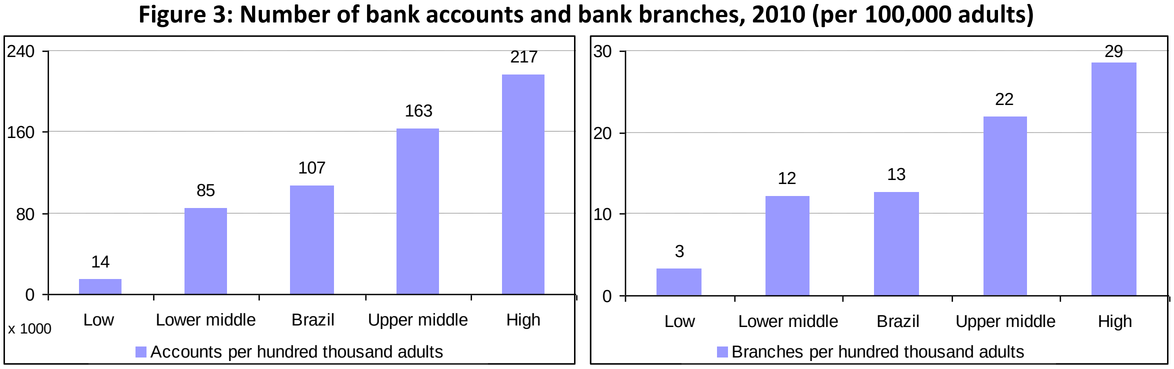
Table 1: Number of bank branches, service outposts and bank correspondents in Brazil (per 100,000 adults)

Year	Branches	Service outposts	Correspondents
2002	14.0	24.3	26.7
2003	13.5	25.2	29.3
2004	13.6	25.1	36.3
2005	13.6	28.3	53.8
2006	13.7	29.5	55.4
2007	13.9	30.2	74.1
2008	14.1	32.5	86.5
2009	14.5	32.9	109.4
2010	14.1	33.6	112.2
2011	14.7	34.5	112.8

2011 data only until November. For correspondents, data available only until May 2011.
Service outposts include PAB, PAA, PAC and PAE.
Source: Central Bank of Brazil and IBGE.

These figures show that recent years have been marked by significant growth in the number of banks and in the access to financial services. However, two points deserve consideration. First, Brazil's financial access indicators remain below the average of countries with similar income levels. Brazil has 107,000 bank accounts per 100,000 adults compared to the average of 163,000 in upper middle income countries and 217,000 in high income countries. Likewise, the ratio of 13 bank branches per 100,000 adults in Brazil[4] is substantially lower than the average of 22 branches per 100,000 adults in upper middle income countries and 29 per 100,000 adults in high income countries (Figure 3).

Figure 3: Number of bank accounts and bank branches, 2010 (per 100,000 adults)



Notes: Adult population is defined as the portion above 15 years of age.
Source: CGAP.

Second, the provision of financial services is very unequal across the different regions in Brazil. The Southeast region, where the richest states are concentrated, has 18.3 bank branches per 100,000

[4] There is a small discrepancy with the value reported in Table 1 which originates from differences in the original sources.

adults. Conversely, the poorest Brazilian regions (North and Northeast) have less than half the number of bank branches per 100,000 in the Southeast region. Similar inequality can be seen in the distribution of service outposts, bank correspondents and ATMs (Table 2).

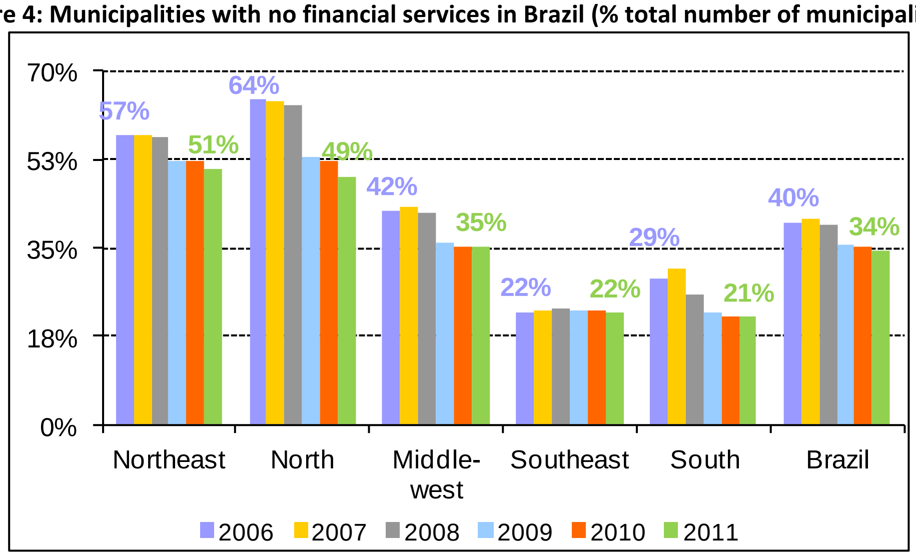
Table 2: Number of bank branches, service outposts, non-bank correspondents and ATMs in Brazilian regions, 2010 (per 100,000 adults)

Region	Branches	Service outposts	Correspondents	ATMs
Northeast	7.2	20.2	81.3	65.1
North	7.4	24.4	60.7	69.0
Middle-west	14.8	38.4	121.2	126.8
Southeast	18.3	38.8	120.4	153.1
South	18.7	46.8	172.6	139.3
Brazil	**14.1**	**33.6**	**112.2**	**117.8**

Notes: Adult population is defined as the portion above 15 years of age.
Service outposts include PAB, PAA, PAC and PAE.
Source: Central Bank of Brazil and IBGE.

The same unequal pattern can be seen in the percentage of municipalities with no banking services (provided by bank branches or PAB). There is a clear downward trend in the number of municipalities financially excluded in all Brazilian regions[5]. While in the North and Northeast nearly 50 percent of the municipalities do not have these service channels, in the South and Southeast this figure is much lower and is approximately 20 percent (Figure 4).

Figure 4: Municipalities with no financial services in Brazil (% total number of municipalities)



Notes: Banking services provided by bank branches or PAB.
2011 data only until November.
Source: Central Bank of Brazil.

Therefore, despite the improvement in recent years, Brazil still needs to expand access to financial services and make this access more equal among regions.

[5] Actually the figure remains steady in the Southeast because the attendance level is already high in that region.

The performance of the banking systemhas been central in enabling the access of a higher portion of the population to financial services. In the next section, we will present a brief description of the most important recent developments in the Brazilian banking system. From the major features and the transformations undergone by the sector, we will try to posit how some of the basic principles for access to the financial system have been met in the Brazilian economy.

Finally, the third section discussesthe main constraints to wider financial access in Brazil and tries to identify specific policy measures which may be taken to improve access to finance in Brazil.

2. Factors contributing to improved access to finance

2.1 Macroeconomic environment

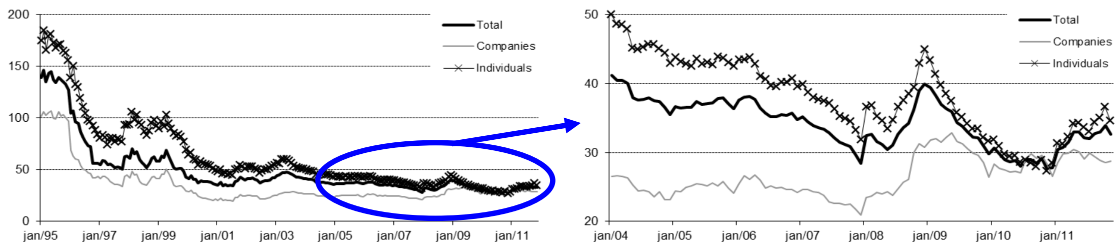
Brazilian banks have experienced profound changes in recent decades. Someof the most significant changes in bank operations have come as a result of changes in the macroeconomic environment. Until the early 1990s, high inflation rates had guided the actions of economic agents. Between 1980 and 1993, the average annual inflation (measured by the Consumer Price Index) was 715 percent. In 1989 and 1993 inflation reached 1,973 percent and 2,477 percent respectively.

Since the launching of the *Real Plan* in July 1994, the rate of inflation has reduced. For example, in December 1995 the inflation rate stood at 22 percent p.a. This new economic climate heralded an important change in the Brazilian economy. Monetary stability has increased the economic predictability, and brought a strong stimulus for banking markets, especially in the credit market.

Despite the improvement in inflation, the series of currency crises in the 1990s and the subsequent high interest rate levels required to maintain the currency anchor inhibited higher levels of growth in the credit markets. Only after Brazil adopted a floating exchange rate regime in January 1999 did declining real interest rates and the sustained economic growth bring about the conditions for a sustained credit market expansion in Brazil.

This qualitative change can be illustrated by the evolution of banking interest rate spreads (over the cost of raising funds) in recent years (Figure 5). In January 1995, the average spread charged by the Brazilian banking system was almost 140 p.p. annually. Recently this rate has floated around 30 p.p. annually. This is still a high spread and is one of the highest rates in the world, however there is no doubt that the significant improvement in the macroeconomic environment was a factor in spurring the demand for credit in Brazil.

Figure 5: Banking average interest spread (p.p. year)



Notes: Spreads are the difference between the customer interest rate and the cost of raising funds.
Source: Central Bank of Brazil.

Changes in the macroeconomic environment affect not only the demand side but the banking system practices as well. According to Baer and Nazmi (2000), the high inflation benefited Brazilian banks in three different ways: (i) by reducing the costs of raising funds, (ii) by reducing the insolvency risks and (iii) by increasing liquidity of the system.

DURING the period of hyperinflation, the operations of Brazilian banks became very concentrated in gains from “floating” basic banking services. Floating operations consisted in raising low costs resources (bills and tax collection) and investing in short-term assets that paid high nominal interest rates[6].

Table 3: Brazilian banks inflation revenues (% GDP and total revenues)

Year	Inflation revenues/GDP	Inflation revenues/Total revenues
1990	4.0	35.7
1991	3.9	41.3
1992	4.0	41.9
1993	4.2	35.3
1994	2.0	20.4
1995	0.0	0.0

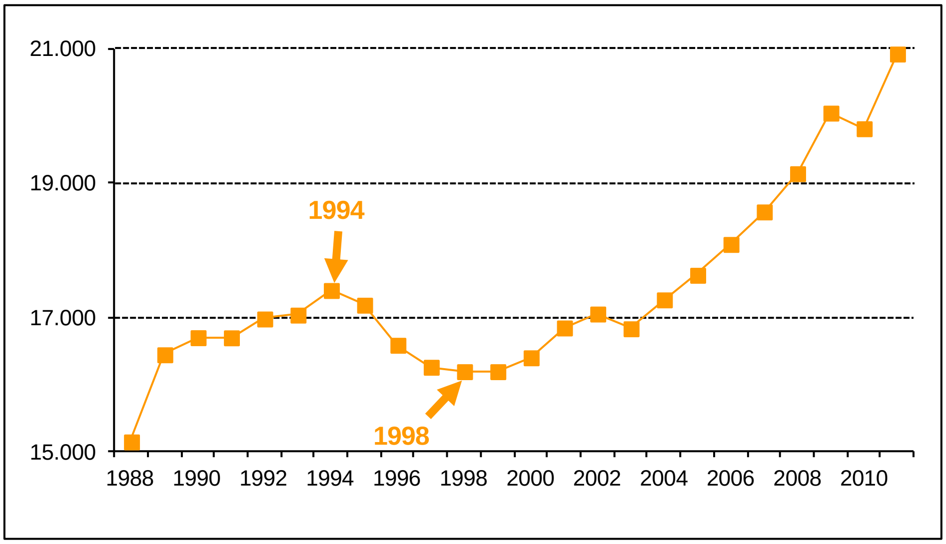
Source: Baer and Nazmi (2000).

Table 3 gives an illustration of the distortions caused by inflation in the banking operations. The Brazilian banking system benefited greatly from inflation revenues during the hyperinflationary years such that between 1990 and 1992, inflationary revenues made up 40 percent of total banking revenues.

The opportunity to profit created a race in the opening of new banks and bank branches during the inflationary period. As a consequence, Brazilian banks developed an advanced technology that enabled them to work with real time operations and to create a wide branch network to raise financial resources. Baer and Nazmi (2000) point out that the average number of branches per banking institution increased from 37 in 1970 to 105 in 1984. This theme is showed in Figure 6 which shows that the number of bank branches operating in Brazil grew in the inflationary period from 15,141 in 1988 to 17,288 in 1994.

[6] For a historical overview about Brazilian banks' evolution, see Baer and Nazmi (2000) and Ness Jr. (2000).

Figure 6: Number of bank branches



Notes: 2011 data only until November.
Source: Central Bank of Brazil.

After the monetary stabilization, Brazil adjusted to the "new times" with a continued reduction in the size of the banking network. This movement can be interpreted as a direct effect of the end of inflationary revenues. As shown in Table 3, after 1995, the inflationary revenues have reverted to virtually zero. Since 1998 the number of bank branches continues to grow and in November 2011, the Brazilian banking system had 20,927 branches.

The combination of monetary stability and the more favorable macroeconomic conditions have guided the banking system toward its traditional goals of raising funds and providing credit. Operating according to these traditional functions, the banking system has contributed greatly to the increase in access to financial services in Brazil in recent years.

Likewise, the improvement in the macroeconomic environment is in itself a powerful tool for financial inclusion. Wealth creates conditions that favor an increase in financial access. The recent economic growth in Brazil has given rise to a growing working class (with a steady income) which wants access to financial services. Indeed, this opportunity to make profits has encouraged the entry of new institutions in the Brazilian financial system, in line with Principle 1, as we will discuss further in following sections.

2.2 Legal and institutional improvements

Improvement in the economic environment has been crucial to the current configuration of the Brazilian financial system. The positive trends in some key macroeconomic variables, such as the employment levels and interest rates, have sustained the strong demand for financial services. In addition, this new environment affected the nature of financial institutions actions by expanding the focus in the provision of financial services.

However, the macroeconomic environment was not the only factor responsible for the recent improvement in the provision and access to financial services. Important advances have been made by Brazilian government in improving the legal and judicial basis for financial system operations and have helped the credit markets.

Brazil has also introduced some initiatives to improve the availability and the quality of information in financial activities.[7] On the hard infrastructure side, the main initiative was the introduction of the New Brazilian Payment System (*Novo Sistema Brasileiro de Pagamentos – SBP*) in 2001. The SPB is an electronic system operated by Central Bank to centralize all inter-banking funds transfers and liquidation, increasing the speed of operations and reducing systemic risk.

According to Costa and De Mello (2006), these governmental measures had the objective to (i) reduce information asymmetries in credit market; (ii) increase the quality of the collateral instruments; (iii) raise the enforcement of contracts, (iv) improve the regulatory system for resolving insolvency problems and (iv) create alternative mechanisms for credit.

Box 1 briefly describes some of the most important and recently implemented reforms which are affecting the Brazilian banking industry.

[7] According to the *Financial Development Report 2010* data, Brazil occupies respectively the 21th and 8th positions in an international ranking (in a total of 57 countries) of private credit bureau coverage and public credit registry coverage. More information is available at World Economic Forum website: http://www.weforum.org.

Box 1: Recent reforms in Brazilian system

1. Soft infrastructure	
(a) Legal and judicial	
Cédula de Crédito Bancário (CCB)	Implemented in 2004, CCB is simpler and more effective in judicial proceedings debt claim created to improve the collateral recognition and contract enforcement in credit operations
New Bankruptcy Law (Law 11,105/2005)	Approved in 2004, this Law aims to support a better insolvency resolution system
Payroll bank loans (Crédito consignado)	Law 10,820/2004 created this class of personal loans where both principal and interest payments are directly deducted from the borrower's payroll check. Part two of this paper presents further discussion about this initiative.
(b) Information	
Credit Information System (SCR)	Implemented in 1999 (and improved in 2000 and 2004), SCR of Central Bank of Brazil is a general registration made by financial institutions with the main features of all credit transactions over R$ 5000
Law on positive registers (Cadastro Positivo)	The Project of Law 405/2007 regulates the establishment and sharing of databases with credit information, both positive and negative ones.
2. Hard infrastructure	
New Brazilian Payment System (SPB)	Implemented in 2001, the SPB is an electronic system operated by Central Bank to centralize all inter-banking funds transfers and liquidation, increasing the operations velocity and reducing the systemic risk
3. Banking regulation	
Resolution 2,682/1999 (and after Resolution 2,697/1999)	This legislation has made stricter the rules for risk credit operations classification and provision constitution
Resolution 2,099/1994 and Circular 2,784/1997	Regulation on capital requirements according to the total assets weighted by their respective risks (Basel Accords)

These reforms have improved the institutional environment, contributing to the rapid expansion of Brazil's credit market. Therefore, in line with Principle 2, we can say that the access to the financial system in Brazil has been facilitated by the building up of legal and information institutions and hard infrastructure.

An example of these measures was the creation of the payroll bank loans (*Crédito consignado*) in 2004 which allowed access to bank credit at lower cost for a growing number of customers. This experiment will be analyzed in greater detail in the second part of this work.

Innovations were also introduced to ensure the safety and soundness of the Brazilian banking system. The most important example is Resolution 2,682/1999 (and Resolution 2,697/1999). Implemented by the Central Bank in 1999, this new legislation has controlled the credit risk classification and provision constitution rules. The standards of banking supervision imposed by the Central Bank are internationally recognized, being an important element in preserving the safety and soundness of FSPs in Brazil.

Another important factor that contributed to the soundness of the financial system was the adoption of prudential practices in line with the Basel Accord in the 90s (Resolution 2,099/1994 and Circular 2,784/1997). In Brazil, financial institutions have to maintain capital requirements equal to or higher than 11 percent, a strict capital requirement when compared to other countries.

On the whole, these regulations adopted by Brazilian authorities contributed to ensuringthe safety and the soundness of financial service providers, and enabled them to increase access to financial services, in line with Principle 4.

2.3 Banking sector structure

Monetary stabilization induced a painful adjustment in the Brazilian banking system. The end of easy gains from floating forced the banks to focus their efforts on the granting of new loans.

According to Baer and Nazmi (2000), the initial loan growth in the early post-stabilization years brought greater risks to the sector. The authors highlight two main reasons for this: (i) lack of expertise in evaluating risk, since it was not necessary to base the credit decisions on sound risk analysis during the inflationary period and (ii) lax supervision and false signals of assurance by the federal government which both led to increased risk appetite.

Furthermore, the early years of monetary stabilization were marked by great volatility. The international crises in the nineties had forced a stiff monetary tightening in order to maintain the exchange parity.

These events brought great difficulties to the domestic banks, resulting in loan retrenchment and increased losses. For example, non-performing loans[8] jumped from 5.5 percent in December 1994 to 10.8 percent a year later. In June 1996, these non-performing loans had reached 12.2 percent of total loans. The financial problems in the Brazilian banking system led the government to propose a series of packages for the industry restructuring in the nineties.

The *Program of Incentives to the Restructuring and Strengthening of the National Financial System* (PROER)[9] was a bailout program implemented in November 1995 in order to deal with the imminent insolvency of Brazilian private banks.

PROER proposed a structure of fiscal incentives and credit facilities to stimulate mergers and acquisition. Under the PROER incentives, seven operations were made feasible, including the large

[8] Loans with greater likelihood of default, according to Central Bank of Brazil classification. Among other things, these loans are delayed for more than 180 days.
[9] For a more detailed discussion, see Baer and Nazmi (2000).

acquisitions operations of Banco Bamerindus (6th largest Brazilian bank in December 1994) and Banco Nacional (8th largest Brazilian bank in December 1994).

Table 4: Recent M&A operations involving Brazilian banks

Acquired institution	Acquiring institution	Date
Banco Nacional	Unibanco	December-95
Banco Geral do Comércio	Santander	December-97
Noroeste	Santander	December-97
BCN	Bradesco	June-98
Dibens	Unibanco	June-98
Bozano, Simonsen	Santander	June-98
Bamerindus	HSBC	June-98
Banco Real	ABN Amro	June-99
Pontual	Bradesco	December-99
Boavista	Bradesco	December-99
Credibanco	Unibanco	June-00
Bandeirantes	Unibanco	December-00
Mercantil de SP	Bradesco	March-02
BBA Creditanstalt	Itaú	September-02
Bilbao Vizcaya	Bradesco	June-03
Sudameris	ABN Amro	December-03
Lloyds Bank	HSBC	March-04
BNL	Unibanco	June-04
Bankboston	Itaú	September-06
Nossa Caixa	Banco do Brasil	November-08
Unibanco	Itaú	December-08
ABN Amro	Santander	December-08
Votorantim	Banco do Brasil	January-09
IBI	Bradesco	June-09

Source: Faria Jr and Paula (2009) and local press.

In August 1996, the Brazilian government launched the Program of Incentives to reduce the State-Level Public Sector in the Bank Activity (PROES)[10] with the goal of recovering the state (provincial) banks. The program aimed to reduce the participation of Brazilian states in the banking industry, through the closure, privatization, or transformation of state banks into development agencies.

State banks in Brazil have a long history of poor financial performance and face political pressure to finance the state government's deficits. In order to encourage the states membership, PROES offered debt restructuring packages to regional governments. Under PROES 12 institutions were privatized, including the operation involving the São Paulo's state bank (BANESPA which was the sixth largest Brazilian bank in December 1999) (Table 5).

The banking system restructuring fits Principle 4 for expanding financial access. The Brazilian government acted particularly to avoid potential systemic problems caused by recurring insolvencies.

[10] Ness Jr (2000) provides a good description of the government participation in Brazilian banking system.

The Mergers and Acquisitions (M&A) and privatizations operations were effective in ensuring the safety and soundness of financial institutions which is crucial for financial access.

Table 5: PROES privatizations

Acquired institution	Acquiring institution	Auction date	US$ millions
Amazonas/BEA	Bradesco	January 24, 2002	80.27
Bahia/BANEB	Bradesco	June 22, 1999	151.27
Goiás/BEG	Itaú	December 4, 2001	280.37
Maranhão/BEM	Bradesco	February 10, 2004	26.06
Minas Gerais/CREDIREAL	BCN/Bradeso	August 7, 1997	123.76
Minas Gerais/BEMGE	Itaú	September 14, 1998	511.33
Paraíba/PARAIBAN	ABN Amro/Real	November 8, 2001	30.97
Pernambuco/BANDEPE	ABN Amro	November 17, 1998	153.68
Rio de Janeiro/BANERJ	Itaú	June 26, 1997	289.13
Rio Grande do Sul/MERIDIONAL	Bozano Simonsen	December 4, 1997	157.22
Paraná/BANESTADO	Itaú	October 17, 2000	960.82
São Paulo/BANESPA	Santander	November 20, 2000	3,698.84
Total	**-**	**-**	**6,465.73**

Source: Central Bank of Brazil.

These restructuring programs[11] represented the beginning of major changes in the Brazilian banking market structure. One such change was the increase in market concentration, as evident in the diminishing number of commercial banks. In 1996 there were 230 institutions authorized to operate in Brazil. The number of commercial banks was 157 in 2010 (Table 6).

While the number of local banking institutions decreased, the number of foreign banks grew. According to Tables 4 and 5, foreign institutions (such as HSBC, ABN Amro and Santander) have taken advantage of the recent consolidation to enter in the Brazilian market. As a result, the number of banks under foreign control increased from 41 in 1996 to 60 in 2010 (Table 6).

[11] There was also a third program, the *Program for the Strengthening of the Federal Financial Institutes* (PROEF), which aimed to restructure and strengthen the federal banks. For more details, see Nakane and Weintraub (2005).

Table 6: Number of commercial banks by ownership

Year	Public	Private	*Private domestic*	*Private with foreign control*	Total
1990	30	187	155	32	217
1994	32	213	175	38	245
1995	32	210	172	38	242
1996	32	198	157	41	230
1997	27	190	141	49	217
1998	22	182	123	59	204
1999	19	175	110	65	194
2000	17	175	105	70	192
2001	15	167	95	72	182
2002	15	152	87	65	167
2003	15	150	88	62	165
2004	14	150	92	58	164
2005	14	147	90	57	161
2006	13	146	90	56	159
2007	13	143	87	56	156
2008	12	147	85	62	159
2009	10	148	88	60	158
2010	9	148	88	60	157

Notes: Commercial banks include multiple banks and *Caixa Econômica Federal*.
Source: Central Bank of Brazil.

Traditional indicators of market concentration support the evidence of greater concentration in the Brazilian banking industry. Table 7 reports the market share of the three (C3) and five (C5) largest banks by total loans, deposits and assets. For example, the share of the five largest banks on the total banking assets has risen from 56.3percent in 1995 and 56.6percent in 2000 to 77.1percent in 2011. C3 and the Herfindahl-Hirschman Index (HHI)[12] provides the same conclusion showing an increase in market concentration in recent years.

Table 7: Market concentration indicators (%)

	C3				C5				HHI			
	1995	**2000**	**2010**	**2011**	**1995**	**2000**	**2010**	**2011**	**1995**	**2000**	**2010**	**2011**
Loans	53,5%	49,0%	55,8%	55,1%	63,5%	62,3%	79,0%	79,5%	11,4%	10,0%	14,0%	13,9%
Deposits	53,3%	53,2%	57,2%	58,2%	64,1%	66,5%	79,3%	80,2%	12,1%	11,6%	14,8%	15,1%
Total assets	45,2%	42,6%	56,2%	55,3%	56,3%	56,6%	77,5%	77,1%	8,4%	8,1%	13,3%	13,2%

Notes: Figure based on commercial banks including multiple banks and *Caixa Econômica Federal*.
Information on 2011 figures was collected in September 2011.
Source: Central Bank of Brazil.

Despite these figures, the increase in market concentration is not a serious problem in Brazil. Growth in market concentration is a characteristic in the banking industry in almost every country. Furthermore, market concentration does not necessarily imply market power. There is strong empirical evidence supporting the view that there is a reasonable degree of competition in the Brazilian banking

[12] HHI is defined as the sum of the squared market shares of the firms which operate in a certain industry, approaching to zero when a market consists of a large number of firms that have approximately the same size. At the other extreme, when there is only one firm in the market, the index is equal to 1.

industry[13]. Finally, the figures for 2011 do not point unequivocally to new increments in market concentration. Instead, the indicators show some reduction.

Table 8 shows evidence of a relative shrinkage not only in the banking system but in the financial system as a whole. The number of other types of financial institutions has also reduced in recent years. The exception was in the entry of alternative types of FSPs which serve the lower end of the market, which include microfinance organizations, credit cooperatives, and special finance for Small and Medium Enterprises (SMEs) from BNDES (Social and Economic Development National Bank). For example, the number of credit cooperatives increased from 1,018 in 1996 to 1,328 in November 2011. In the same period, 42 new societies for financing SMEs were created.

Table 8: Number of FSPs

Type	1996	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Commercial banks	230	192	182	167	165	164	161	159	156	159	158	157	161
Development banks	6	5	4	4	4	4	4	4	4	4	4	4	4
Investment banks	23	19	20	23	21	21	20	18	17	17	16	15	14
Leasing societies	75	78	72	65	58	51	45	41	38	36	33	32	31
Credit cooperatives	1,018	1,311	1,379	1,430	1,454	1,436	1,439	1,452	1,465	1,453	1,405	1,370	1,328
Small business financing societies	-	11	23	37	49	51	55	56	52	47	45	45	42
Others	1,060	888	854	810	783	770	740	717	705	693	678	671	658
Total	**2,412**	**2,504**	**2,534**	**2,536**	**2,534**	**2,497**	**2,464**	**2,447**	**2,437**	**2,409**	**2,339**	**2.294**	**2.238**

Notes: Commercial banks include multiple banks and *Caixa Econômica Federal*.
2011 data only until November.
Source: Central Bank of Brazil.

Besides the financial system strengthening, the banking restructuring was marked by the entry of new foreign institutions (and alternative FSPs to a lesser extent). The entry of these institutions was important to assure the competition in that industry, in line with Principle 1 for increasing access to finance.

3. Obstacles to and recommendations for improved financial access in Brazil

3.1 Business and institutional environment

According to the World Economic Forum *Financial Development Report 2011* (Financial Development Index – FDI), Brazil occupies the 30th position (in a total of 60 countries) in an international ranking which evaluates the financial system development, defined as the "factors, policies, and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital

[13] Formal tests of market power for Brazilian banking usually reject the extreme cases of perfect competition and collusion. The point estimates, however, are closer to the former. See, for example, Nakane (2002), Belaish (2003), Petterini and Jorge Neto (2003), Araújo, Jorge Neto and Ponce (2005), Nakane, Alencar and Kanczuk (2006), Lucinda (2010) and Sanches, Rocha and Silva (2009).

and financial services"[14]. This intermediate position classifies the Brazilian economy a little ahead of other emerging markets such as Russia (39th position), Mexico (41th position) and India (36th position).

The greatest benefit of such multidimensional ranking is that it helps to highlight some of the main problems which prevent further development in Brazil's financial system. Solving these problems is important for the strengthening of the financial system and consequently for expanding access to financial services in the country.

Among the seven dimensions examined by the FDI, the worse ratings are in the banking financial services (41th position), institutional environment (41th position) and business environment (50th position). In other segments[15], the Brazilian financial system has a rating above or very close to the overall financial indicator.

Table 9: Top 10 Financial Development Index (2011)

Ranking	Country
1	Hong Kong
2	United States
3	United Kingdom
4	Singapore
5	Australia
6	Canada
7	Netherlands
8	Japan
9	Switzerland
10	Norway
30	**Brazil**

Source: World Economic Forum.

The problems reported in the business environment evaluation are general and affect the Brazilian productive structure on the whole. This analysis takes into account the quality of human capital, the state of physical capital (including infrastructure) and other aspects of business environment such as taxes and easing of doing business.

The time to pay taxes (60th position), the quality of the infrastructure (50th position) and the costs of doing business (46th position) are factors that make the financial system performance in Brazil more costly. As a result, there is a direct effect on the prices of services offered with negative repercussions on the financial access.

On the institutional front, more specific problems in the functioning of the financial systems are considered. In Brazil, the weaker points appear in items such as the number of procedures to enforce a contract (55th position), strength of legal rights (53th position) and burden of government regulation

[14] More information is available at World Economic Forum website: http://www.weforum.org.

[15] The other dimensions evaluated by FDI are: financial stability (11th position), non banking financial services (11th position), financial markets (27th position) and financial access (23th position). Financial access development was addressed based on penetration indicators similar to the ones used in the first section.

(60th position). These poor quality rankings in institutional environment give rise to operational costs and in risk taking, with direct effects on the prices of financial products.

The previous section showed that important reforms took place in the Brazilian financial system. Legal improvements such as the implementation of the *New Bankruptcy Law* will make the functioning of the financial system easier. But, the institutional and business environments are still obstacles to the access to finance in the country. What this poor ranking in FDI has done is to show how burdensome the requirements (administrative, regulatory, and legal) are to the functioning of financial system in Brazil.

In order to improve the business environment, more general recommendations include the promotion of a broad tax reform that might ease fiscal pressure on the financial sector. Furthermore, it is essential that measures be taken to simplify the procedures required by regulatory authorities.

In order to improve the institutional environment, efforts must be taken to facilitate the enforcement of contracts. Efforts should be made towards changing the legal codes to speed up judgments. In addition, the rights of creditors can be better strengthened through educational campaigns to judges to ensure that they understand the economic costs of lax enforcement of credit contracts.

3.2 Public sector participation

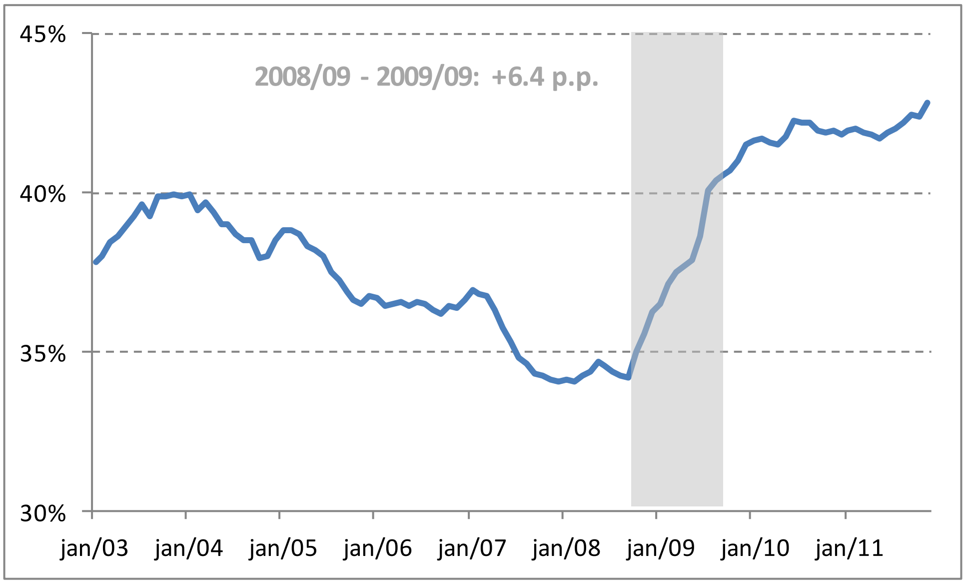
Despite the great reduction in the role of states in the banking system, as promoted by PROES, the government's role in financial markets is still widespread in Brazil. In fact, the strong state presence has become a remarkable feature in the Brazilian banking market.

Three state-owned banks (Banco do Brasil (BB), BNDES and Caixa Econômica Federal (CEF)) are amongst the 10 largest banks in the country. In terms of total assets, BB, BNDES and CEF rank first, fourth, and fifth, respectively. Furthermore, state-owned banks accounted for 42.4 percent of assets, 45.6 percent of credit, 46.3 percent of total deposits, 45.8 percent of labor force, and 41.5 percent of branches in the banking sector (position in September 2011).

The strong position of state-owned banks gives the Brazilian government an important role in the credit market dynamics. For example, the Brazilian government deliberately used the state-owned banks to provide liquidity to the markets and to tackle the recessionary effects of the international financial crisis in 2008. In addition to the more prudent behavior of the private sector, this strategy resulted in significant gains of market share to the state-owned banks. After September 2008, the market share of state banks grew rapidly, rising by 6.4 percentage points to reach 40.6 percent one year later (Figure 7). State banks have preserved their high market share since then, with the public sector accounting for 42.8 percent of total loans granted in November 2011.[16]

[16] See IPEA (2011) for an appraisal of the recent behavior of state-owned banks in Brazil and particularly on their countercyclical role.

Figure 7: Share of state owned banks on total credit (%)



Notes: 2011 data only until November.
Source: Central Bank of Brazil.

A first point of concern about public banks is that their performance does not match their size. State-owned banks accounted for 33.2 percent of net worth, and 35.5 percent of net profits in the banking sector (position in September 2011). Supporting this idea, Jorge Neto and Wichman (2006) and Nakane and Weintraub (2005) report evidence of lower efficiency levels in Brazilian public banks.

Another dimension of government involvement in the banking system is in the mechanisms of direct lending. Rural loans (through BB), housing finance (through CEF) and corporate finance (through BNDES) are the most significant ones.

Directed loans do represent a significant portion of the Brazilian credit market. Between 2001 and 2003, they accounted for 36.5percent of the total market on average. An increase in the nonearmarked segment brought the directed credits share down from 39percent in January 2004 to 28percent in September 2008. With the international crisis, the share of earmarked loans grew to 34percent in September 2009 and 35.7percent in November 2011.

Direct lending leads to two possible distortions to the market. The first one is related to allocative distortions which arise when direct lending is coupled with interest rate ceilings. In Brazil, the most relevant ceilings are imposed on interest rates of rural loans, real estate loans, microfinance, BNDES loans, and passbook savings. The last one (passbook savings) differs from the others because it is a limit on the deposit rate rather than on lending rate. Table 10 summarizes the existing limits on such rates.

Table 10: Interest rate ceiling in Brazil

Products	Rate Limits	Earmarked
Passbook savings	6% p.a. + TR	
Real estate loans	Up to 12% p.a. + TR	52% of passbook savings
Rural loans	6.75% p.a.	30% of demand deposits
Microfinance	4% p.m.	2% of demand deposits
BNDES	TJLP + 2%-6% p.a.	

Notes: TR refers to Taxa Referencial or Reference Rate. TJLP refers to Taxa de Juros de Longo Prazo or Long Term Interest Rate.
Source: Central Bank of Brazil.

Anecdotal evidence of the distortions caused by interest rate ceilings comes from incentives given to microfinance operations. National Monetary Council (CMN) Resolution 3,109 from July 2003 created an additional reserve requirement of 2 percent of demand deposits to be directed to microfinance operations with interest rates capped at 2percent per month. [equivalent to 26.8 percent p.a.]. The potential amount of resources was close to R$ 1.2 billion. The average amount of microfinance loans reached R$ 212 million at the time (only 17.6 percent of the total available amount). The reason for this low interest by the commercial banks at the time was precisely the rate ceiling of 2 percent p.m., which was deemed too low to cover the operational costs for such loans.[17] In recognition to this fact, a new legislation (Resolution 3,229) was enacted in August 2004 doubling the rate ceiling to 4 percent p.m. [equivalent to 60 percent p.a.] for microcredit provided for productive purposes (but it kept the 2 percent p.m. ceiling for microcredit loans to individuals).

A second important dimension of direct lending is the crowding-out of the private sector. Direct provision of credit by the public sector is usually justified on the grounds that the private sector lacks interest in providing credit to such markets/segments[18]. Such justification may apply for rural loans for family agriculture, or to housing finance for the poor, or to finance intensive capital projects like infra-structure. But, it is harder to justify the benefit accrued to some segments by direct lending. Rural loans to big producers, sometimes even multinational ones are harder to justify. Another example is short-term working capital finance given by BNDES, which were created to overcome liquidity shortages during the recent international crisis but remained in place after the crisis. BNDES also seemed very generous in financing strong national groups that could easily have access to private debt markets.

Formally, none of main direct lending mechanisms available in Brazil involve direct subsidy by the State. Although they are granted at below-market rates, their funding costs are also below-market rates. So, the lending rates match with the funding rate.

Table 10 above makes this point clearer. Lending rates for rural loans are capped at 6.75 percent p.a. But the resources to finance such loans come from demand deposits. The same happens to housing finance. While the lending rate is capped at 12 percent p.a. (plus TR), the funding for such loans come from passbook savings, which, in turn, is capped at 6 percent p.a. (plus TR).

[17] See "Não decolou" at www.forumdemicrofinancas.org.br/article.php3?id_article=30 [visited on 07/02/2010].
[18] A classical reference on the role of the State in credit market is Stiglitz (1993). For a critical view of State intervention, see Besley (1994).

Although there are no formal government subsidies, there is an implicit subsidy (from the viewpoint of commercial banks). From a bank's perspective, a more appropriate comparison is the marginal return and the marginal cost of funds. The marginal return may be lower than the lending rate due to delinquency. The marginal cost of funds is probably closer to the cost of raising resources through the issuance of certificates of deposits than the cost of raising passbook savings. If an optimizing bank is required by legislation to engage in direct lending, it will cross subsidize, charging more on products offered at market prices.

Some credit programs have a direct government subsidy. One of them is a program for popular housing finance (*Minha Casa Minha Vida*). There are also different programs related to rural loans.[19] Such programs are properly budgeted by the Treasury. However, to the best of the authors' knowledge, there is no study evaluating such programs. It is therefore unclear whether such subsidized official programs are successful in terms of targets, objectives, transparency, etc. It is very important to establish mechanisms for monitoring and evaluation of these initiatives.

There are some elements in rural loans that may raise questions about the efficiency and effectiveness of the subsidies. First, not all programs have a well targeted focus, benefiting both large and small rural producers[20]. Second, there have been many debts restructuring programs in the past,[21] which may signal possible problems with evaluating and monitoring of the borrowers.

From this point of view, subsidized loans (earmarked credit) have a large weight in the Brazilian credit market. Concerning the proposal of Principle 9 for credit access, there are serious doubts about the effective and efficient use of subsidies and taxes in Brazil. It is not clear whether such subsidized official programs are successful in terms of targets and objectives.

In general, contrasting the Principle 8 of balancing government's role with market financial-service provision, the strong government involvement in the banking sector raises some concerns of allocative inefficiencies and crowding out of the private sector.

Recommendations in this area include a policy of reduction of direct lending. The main source of inefficiency is the simultaneous determination of prices and minimum quantities to be allocated in the chosen segments. The Brazilian government should implement a transition program towards a free market approach to allocating resources and charging interest rates on direct loans. In the short term,

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[19] See Banco Central do Brasil (2010a) for a description of the various governmental programs on rural loans available. Some of these programs are related to strengthening of family agriculture, rural employment and income creation, development of cerrados, programs for coffee, cocoa, credit for land reform. Resources for rural loans in 2009 came from the following sources: 48.3% from direct lending from demand deposits, 26.1% from rural savings deposits; 7.3% from federal constitutional funds; 7% from BNDES, 4.2% from freely allocated market resources; and the remaining 6.1% from other sources.

[20] Kumar (2006) estimates that less than 15% of annual agricultural production is financed by official programs. Furthermore, according to the author, since a part of the subsidies are captured by nontarget beneficiaries, loans are channeled for nonagricultural purposes and the majority of the farms are excluded of the subsidized credit, there would be a blur in the linkages between formal credit and agricultural production.

[21] Debt restructuring for rural loans have been approved in 1998, 2002, 2003, 2004, and 2006. See Banco Central do Brasil (2009).

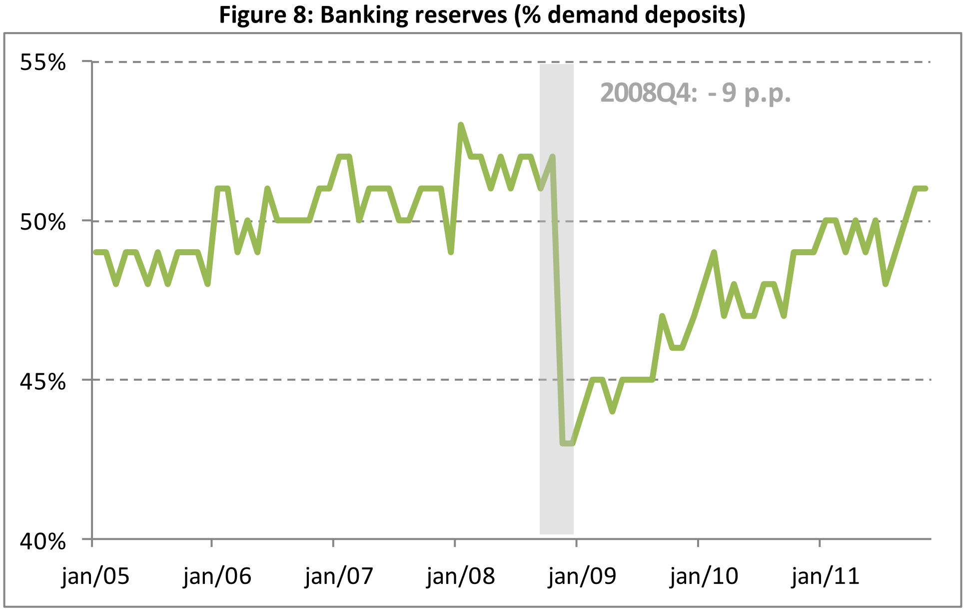
as mitigation, government could let one of these two dimensions (price or quantity) to be set by the market.

As a general rule, government interventions should be more market oriented. The mechanism for setting interest rates and quantities has resulted in the exclusion of a significant part of the segments chosen for the directed lending policies. One example of a market oriented strategy would be the creation of partial guarantees which could help in financial inclusion without creating significant distortions. The subsidized funding must be strongly justified on market failures or on poverty reduction basis, and approved only when market-driven options have been exhausted. Monitoring and evaluation the achievement of these conditions are essential to guide the functioning of directed credit.

Finally, an idiosyncrasy of the Brazilian banking system is the high rate of reserve requirements on commercial banks deposits. The rates of compulsory requirements in Brazil are: (i) 43 percent on demand deposits, (ii) 20 percent on term deposits and (iii) 20 percent on saving deposits.

This high rate of reserves requirement has been acting as a liquidity buffer which makes the Brazilian banking system sounder. During the recent international financial crisis, the Central Bank of Brazil actively managed these requirements in order to assure an adequate level of liquidity in the system (Figure 8). The increased risk aversion reduced the operations in interbank market and brought difficulties to the banks who were more dependent on this source of funding.

Figure 8: Banking reserves (% demand deposits)



Notes: 2011 data only until November.
Source: Central Bank of Brazil.

To address this problem, the BCB reduced the level of required reserves and released a part of the non-remunerated reserves conditional on the purchase of assets of small and illiquidity banks[22]. As a

[22] Mesquita e Torós (2010) bring a detailed discussion on these measures.

result, the total of reserves collected by the banking system fell from 52 percent of demand deposits in August 2008 to 43 percent in December 2008. This rapid action of the BCB was important to avoid more serious problems in the Brazilian banking system[23].

The rate of reserve requirements on commercial banks deposits is still very high, at around 50 percent in November 2011. On the one hand, this level of reserves brings soundness to the banking system and gives to the Brazilian authorities a powerful tool to practice counter-cyclical economic policy[24]. However, this peculiarity makes the banking system operation more complex and costly with direct effects on banking spreads. As in the direct loans, government must create a credible transition program for reducing these compulsory requirements.

3.3 Data, financial literacy and other problems

Data availability

In recent years, the Central Bank of Brazil has made great efforts in disseminating information about the Brazilian economy. However, the availability of data to measure the degree of access and financial exclusion in Brazil still needs to be improved.

The Central Bank regularly collects and makes available overall and aggregate statistics about credit and financial sector. In these regular reports it is possible to obtain some information on the distribution of banking network in Brazil. These data and other disperse figures in the Central Bank's website constitute the primary source for the indicators presented in the first section of this work.

The problem is that this information is not collected and made available for the purpose of showing the degree of financial access in Brazil. Currently, such data is sparse and too aggregated. Public data for conducting more detailed studies on the impact of financial access initiatives are simply non-existent.

Another important initiative of the Central Bank of Brazil is the recent compilation of the "Financial Inclusion Report" [Banco Central do Brasil, 2010c and 2011] which also has been an important data source for the analysis made in this paper. Therefore the recommendation is that this report should be continued over time and the information collected should be expanded. One example would be the construction of time series on the regional distribution of the main channels of delivery of financial services.

Another initiative in this area is the recent publication of the report "Banks: exclusion and services" (*Bancos: exclusão e serviços*) by IPEA [IPEA (2010)]. This research brings some interesting information but is not very informative about the access to financial services. This study probably will be

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[23] For more details on the effects of reserve requirement as a policy instrument, see Montoro e Moreno (2011).

[24] Central Bank of Brazil has diversified its policy instruments to inflation control. In December 2001, the monetary authority proposed a set of macro-prudential tools to contain the credit market. Among other things, the BCB raised the capital requirements on term loans to individuals and elevated the tax charged on credit to households (IOF). More recently, to combat the risks caused by the global deceleration, a part of these measures has been removed.

discontinued because it is a special report from the institution's presidency. The ideal would be to continue the research and improve the information on financial access. Also, it would be very important to conduct the studies in partnership with the Central Bank which has been debating the theme for a long time.

At the same time, household surveys that include financial questions are urgently needed. A regular (annual) household survey is conducted by IBGE but with no information on financial issues at all. IBGE seems to have the expertise and is well equipped to enlarge their set of regular questionnaires to include questions on financial issues.

All of these recommendations would help address Principle 10, which, currently is one of the major shortcomings in the country.

Financial education and literacy

Financial education and literacy are key factors for stimulating an informed consumer base and expanding the access to financial services (Principle 3). With basic knowledge on financial products and family financial planning, customers can make more efficient use of services and reduce the risk of being exploited. Financial illiteracy is an even greater constraint in Brazilian economy due to the very short history of macroeconomic stabilization and financial system deepening.

On the private sector side some sparse educational initiatives by Febraban (*Meu Bolso em Dia*) and by some private FSPs (for example, *Uso Consciente do Dinheiro* by *Banco Itaú Unibanco*) can be mentioned. An official financial literacy program *Estratégia Nacional de Educação Financeira* (National Strategy for Financial Education) was recently launched (December 2010). The main guidelines for action spelled out by this official initiative highlight that there are three areas where efforts will be focused: information, education/training, and advice. A program for financial education at schools is being devised as part of this national strategy.

There is still a significant gap to be filled in the provision of financial education and literacy. One possible strategy would be to use the government income transfer programs to promote a broad program of financial literacy.

As we will discuss in the second part of this paper, the Brazilian government has used the broad reach of social programs to create mechanisms for financial inclusion (the creation of simplified bank accounts arises in this context). The financial literacy should take the same course to help the millions of supported families which are having their first contact with the financial system.

The Ministry of Social Development and Fight against Hunger – MDS has recently established the legal framework to promote financial inclusion for families supported by the government social programs (Decreto 7,013/2009). Among other things, the norm explicitly prescribes that financial inclusion should contemplate the promotion of financial literacy actions. That is a good initiative that the government should put in and which has a high potential of improving financial access. It is also a fitting example of how Principle 7 can be used to combine initiatives from different agencies to reach financial inclusion.

On the other hand, Central Bank of Brazil has also tried to make some advance in keeping more informed demand. The regulatory authority initiatives try to promote the transparency of financial products costs. It is possible to mention some measures related to:

- *Total effective borrowing cost (Custo Efetivo Total - CET)*: since May 2008 FSPs should inform their clients of the total cost of credit operations, including interest rates, fees, taxes, insurance and all expenditures charged. (Resolution CMN 3,517/2007).

- *Interest rates and banking fees:* although somewhat hidden, the Central Bank of Brazil website reports the banking fees charged by commercial banks and interest rates charged on several individuals and firms credit market segments.

Both initiatives are very positive. The major challenge is getting this information to the financial costumers. In order to make these measures more efficient, the Central Bank must increase the disclosure of prices and fees charged by financial institutions. The comparison between the financial services costs should be simpler and easier to access in the websites of Central Bank and other financial institutions.

Regional Inequalities

One important reason for financial exclusion in Brazil is the unequal distribution in income. For a large portion of the population, low income is the greatest obstacle to financial services access. As already argued, the country's improved economic situation tends to promote the availability of financial services to this population. Governmental measures (such as the initiatives studied in the second part of this work) may also be important do ameliorate this situation.

Another dimension of financial exclusion may be seen regionally, with great inequality in the provision of financial services within the Brazilian territory. Much of this inequality is due to differences in population density and in income per capita. As a result, the pattern of recent Brazilian growth is more concentrated in the peripheries and tends to contribute to greater financial inclusion.

When making geographical financial inclusion plans, the government should consider a more disaggregated spatial delimitation (as neighborhoods). Peripheral areas of large cities, for example, can count on an offer of financial services as low as those of the poorest Brazilian regions. Besides the installation of service outposts, locational policies should aim to design the best fit between the services offered and the community that is financially excluded.

Access to Financial Services in Brazil: Part II

In the late 1990's and early 2000's, Brazilian authorities launched several initiatives and actions with the aim to address issues related to financial access, including:

- Correspondent banking: created in 1999 with further legislation in 2003;
- Simplified bank accounts: created in 2003;
- Credit cooperatives: change in legislation in 2002 and in 2003;
- Microcredit: relevant legislation in 1999, 2003, 2005;
- Payroll bank loans (*crédito consignado*).

Part II of this report discusses three of these:

1. Correspondent banking;
2. Simplified bank accounts;
3. Payroll bank loans (*credito consignado*).

We selected these initiatives above because of their relevance and because they are all relatively new initiatives (whereas, credit cooperatives, for example, have existed since the 1940s). The relevance of such initiatives is due to the fact that they address two important obstacles to the broadening of financial access in the country: a) transaction costs related to geographical distances and to unaffordable financial services; and, b) wealth constraints of the poorer population.

1. Correspondent banking

1.1 Context

Brazil is a large country with an uneven distribution of the population across its territory. With an estimated population of 185.7 million (2010 Census data) and an area of 8, 515 thousand km², the population density of 21.8 people per km² is similar to that of countries like Uruguay (19.8), Sweden (20.7), Chile (22.7) or Peru (22.9). There is huge population disparity across the Brazilian regions as shown in Table 11.

Table 11: Population, area and density across Brazilian regions

Region	Population		Area		Density
	Thousand	%	Km²	%	
Northeast	51,871	27.9	1,554,257	18.3	33.4
North	15,485	8.3	3,853,327	45.3	4.0
Middle-west	13,677	7.4	1,606,372	18.9	8.5
Southeast	77,657	41.8	924,511	10.9	84.0
South	27,022	14.6	576,410	6.7	46.9
BRAZIL	185,713	100	8,514,876	100	21.8

Source: IBGE.

The Southeast is the most populated region in the country with 41.8 percent of the total population but accounts for only 10.9 percent of the Brazilian territory. As a result, population density in the Southeast is the largest in the country with 84 people per km². By contrast, the North region has 8.3 percent of the total population but 45.3 percent of the total territory. Thus, population density in this region is just 4 people per km².

The figures are even more dramatic for the states. For the states in the North, in the Amazon region, population density ranges from 1.9 people per Km² (Roraima) to 6.5 people per km² (Rondonia). In the richest states in the Southeast, population density reaches 160.9 people per km² in Sao Paulo and 347.4 people per km² in Rio de Janeiro. At Distrito Federal, because of the location of the federal capital city of Brasilia, population density reaches 425.6 people per km².

With such a dispersed population, the supply of financial services through standard channels had always been a challenge. Table 12 displays the number of municipalities in the main Brazilian regions with no access to standard distribution channels for financial services back in 1999 before the advent of bank correspondents.

Table 12: Municipalities with no financial service provision in Brazil in 1999

Region	Number of municipalities	Municipalities with no bank branches*	
		Number	%
Northeast	1846	841	45.6
North	471	284	60.3
Middle-west	464	105	22.6
Southeast	1669	263	15.8
South	1176	186	15.8
BRAZIL	5626	1679	29.8

(*) Include municipalities with no branches and with no *Postos de Atendimento Bancário* (PAB).
Source: Central Bank of Brazil, *Relatório de Evolução do SFN 2000.*

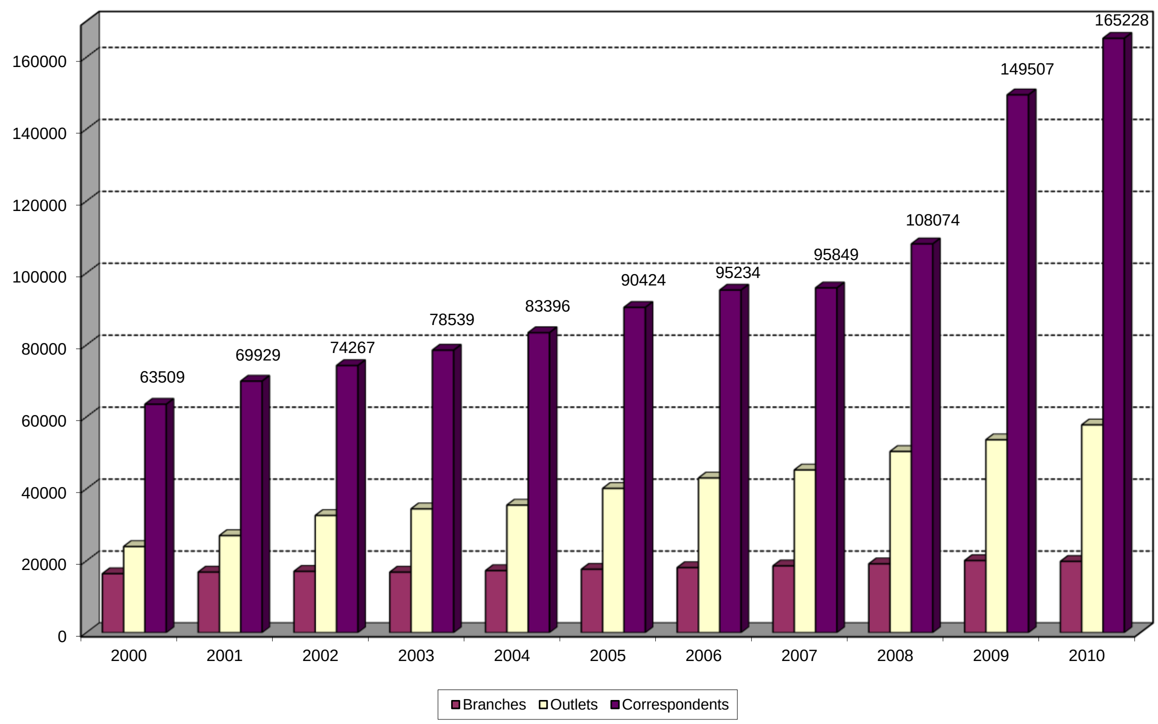
As shown, 29.8 percent of Brazilian municipalities lacked access to standard distribution channels of financial services back in 1999. In the poorest states in the Northeast and in the North regions, the situation was even worse with the proportion of unassisted municipalities reaching 45.6 percent and 60.3 percent, respectively. Such states not only have a larger proportion of the poor but also (for the North region) have very dispersed populations

The public response to this situation was to create bank correspondents. *Bank correspondents* are nonfinancial or financial firms hired by financial institutions to offer some financial services. Examples in Brazil include lottery houses (correspondent for Caixa Econômica Federal CEF) and post offices (correspondent for Bradesco)[25]. They probably represent the most visible action towards financial inclusion in the country. This model has even been exported to other countries and is largely seen as a success story. The relevant legislation was put forward in early 2000. As a result, since 2002 there is no municipality in the country without access to some form of financial services.

[25] Until end of 2011. After that, post offices became correspondents for Banco do Brasil.

There has been a large increase in the number of bank correspondents in the country since the early 2000s. Figure 9 illustrates the upward trend. The number of bank correspondents grew from 63,509 units in 2000 to 165,228 in 2010, an impressive 160 percent increase. It became the main channel of delivery of financial services, largely surpassing other more traditional forms of distribution.[26]

Figure 9: Number of branches, outlets, and bank correspondents in Brazil



Sources: Central Bank of Brazil, Soares and Melo Sobrinho (2008).

Bank correspondents are allowed to perform the following list of services [Central Bank Resolution 3,954 from February 2011]:

(i) - receiving and forwarding deposit account (demand, time, and savings) opening applications;
(ii) - receipts, payments and electronic transfers related to deposit accounts;
(iii) - receipts, payments and other activities related to agreements for the rendering of services by the contractor;
(iv) - execution of payment orders;
(v) - receiving and forwarding loan and leasing requests;
(vi) - receipts and payments linked to bills of exchange;
(vii) - receiving and forwarding credit card applications;

[26] Correspondents include both those authorized by the Central Bank and those only communicated to the Central Bank. Outlets include Postos de Atendimento Bancario (PAB), Postos de Atendimento Eletrônico (PAE), Postos de Arrecadação e Pagamentos (PAP), Postos Avançados de Atendimento (PAA), Postos de Atendimento Cooperativo (PAC), Postos de Atendimento ao Microcrédito, Postos Avançados de Crédito Rural (PACRE).

(viii) -exchange related transactions.[27]

For activities (i), (ii), (iv) and (vi), the correspondent cannot have as their main activity the service of correspondent itself. The contract between the financial institution and the agent hired as correspondent should be communicated to the Central Bank. Thus, there is no need for formal approval by the Central Bank. Approval by the Central Bank is only required if the agent displays the name “Bank” (or similar) on its commercial denomination.

The responsibility for all the services provided by the agent stays with the principal. The Central Bank has overall access to all the information and documentation related to the services carried out by the agents.

The state-owned Caixa Econômica Federal (CEF) has the largest network of correspondents in the country. CEF started its operations with correspondents when it was chosen by the federal government to be the agent to distribute social benefits. CEF then started a partnership with lottery houses in 2000. Later in 2003 CEF started to set up correspondents with commercial establishments in a program called *Caixa Aqui*. By 2011.3Q, CEF had 36,385 correspondents, of which 11,072 were lottery houses and 25,313 were from *Caixa Aqui*.

Another important network of correspondents was established by Bradesco, a national private bank. It created a partnership with post offices and created *Banco Postal* in 2001. There were 6,233 correspondents from *Banco Postal* in 2011.3Q. *Banco Postal* ceased to be Bradesco correspondent at the end of 2011. In addition to Banco Postal, correspondents in commercial establishments were also set up under the name *Bradesco Expresso*. There were 31,372 correspondents from *Bradesco Expresso* by 2011.3Q.

The third largest network of correspondents belongs to the state-owned Banco do Brasil. This bank created another subsidiary called *Banco Popular do Brasil* which started operating in 2003. This subsidiary set up correspondents with commercial establishments and had reached 3,500 correspondents by the end of 2009. In August 2010, *Banco Popular do Brasil* was terminated and incorporated by Banco do Brasil. In addition, Banco do Brasil has another network of correspondents called *Mais BB* with 12,739 units in 2011.2Q. In July 2009, Banco do Brasil incorporated 6,500 correspondents from Lemon Bank, which then became a network manager for such correspondents. And, as already mentioned, starting in 2012, *Banco Postal* became Banco do Brasil correspondent, adding more than 6 thousand units to their network.

1.2 Problem(s) the initiative aims to address

Correspondent banking is one example of branchless banking.[28] Correspondent banks aim to address access problems related primarily to geographical or locational barriers/constraints. Setting up of bank

[27] Exchange related transactions were included in the set of possible activities by the correspondents only with in February 2011. If such operations involve purchase/selling of foreign currency correspondents should be financial institutions, tourism services providers, post offices or lottery houses.

branches is costly and the decision for a commercial bank to open a branch in some particular venue balances such costs to the perceived profitability associated with expected economic activity and customer incomes for the surrounding area. Economic considerations can therefore leave large areas of the country without the physical presence of banks. Population and economic density may not be profitable enough to attract banks to set up physical branches.

Bank correspondents aim to bring access to financial services to populations that lack the physical presence of banks. Small rural communities, isolated places (due e.g. to geographical distances), poor neighborhoods, peripheries of cities are the places where bank correspondents are most likely to be found.

Cost considerations are equally important for the FSPs and for the users. In the absence of nearby branches, customers have to travel long distances and spend time (traveling, queuing up) to use financial services. A customer survey carried out by CEF found that prior to the opening of *Caixa Aqui* outlets, 51 percent of respondent clients had to travel more than an hour to get to a bank branch. In addition, 55 percent of respondents had to spend R$5-R$15 in travel expenses to get to a branch [Kumar *et a*l. (2006), p. 18].

The model is also attractive to the correspondents. Correspondents are paid a commission per transaction, improving their revenues. On the cost side, initial investment is set by the contracting financial institution and the existing personnel can also handle the extra work, without the need for hiring additional staff. In addition, when the customer cashes out, he or she may decide to spend part of his or her income at the retail store, increasing sales.

In local communities, retailers hold valuable knowledge on the shopping and payment habits of their customers. If they become bank correspondents, such knowledge can be used in loan applications helping to mitigate asymmetric information problems.

Another interesting dimension is that correspondents usually have longer opening hours than bank branches. The opening hours of bank branches are regulated by the Central Bank whereas the opening hours of correspondents follow less strict regulation from commercial law.[29]

Even in places that are served by standard bank branches, correspondents can still play a role because they are seen as more friendly venues than branches. The intimidating aspect associated to bank

[28] According to Mass (2009), branchless banking is characterized by the following elements: "1. Non-bank retail outlets are used as customer touch-points, at least for cashing in or out of the accounts; 2. Technology, such as payment cards or mobile phones, is used to identify customers and authorize transactions electronically and, in some cases, to allow customers to initiate transactions on their own; 3. Transactions can be processed against an electronic store of value (although cash-based services for non-customers may also be offered in addition); 4. Accounts are issued by institutions recognized and explicitly or implicitly authorized by the banking regulator, although they may not be formally licensed and regulated" (p. 60).

[29] There were some judicial actions in the country asking for the bank correspondent employees to have the same working rights of bank employees; in particular, the right to have reduced working hours that bank employees have. There were also some lower court decisions asking for bank correspondents to have the same security and safety requirements needed for bank branches. Many specialists see such decisions as threats to the commercial viability of such businesses.

branches is termed the *revolving door* effect in Brazil making reference to the system found at the entrance of bank branches for security reasons.

But, from the standpoint of access, another important element is the demand side. In other words, it is one thing is to have a correspondent nearby and another different element is to have people using their services. The use of services must match the clients' needs in terms of availability of services as well as costs. Other initiatives studied here like simplified accounts and payroll loans (consignado) address some of the issues related to cost and availability of services. Lack of detailed data prevents us from making a thorough analysis of the use of the correspondents by the population. Central Bank reports some aggregate data on annual basis (see discussion in section 1.4).

1.3 Relation to the Taskforce Principles

Principle 1 (promoting entry of and competition among financial firms)

Correspondent banking does not bring new FSPs to the market but, nevertheless, this initiative still promotes competition at the delivery channels of financial services. For many isolated places in the country, correspondent banking was the way to bring financial services to the community. But even for places already attended by bank branches, there was entry by bank correspondents. In such cases, competition at the delivery channel is more direct.

Principle 2 (Building up of soft infrastructure)

Correspondent banking can help mitigate problems of asymmetric information to the extent that correspondents can benefit from the knowledge they have about the local communities. In addition, if the bank correspondent is also a commercial store, it may have previous relationship with the client, and, therefore, it may know his or her previous record on payments, purchases, defaults, and so forth.

The commercial relation between the bank correspondent and the bank customer can therefore work as a partial substitute for the lack of formal credit registries when it comes to the evaluation of loan applications.[30] Over time, the development of the dual commercial/financial relationship can also work as a monitoring device: preservation of good reputation in the commercial transactions can exert a disciplinary effect on the loan transaction with the bank correspondent. This mechanism is more likely to be effective for local communities where commercial relationships based on personal interaction are more established.

Principle 2 (Building up of hard infrastructure)

Bank correspondents have to be endowed with infrastructure for retail-payment systems and even with sufficient currency notes to meet demand needs. The system for retail payments is provided by the contracting financial institution.

[30] Federal government has recently (June 2011) approved the creation of credit registries with positive information. Up to this date, only registries with negative information were working in the country.

According to Kumar et al. (2006, p. 7), most bank correspondents "have a point-of-sale device (POS), with or without a personal computer, barcode readers and/or additional keypads for clients to enter their personal pin numbers. Correspondents are linked to their contracting financial institution's servers using a telephone line, cable or satellite (VSAT) technology. Most transactions take place in real-time via high-speed internet connections". Some correspondents have ATMs available for direct use by clients.

Principle 3 (stimulating informed demand)

Bank correspondents are seen as friendlier environments than standard branches. In many situations, they can be the first contact between a person and the financial world. Their friendlier appearance as well as their widespread outreach throughout the country makes them well suited to play an important role in enhancing financial literacy amongst the poor, although there are no direct guidelines related to this aspect in the regulations on bank correspondents.

At the moment, this aspect is not embedded in the legislation but it may be included as part of it. The use of bank correspondents to disseminate initiatives of financial education can be seen as a potential benefit rather than a fulfillment of Principle 3.

Principle 4 (ensuring the safety and soundness of FSPs)

The contracting financial institutions must bear all the risks related to the correspondent operations. Central Bank authorization for bank correspondents is not required except when the correspondent displays "Banco" (or similar) on its commercial name.

A change in legislation made prudential regulation concerns related to correspondent banking less strict than previously. Before Resolution 3,654 was enacted in December 2008, bank correspondents had to be *authorized* by the Central Bank to perform the services of receiving and forwarding deposit account opening applications and also to accept receipts and to make payments related to deposit accounts. Such authorization is not required anymore, but there is no sign that this easing of regulation has weakened financial soundness.

Some safeguards are embedded in the legislation address safety and soundness issues. For example, correspondents are forbidden from making advances in anticipation to resources still to be released by the contracting financial institution. Another safeguard is the requirement that all the financial netting positions between the correspondent and the contracting financial institution must be settled every two working days, at most. Another safeguard is that payments for the correspondent services must be in accordance to the FSP risk management policies and, in particular, should not provide incentives for excessive risk taking.

Thus, to a large extent, correspondent banking relies on mechanisms of self-regulation rather than oversight by the Central Bank. Although some safeguards exist, the risk remains with the financial institution and, therefore, *Principle 4* is not totally addressed by this initiative.

Principle 5 (protecting low-income and small customers against abuses)

Protection against abuses by FSPs is dealt with by the consumer protection legislation. As for the nonfinancial firms, there may be issues related to protocols for real-time fund transfers, training and certification of staff[31], truth-in-lending, anti-tying practices.

When a correspondent is also a commercial store, there might be lock-in effects where the customer is induced to spend part of his or her payment (especially social benefits) at the store.

On the other hand, one can find some safeguards related to protecting customers in the current regulation. An important one is the prohibition of charging any fees related to the service provided by the correspondent (on top of the bank fees). Another safeguard is that a correspondent should inform the customers the terms of conditions of all FSPs for which it works as correspondent.

Overall, some concerns related to Principle 5 still remain with this initiative.

Principle 8 (balancing government's role with market financial-service provision)

As mentioned above, the three largest networks of bank correspondents belong to two state-owned (CEF and Banco do Brasil) and one private (Bradesco) bank. Correspondents set by the public banks offer simplified bank accounts (see next section) whereas Bradesco and private bank correspondents do not. The structure of fees also differs between state-owned and private banks.

The fact that both state-owned and private banks set up large networks of bank correspondents indicates that this action balances well the commercial market logic and therefore meets Principle 8.

Principle 10 (ensuring data collection, monitoring, and evaluation)

There are many gaps to be addressed regarding data issues on bank correspondents. The sparse data available are far too aggregated for proper monitoring and evaluation. And even the data that do exist are not publicly available on a recurrent basis.

Correspondent banking addresses financial access issues related to geographical/distance barriers. Such issues affect not only isolated municipalities but also poor urban neighborhoods. Some available data contain information aggregated at the municipal level. This aggregation works fine for small and isolated municipalities but it is far too aggregated for large towns. Without more disaggregated data it is hard to make any evaluation about the success of correspondent banking in meeting the needs of the poorest population, especially those living in large towns.

[31] Staff involved in loan application activities should now (after Resolution 3954 from February 2011) be trained and take formal certification exams.

Data on the client usage of bank correspondents is also very poor. The available data are not public or aggregated at the national level. Individual data on the client usage of bank correspondents are not publicly available.

There are no data to perform impact analysis. In other words, if the arrival of bank correspondents has had any measurable impact on wealth, consumption, income, risk-taking, entrepreneurship, etc. There are simply not enough data to make assessment studies in the country.

Another type of data that is lacking for Brazil is household survey data with financial information. There is a regular annual household survey conducted by IBGE in the country called PNAD but with no information on financial aspects.

Summing up, correspondent banking addresses Principles 1, 2, and 8 well. It has good potential to advance Principle 3 as well. There are some concerns related to Principles 4, and 5. And this initiative addresses Principle 10 very poorly.

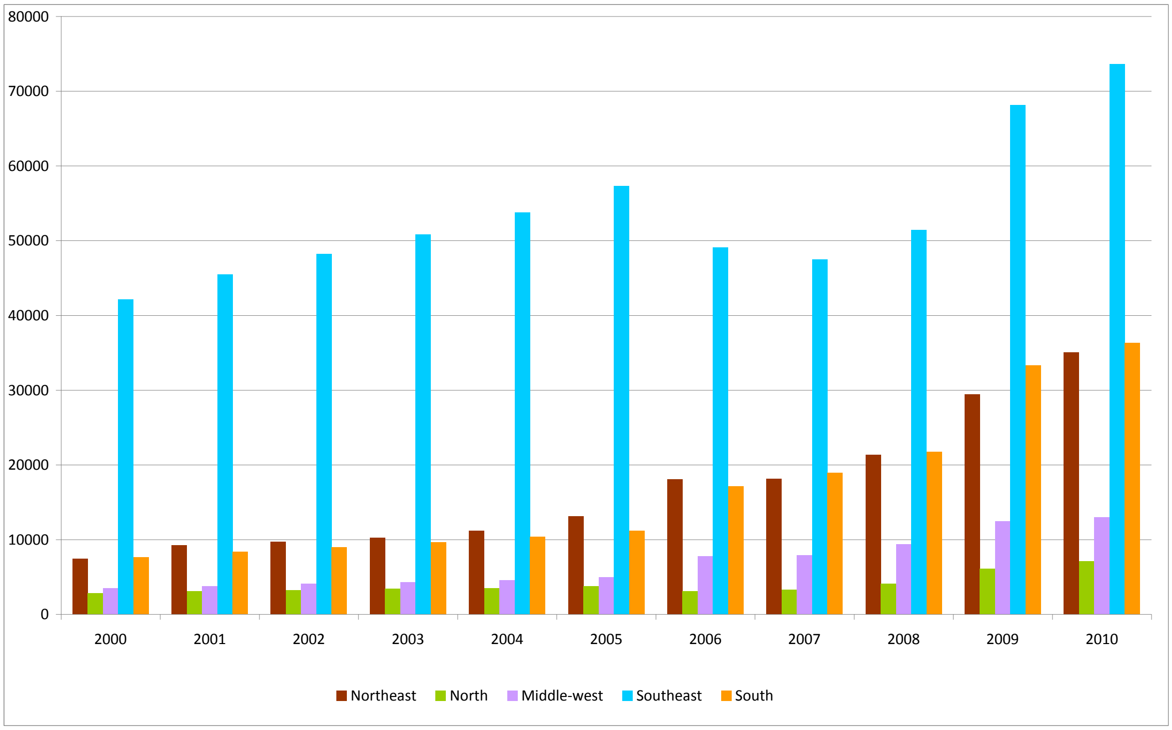
1.4 Assessment of success

Numerical indicators of reach (number of correspondents; geographical distribution of correspondents) and use (number and value of main transactions) are collected by the Central Bank. However, the Central Bank does not make them available on a recurrent basis. Scattered information from Central Bank publications allows one to reconstruct basic aggregate series.

One important indicator of success is the number of bank correspondents. We have already seen (Figure 7) that this initiative performs well according to this indicator. So, the number of banking correspondents grew from 63,509 units in 2000 to 165,228 in 2010. As a result, all municipalities in the country are served by some form of FSP since 2002.

The geographical distribution of the bank correspondents is another important dimension to evaluate. After all, as argued in subsection 1.1, one of the reasons for the establishment of bank correspondents is precisely to address issues related to geographical and distance barriers. Figure 10 shows the distribution of bank correspondents across regions in the country.

Figure 10: Distribution of bank correspondents across regions



Source: Central Bank of Brasil, Soares and Melo Sobrinho (2008).

There is a large concentration of bank correspondents in the richest Southeast region. This region accounted for 73,644 units of bank correspondents in 2010. The poorest regions in the country, the Northeast and the North, had 35,097 and 7,137 bank correspondents in 2010, respectively.

Over time, the concentration of bank correspondents in the Southeast region has reduced: the share of bank correspondents in this region went from 66.3 percent in 2000 to 44.6 percent in 2010. But the share redistribution of bank correspondents over time was not in favor of the North region. This region kept its share over the period, changing from 4.5 percent in 2000 to 4.3 percent in 2010. The Northeast region increased its share of bank correspondents from 11.7 percent in 2000 to 21.2 percent in 2010. The same happened to the South region, which went from 12 percent in 2000 to 22 percent in 2010.

More disaggregated data on the location of each bank correspondent is needed to evaluate the extent to which they contributed to the reduction of transaction costs. One issue is whether they complement or substitute for bank branches. In a recent study, Loureiro (2011) reports that there are more correspondents per capita in municipalities with fewer bank branches per capita (after controlling for different characteristics of the municipalities), which suggests substitution between the two.

Although this does not give a full picture, an important element to evaluate the outreach of bank correspondents comes from those locations that are not covered by standard channels of financial service delivery. Table 13 reports the contribution of bank correspondents in bringing financial services to these locations.

Table 13: Municipalities with no financial service provision in Brazil in 2010

Region	Number of municipalities with no:		
	Bank branches*	**Bank dependencies****	**Direct bank access*****
Northeast	935	116	109
North	234	36	32
Middle-west	171	15	14
Southeast	377	13	12
South	255	4	0
BRASIL	1972	251	167
	… But, from which, there is at least one correspondent:		
Northeast	935	116	109
North	234	36	32
Middle-west	171	15	14
Southeast	377	13	12
South	255	4	0
BRASIL	1972	251	167

(*) Include municipalities with no branches and with no *Postos de Atendimento Bancário* (PAB).
(**) Include municipalities with no branches, no PABs and no *Postos Avançados de Atendimento* (PAA).
(***) Include municipalities with no branches, no PABs, no PAAs and no Postos de Atendimento Bancário Eletrônico (PAE).
Position in December 2010.
Source: Central Bank of Brazil, *Relatório de Inclusão Financeira2011.*

The upper half of the table shows the number of municipalities in each of the Brazilian regions that are not served by standard channels of financial service distribution. The second column shows the number of municipalities with no standard bank branches. The third column includes PAAs, which have simpler structures than standard bank branches. And the final column includes PAEs, which are closer to ATMs (no personnel assistance to the customer). The lower half of the table shows the number of municipalities from the upper half that has at least one bank correspondent.

Table 13 shows the important role played by bank correspondents in bringing access to financial services to those places not served by standard banking. Thus, for the country as a whole, there were 1,972 municipalities (35.4 percent of the total 5,571) without bank branches in December 2010. But, all of them were served by bank correspondents. Similarly, 251 Brazilian municipalities have no bank dependencies (branches or PAAs) but all of them are served by bank correspondents.

In today's virtual world, the widespread coverage of correspondent banking signal that brick and mortar banking is still important for large sections of the population. Standard banking theories of transaction costs (in contrast to more modern explanations related to asymmetric information) may still be important to the understanding of financial service provision to the poor.

Some aggregate data compiled by the Central Bank on the usage of bank correspondents are displayed in Table 14. Unfortunately, the disclosure of data in the format of this table does not go past 2007.

Table 14: Bank correspondents: Volume and Value of Transactions

	Consult/ Balance	Payments Receipts	Deposits	Withdrawals	Credit
I Transactions (thousands)					
2001	4,177	696,573	3,876	1,345	0
2002	13,446	773,573	10,209	3,695	9
2003	28,710	873,167	24,667	138,235	71
2004	51,589	1,069,256	48,381	194,206	129
2005	85,229	1,518,522	71,374	128,204	127
2006	99,120	1,337,060	83,420	252,590	286
2007	134,637	1,611,450	98,964	299,984	513
II Values (R$ million)					
2001	-	14,510.12	304.58	399.70	-
2002	-	19,435.95	918.22	1,615.84	2.35
2003	-	24,911.41	1,865.50	6,344.08	12.56
2004	-	58,505.73	8,654.11	16,047.59	45.28
2005	-	92,229.18	13,657.99	17,123.61	66.27
2006	-	106,819.80	17,404.58	32,332.18	299.26
2007	-	161,584.33	22,405.63	46,078.56	677.95
III Average values (R$ per transaction)					
2001	-	20.83	78.58	297.17	-
2002	-	25.12	89.94	437.31	261.37
2003	-	28.53	75.63	45.89	176.91
2004	-	54.72	178.87	82.63	350.98
2005	-	60.74	191.36	133.57	521.81
2006	-	79.89	208.64	128.00	1,046.37
2007	-	100.27	226.40	153.60	1,321.55

Constant values Jan 2010.
Source: Soares and Melo Sobrinho (2008)

The first thing to notice is that payments (bills, benefits) dominate the transactions in terms of both volume and value. Credit operations lag far behind whereas cash withdrawals and deposits come in an intermediary position. Thus, bank correspondents seem to be a good channel to provide 'transactional' services in contrast to 'relationship' services.

Average values of all different transactions have increased over the years. Although disaggregated data by the type of deposits are not available, the increase in the average value of deposit indicates that some form of savings is occurring. Another interesting feature is that, despite the relatively low significance of credit operations for the aggregate, the average real amount borrowed has increased substantially over the years from R$ 261.37 in 2002 to R$ 1,321.55 in 2007.

The Central Bank also releases annual information on the aggregate number of financial retail transactions ordered by the different channels of delivery (including bank correspondents). It also reports separately the figures for payments transactions. Table 15 reports the figures.

Table 15: Volume of Transactions according to Delivery Channels

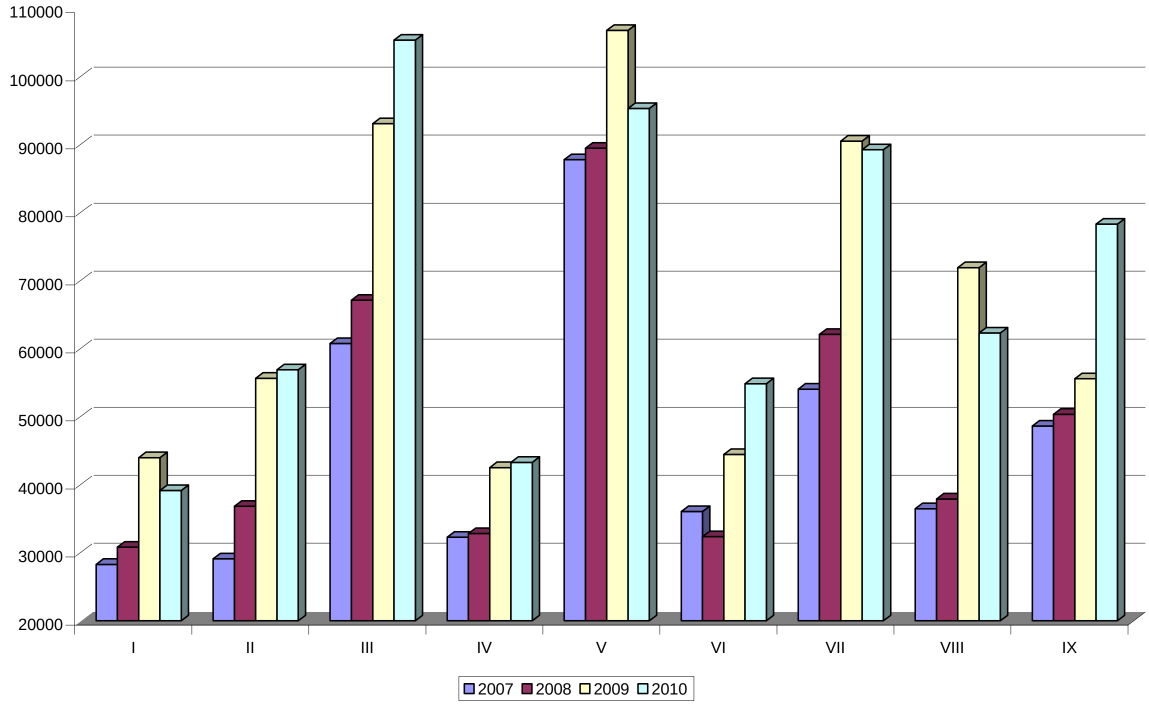
	Correspondent	Remote (internet)	ATM	Branch	Call Center	Mobile
I All Transactions (million)						
2006	1,806	5,107	7,158	5,427	1,246	48
2007	2,166	6,413	7,553	5,598	1,607	37
2008	2,318	7,309	8,235	5,844	1,636	65
2009	2,591	8,358	8,124	6,501	1,613	96
2010	2,905	10,593	8,558	7,481	1,562	61
Growth 06-10	61%	107%	20%	38%	25%	28%
II Payments (taxes, bills) Transactions (million)						
2006	1,338	869	383	1,428	22	0
2007	1,612	1,070	470	1,432	23	2
2008	1,704	1,260	503	1,517	25	3
2009	1,932	1,470	513	1,466	29	3
2010	2,157	1,782	598	1,493	30	3
Growth 06-10	61%	105%	56%	5%	34%	1,022%

Source: Banco Central do Brasil (2010a)

The figures in Table 15 confirm the importance of bank correspondents, especially in relation to payments transactions. Since 2007, correspondents have been the main channel for payments transactions in the country.

Bank correspondents can offer different bundles of products and services as long as they comply with the list of activities regulated by the Central Bank Resolution 3,954. Figure 11 shows the evolution of the number of bank correspondents according to the type of activity they perform.

Figure 11: Evolution of number of bank correspondents according to type of activity



Source: Central Bank of Brazil

Activities follow the list in (now outdated) Res. 3,110 from July 2003:

I - receiving and forwarding (demand, time, and savings) deposit account opening applications;

II – receipts and payments relative to deposit accounts; accepting contributions and withdrawals in investment funds;

III – receipts, payments and other activities related to agreements for the rendering of services by the contractor;

IV – execution of payment orders on behalf of the contractor;

V - receiving and forwarding loan and financing requests;

VI – analysis of credit and registration of loan applicants;

VII- execution of collection services;

VIII - receiving and forwarding credit card applications;

IX – other control services, including processing data, from convened services.

The majority of bank correspondents in the country deal with payment transactions (e.g. invoices, government benefits). In December 2010, 105,369 correspondents were offering this service. Another large number of correspondents (95,318 in December 2010) were intermediating loan requests.

This last activity seems to have produced specialized correspondents offering only such particular service: forward loan proposals to the contractors. The third largest network of bank correspondents in December 2010 was from Aymore CFI, an FSP specializing in consumer finance. Their 24,853 correspondents were only offering the service of intermediating loan requests.

Bank correspondents are an important channel of payment of government benefits. Payments of "bolsa família", which benefits mainly the poorest, through bank correspondents reached 7,7 million transactions in December 2010 or 68.5 percent of all payments of this social program [source: Banco Central do Brasil (2011)]. Loureiro (2011) shows that the number of "bolsa familia" beneficiaries per capita at the municipality level has a positive impact on the number of correspondents per capita when this social program started (2003) after controlling for different characteristics of the municipality.

1.5 Lessons and potential for replication

On a broader level, replication can simply be understood as taking up the initiative and creating it elsewhere. On this very general level, the idea of correspondent banking can be replicated whenever geographical or distance barriers represent the main constraint to financial access. The technology of setting up bank correspondents is trivial and do not require too much of start-up costs (when contrasted to setting up bank branches). Bank correspondents have actually been set up in different countries in the world, as the case studies for India, Mexico and Peru show.

Another separate and distinct matter is *successful* replication. One has to examine the reasons behind the success of the initiative in a particular country and assess whether such reasons can also be found elsewhere. Along this dimension, there are many factors behind the success of correspondent banking in Brazil that seem to be specific to the country and, therefore, that should be taken into consideration when this initiative is implemented elsewhere.

In terms of elements specific to Brazil, some regulatory peculiarities seem to have favored the model adoption in the country. In particular, regulations concerning space and equipment for bank branches and agreements related to salaries of bank employees. These regulations are very strict for branches but not as much for correspondents.[32] Another regulatory issue is the range of services that bank correspondents can offer. Some countries set limits on cash-handling by non-financial firms, for example, which may hamper the services provided by correspondents. Still related to regulatory issues, bill payments of utilities have to be done through banks in Brazil, which creates a predictable demand in the provision of this service.

Another specific reason for the success of this model in Brazil is the engagement of large retail banks, including two state-owned ones. Although not unique to Brazil, this specificity is not universal either and may influence the rapid spread of bank correspondents across the country.

An important element that is also country specific is the government decision to make all the payments of social benefits through the state-owned bank *Caixa Economica Federal* (CEF). This bank has the largest network of correspondents in the country through its partnership with lottery houses and retail stores.[33]

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[32] For example, bank branches have to comply with stringent safety and security requirements and have more limited opening hours. Workers union for the banking industry is strong and better organized, increasing personnel costs at branches.

[33] CEF reports that made 297 million payments for programs of income transfers for a total of R$ 137.7 billion in 2010 (from which R$ 13.4 billion related to *Bolsa Familia*). In addition, other 118 million payments related to social security and unemployment benefits (for a total of R$ 72.5 billion) plus 31 million payments of annual bonuses for workers (totaling up R$ 50.6 billion) were also made in 2010. See *Relatório da Administração de 2010*.

Another reason for the success of correspondent banking, which may also be specific to Brazil is the strong political support for expanding financial access. Alongside correspondent banking there were other important measures put into place, including some analyzed in this study, like simplified accounts, and payroll loans (consignado). Other initiatives aimed at broadening financial access included changes in the legislation related to credit cooperatives, and to microfinance.

Evaluating the Brazilian experience, regulatory design issues seem to stand out as an important precondition for the success of this model. Overall regulation concerning commercial activities is, in general, less strict than regulation of financial service provision. Correspondent banking can benefit from this differentiated regulation. Specific regulatory design on correspondent banking shapes the bundle of products and services bank correspondents can offer. If well designed, the model is commercially attractive for both FSPs and the correspondents, on the one side, and the bank customers on the other.

1.6 Policy recommendations

The model of correspondent banking in place in Brazil is largely seen as a success case but it can be further improved. Some regulatory improvements enacted in February 2011 (Resolution 3,954) addressed issues related to safety and soundness concerns of FSPs (Principle 4) as well as concerns related to consumer protection (Principle 5).

Some recommendations to further improve this initiative cover the following aspects:

1. Increase in the list of products and services provided by bank correspondents. For example, inclusion of insurance and microinsurance products and services. The current array of services provided by correspondents in Brazil is related to current account, payment transactions, savings instruments and credit. In the February 2011 change in the legislation on correspondents, exchange transactions were included. From a financial inclusion perspective, however, insurance and microinsurance products and services seem to be lacking. The poorest face more risk than the well off and, even for the same risks they are more vulnerable. Risk management strategies for the poor include actions like in kind savings (e.g. grain storage), self-insurance, savings, mutual insurance (e.g. loans from relatives, friends), etc. Formal insurance products tailored to the poor (microinsurance) can be part of risk mitigation actions. Being close to the customer may provide correspondents with some informational advantage when offering such products.
2. Use of bank correspondents as a way to diffuse financial education initiatives. The extension and outreach of correspondent networks make them strategically well positioned to contribute in actions related to financial education. One example is the inclusion of modules related to financial education and financial counseling in the training and certification process that correspondent staff now perform as part of loan requests. Bank correspondents in Brazil are still primarily used for payments transactions. Financial education initiatives may play an important role in promoting savings as well as credit products, which both help to alleviatepoverty.

3. More and better publicly available data on the client usage of bank correspondents (Principle 10). In its current form, public available data is too aggregated and is insufficient to perform evaluation exercises on client usage.

2. Simplified bank accounts

2.1 Context

Simplified bank accounts were created in 2003 giving access to some basic financial services at low maintenance cost. The legal basis for their operation was established by the Central Bank of Brazil Resolution 3,211 of June 2004, which created simplified current accounts and simplified savings accounts.

According to this rule, these accounts (i) can only be opened by individuals, (ii) should be the only account owned by the individual in the financial system, (iii) can not have a balance above R$ 2,000[34] (roughly US$ 1,176) or sum of deposits within a month exceeding this value, and (iii) should have their funds withdrawn only through electronic cards. The basic service package is free of costs for the bank client and should include monthly:

(i)- execution of four withdrawals;
(ii)- provision of four bank account statements;
(iii)- execution of four deposits.

Banks charge for transactions exceeding these limits. No maintenance fee can be charged. The account is blocked if, at any time, the amount held or the sum of monthly deposits exceeds R$ 5,000[35] (roughly US$ 2,941).

The required documentation for the account opening is simpler than the procedures for the opening of standard bank accounts in the country. Official ID proof plus the registration number at the national tax agency are the documentation required. There is no need for proof of residence or proof of income (as required by standard bank account openings). Indeed, on a temporary basis (for six months), a registration number from the social benefit programs is accepted in place of the ID and registration at the national tax agency.

The initiative is not mandatory for the banks. In practice, only state-owned banks offer such accounts.

This initiative seeks to regulate the provision of basic banking services at low cost. The objective is to facilitate the access and to serve as a front door for poorer people into the financial system. The great expansion of the simplified bank accounts seems to indicate some success of this initiative (see section 2.4).

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[34] Original value was R$ 1,000.00. New value is in effect since June 2010.
[35] Original value was R$ 3,000.00. New value is in effect since June 2010.

The launching of simplified accounts was closely related to the unification that took place in January 2004 of different official social programs under the heading of *Bolsa Família*[36] and the decision to have the state-owned Caixa Econômica Federal to be the channel through which *Bolsa Familia* benefits would be paid. *Bolsa Familia* is paid through a magnetic card and, although the opening of a bank account is not required by this income transfer program, the authorities saw an opportunity to also offer access to (basic) financial service to the beneficiaries.

2.2 Problem(s) the initiative aims to address

Simplified bank accounts aim to address financial access problems related to the poor families' resource constraints in acquiring financial services. One of the most important reasons to the financial exclusion in Brazil is the critical level of social exclusion. According to official sources[37], more than 22 million families in Brazil are considered poor, living with monthly income per capita below R$ 232.50 (around US$ 129). In this scenario, the government has regulated the provision of basic banking services at a virtually free maintenance cost, which is an important condition for financial inclusion of this mass of poorer population.

This government intervention is not related to "second best" explanations of market failure. There was no clear impediment to the offering of simplified accounts by the banking sector. The fact that banks were not offering this product prior to the 2004 legislation was not due to problems of asymmetric information, technological/infrastructure shortcomings, regulatory constraints, etc. It was just that, from a profitability point of view, (state-owned and private) banks did not consider this segment of the market to be worth serving. Operational costs required to bring services to this group are too high and per-unit revenue is too low to make simplified accounts a sustainable business model for most of the banks.

As mentioned in the previous section, the simplified account regulation was primarily introduced as a way to bring poor families beneficiaries of *Bolsa Familia* into the financial world. Since the payment of such benefits has to be done through CEF, most of the operational and fixed costs to serve the targeted customers of simplified accounts had to be incurred regardless. In addition, CEF is remunerated by the government for making *Bolsa Familia* payments. Thus, at least for CEF, it was interesting to offer some product tailored to the needs of this segment.

2.3 Relation to the Taskforce Principles

<u>Principle 1 (promoting entry of and competition among financial firms)</u>

Only state-owned banks are currently offering simplified bank accounts. The prohibition of charging fees on these accounts makes them unprofitable. The lack of private sector involvement on such

[36] Briefly, *Bolsa Família* is a government program of direct income transfer (with conditionalities) for families in poverty.
[1] Ministry of Social Development and Fight against Hunger - MDS. See: www.mds.gov.br.

initiative cannot be taken as a sign of failure though. Actually, as a reaction to the initiative, private banks started to offer their own versions of popular current accounts with reduced maintenance fees. Thus, the initiative had a positive competitive impact on private banks, in accordance to Principle 1.

To illustrate, Bradesco, the second largest private bank in the country, offers a bank account to their correspondent customers with the following monthly services:

a) emission of twelve checks;
b) execution of five withdrawals;
c) provision of four bank account statements (unlimited number through internet);
d) execution of seven transfers (unlimited number through internet).

Unlike simplified bank accounts, the account offered by Bradesco has no limit on the amount held or on the number and size of deposits made. The monthly maintenance fee for such account is R$ 7.80 (US$ 4.33) with deductions according to the financial investments held by the depositor.

Principle 4 (ensuring the safety and soundness of FSPs)

One concern of the authorities was that simplified accounts could be abused and used for money laundering purposes. The inclusion of a maximum limit on the amount held on such accounts as well as the limitation on the number of monthly possible transactions (deposits and withdrawals) work towards guaranteeing that such accounts will not be used for unscrupulous and malicious purposes.

Another similar safeguard is the limitation that account holders cannot have other accounts in the banking system.

Principle 5 (protecting low-income and small customers against abuses)

The main goal of simplified accounts is to reduce the costs of financial services for poor families. In addition, this initiative also addresses an old local authorities’ aim: further simplification and greater comparability of services offered by FSP's.

In this sense, the creation of simplified bank accounts matches Principle 5, since it establishes a standardized banking product with the main features regulated by the government. Likewise, for the initiative’s target audience, the possibility of abusive prices due to more complex and opaque service packages can be avoided.

The structure of bank fees can be highly complex in view of the varied array of products and services banks usually offer to their clients. Moreover, banks also usually offer packages of products and services where certain types and amounts of services are bundled and charged a single monthly fee. Different packages are offered according to the targeted customer segment. In addition, it is common practice that banks offer deductions on their fees as rewards for relationship.
For poorer customers, such structure of bank fees and service packages can look very complex and opaque. Thus, a simplified accounts work towards protecting them against any abuse by FSPs in

offering and charging bundles of products and services that are not really needed by the poorer population.

Principle 8 (balancing government's role with market-financial service provision)

Offering of simplified accounts by FSPs was not made mandatory by the legislation. As a result, state-owned banks are predominant in the provision of simplified accounts, mainly through *Banco do Brasil*' subsidiary *Banco Popular do Brasil* (*Conta Popular*) and *Caixa Econômica Federal* (*Conta Caixa Fácil*).[38] According to Feltrim et. al. (2009), despite the attraction of new customers, the increase in operating cost creates disincentives for a more active behavior of private sector in expanding these accounts.

It is actually doubtful that there will be some interest from private banks in the provision of simplified accounts under the current settings. Restrictions on the fees that can be charged on these accounts makes them unprofitable. The trend is actually for increasing participation of state-owned banks (and CEF in particular) in the provision of such accounts. The main reason for this trend is explained in the next section and is related to the government official aim of bringing financial inclusion to *Bolsa Familia* beneficiaries where one important component is precisely to increase the share of payments of such benefits through *Caixa Facil* accounts.

The lack of an exit plan for the state-owned banks might seem to jeopardize the fulfillment of Principle 8 but that is not necessarily the case. If CEF keeps being the channel through which government benefits are paid, simplified accounts offered by the same FSP may be the best cost effective way of bringing financial services to this target group. The additional operational costs of managing such accounts are marginal given the fact that CEF has already incurred the costs to pay the benefits (and being compensated by the government for that). In reality, CEF enjoys some economies of scope in providing both benefit payments and simplified accounts to the same customers.

There is of course the question of why CEF has to be the only channel through which *Bolsa Familia* benefits are paid. There is no clear justification for that. It is true that CEF has a widespread network of branches and correspondents. But so does the private bank Bradesco.[39] CEF plays an important role in the registering of the beneficiaries.[40] But this activity could be separated from the benefit payment itself. A case in point is given by the payments of pensions and official social security benefits, which is done through the entire banking system (according to the beneficiary indication). Thus, it could be possible to increase the private participation in the provision of such simplified accounts if they had a level playing field when it comes to benefit payments to reap the benefits of economies of scope as CEF does.

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[38] *Banco Popular do Brasil* was totally incorporated by Banco do Brasil in August 2010. Since then Banco do Brasil does not seem to be offering simplified bank accounts any more. CEF reports 7.4 million *Caixa Facil* accounts by the end of 2010.

[39] According to Central Bank data for December 2010: CEF has 2,104 branches, 1,648 PABs, PAAs and PAEs, and 31,863 correspondents. Bradesco has 3,496 branches, 16,092 PABs, PAAs and PAEs, and 31,360 correspondents.

[40] CEF is also responsible for the management of a unified register for *Bolsa Familia*, which, under the coordination of the Ministry of Social Development and Hunger Alleviation, organizes the data reported by municipalities regarding poor families.

Principle 10 (ensuring data collection, monitoring, and evaluation)

Similar to the other initiatives studied here, Principle 10 is also poorly addressed by simplified accounts. Only aggregate data related to the number of simplified accounts is public available. Some disaggregated information could be made publicly available. In particular:

- Data on simplified accounts by individual banks, which would help to address issues related to Principle 8, as discussed above;
- Data on the geographical distribution of such accounts;
- Linked data on simplified accounts and bank correspondents;
- Linked data on simplified accounts and *Bolsa Familia* payments.

One important qualitative indicator would be some information about the use of the accounts by the holder. Some useful statistics are how frequent is customers use the account, what services are used, the average value for the used services, etc. Unfortunately, such indicators are not available.

Data to perform an impact study is missing. That is, data that allows one to evaluate the impact of simplified bank accounts on people's financial services access and welfare. In fact, to the best of our knowledge, there is no empirical work evaluating the economic impacts of simplified current account in Brazil.

One possible way to start collecting the required type of data is the use of the *Bolsa Familia* database. Questions related to how benefits are paid and how simplified accounts by the beneficiaries are used could be included in the regular reports. As further discussed in the next section, better data and information are some of the financial inclusion initiatives related to *Bolsa Familia*.

A promising methodology for data collection is the use of financial diaries as done in countries like India, Bangladesh and South Africa in the pioneering initiative reported by Collins et al. (2009).

In sum, simplified accounts address Principles 1, 4 and 5 well. There some doubts as to how well Principle 8 is met by this action whereas Principle 10 is poorly met.

2.4 Assessment of success

Monitoring the progress of this initiative can be made based on aggregated statistics released by Central Bank of Brazil. Indicators publicly available comprise the total number of simplified bank accounts divided by active and inactive ones. Table 16 reports figures for simplified current accounts. These figures are reported frequently, although non-periodically, forming a monthly time series initiated in January 2004.

According to the Central Bank, in 2004, in the early days of the program, nearly 4 million simplified current accounts were already opened. Nearly seven years later, this figure was close to 10.8 million, showing a169 percent increase in the period. With this evolution, simplified current accounts represented 7 percent of total current accounts in Brazil by the end of 2010 compared to 4.5 percent recorded in 2004.

Table 16: Number of simplified current accounts

Year	Total number of accounts	Active accounts		% total current accounts
		Number	% of Total	
2004	4,021,095	3,883,787	96.6	4.5%
2005	6,292,622	4,467,874	71.0	6.6%
2006	6,792,625	4,590,036	67.6	6.6%
2007	7,622,448	4,488,229	58.9	6.8%
2008	9,872,306	5,771,637	58.5	7.9%
2009	10,037,109	5,713,541	56.9	7.5%
2010	9,858,300	6,604,702	67.0	7.0%
2011*	10,808,857	6,632,119	61.4	--

*Values in October 2011. Total number of current accounts is not available yet.
Source: Central Bank of Brazil.

An indication of how successful this initiative has been is in the share of active accounts, which reached 61 percent in October 2011, showing an improvement over the last three years.[41] This share is comparable to what is found in other countries. The case study for South Africa reports that active accounts constituted 58 percent of Mzansi accounts at the end of 2008. This share is also comparable to what is found in standard current accounts in the country. In 2010, 63 percent of total current accounts were active, making the proportion of active accounts for simplified accounts even slightly better than that for comparable accounts.

As already stressed, an important point of this initiative was the use of income transfer federal programs as an instrument of banking inclusion. The government's strategy is to encourage the beneficiaries of *Bolsa Família* program to open simplified bank accounts. According to official information, nearly 13 million households are served by this program, which shows the potential of this policy (Table 17).

Table 17: Number of families registered in *Bolsa Família* program (December 2010)

Total population*	190,732,694
Total families registered in program**	16,020,350
Total families beneficiaries	12,778,220

* Census 2010.
** Families with monthly income per capita up to R$140.
Source: Ministry of Social Development and Fight against Hunger - MDS. See: www.mds.gov.br.

2.8 million beneficiaries of *Bolsa Familia* have opened simplified bank accounts. Of the 12.8 million benefits paid, 1.77 million were paid through simplified bank accounts [Banco Central do Brasil (2010c)]. The strategy of using *Bolsa Familia* as a means to achieve financial inclusion was made official through Decree 7,013 in November 2009. Amongst other initiatives, this legislation states that banking

[41] The increase in the number of active accounts in 2010 is related to the upward adjustment it the maximum amount allowed in these accounts, which went from R$ 1,000 to R$ 2,000 in June.

inclusion of the beneficiaries will be primarily made through simplified bank accounts.[42] As part of this strategy, dissemination efforts to advertise *Caixa Facil* accounts amongst the beneficiaries were launched and even specific magnetic cards for those opening these accounts were issued.

Another factor contributing to the success of this initiative is the combined increase in correspondent banking studied in the previous section. If bank correspondents help to bring financial services closer to the poor and isolated families, simplified accounts enabled them to actually make use of at least a basic basket of services. As an illustration, CEF reports that for *Caixa Facil* accounts opened in 2010 (until October), 70 percent were opened through lottery correspondents, 13 percent through *Caixa Aqui* correspondents and the remaining 17 percent through bank branches. Transactions with *Caixa Facil* debit cards in 2010 (until October) were done according to the following purposes: paying for shopping at commercial stores (22.8 percent of transactions), withdrawing at branches (1.3 percent of transactions) and withdrawing at other locations including correspondents (76 percent of transactions).[43]

As we have mentioned previously, the creation of a bank account is very different from the effective use of financial services. That means that besides the issue of costs of services, there should be a match with the needs of new customers. Due to a lack of data, it is difficult to assess the usage behavior of simplified accounts. However, a recent survey by IPEA [IPEA (2010)] reports that 67.1 percent of the respondents with income up to two minimum wages see the main role of a bank as related to currency movement and safe keeping. Only 5 percent of them see credit and lending activities as the main role for a bank. If this perception reflects the needs of those targeted by initiatives like simplified accounts, one can see that there is a good match between what is offered and what is needed by the target population.

The absence of private sector engagement in this initiative should not be seen as an important shortcoming. Because of the role played by CEF in the distribution and payment of social benefits, this FSP is better positioned to offer simplified accounts to the targeted population. CEF can reap the benefits of economies of scope, reducing concerns related to sustainability issues.

Although the same legislation also created simplified savings accounts, the number of such accounts has been quite limited so far. In October 2011 there were only 10,140 of such accounts opened. Such

[42] It is interesting to observe that many of the financial inclusion principles mentioned by this Decree meets the taskforce Principles. For example, there is mention to "ample and easy access to adequate information about financial services, especially with respect to interest rates, maturity, costs or risks associated to the services" (Principle 5), "protection against tying, embarrassment and other abuses in the marketing of financial services, especially those arising from socio-economic vulnerability" (Principle 5), "promotion of financial education and dissemination of information on the proper use of financial services" (Principle 3), "periodic supply to the Ministry of Social Development and Fight against Hunger MDS of data and information that enable research on the impact, efficiency, effectiveness and potential of financial inclusion promoted under the Bolsa Familia program" (Principle 10), "MDS will coordinate with public institutions and civil society to promote coordinated and continuing actions towards financial inclusion and financial education for beneficiaries of Bolsa Família" (Principle 7).

[43] Presentation at the *II Forum Banco Central sobre Inclusão Financeira*. Available online at <http://www.bcb.gov.br/pre/evnweb/atividade/18nov_Painel%205_Mesa%202_Humberto%20CAIXA_201012161221159250.pdf > (visited in January 19, 2012)

number is insignificant considering that the universe of savings accounts in the country is 103.5 million [in June 2011; source: FGC]. There was actually a reduction in the number of simplified savings accounts over time. In December 2006, there were 340 thousand of such accounts.[44]

Even amongst *Bolsa Familia* beneficiaries, holdings of savings accounts is much larger than the number of existing simplified savings accounts, indicating that this basic form of savings accounts does not serve this public.[45]

Overall, the available evidence is favorable to this initiative when current accounts are concerned. However, this initiative is quite a failure when savings accounts are considered.

2.5 Lessons and potential for replication

As in the previous discussion, one has to make a distinction between overall replication and successful replication. In general, there is no reason for this experience not to be replicated in other countries. Different countries in the world have adopted some form of simplified bank account, as the case studies for India and South Africa testify, although the details differ in each country.

With respect to issues that are particular to each country, two sets of concerns seem to be important. First, the design of the initiative, including the set of products and services that is included in the basic bundle. There is a tradeoff here to balance between the financial needs of the targeted population on the one hand and possible abuses (in terms of fraud, money laundering, etc) on the other. If the match between what is offered and what people wants/needs is poor then the end result may be a large proportion of inactive accounts.

The design of the simplified accounts in Brazil seems to have adequately addressed such trade offs. Opening requirements are much simpler than the requirements for opening standard current accounts. In particular, neither proof of residence nor proof of income are asked. Restrictions on the amount as well as on number and type of allowed transactions make this product suitable to the targeted people. These accounts areseen as the entrance door to the financial world to the poor and, as such, are designed to be simple and inexpensive.

The needs of the targeted people may differ according to each country. In Brazil, the account is used mainly to withdraw funds (usually from social benefit payments) and to use debit cards at commercial stores. In places where remittance services are required, simplified accounts should include such facilities.

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[44] A drastic reduction took place in June 2010 when the number of simplified savings accounts dropped from 130,725 to 6,823. This reduction followed the enaction of Resolution 3881 in the same month and was apparently motivated by an enforcement of the strict rules on maximum balances and value of deposits allowed.

[45] 307,601 beneficiaries of *Bolsa Familia* included in the Financial Inclusion initiative were reported to hold savings accounts in December 2010 [source: Banco Central do Brasil (2011)].

Simplified accounts do not address all the dimensions related to financial inclusion and are not designed to do that. Even from the point of view of a normal current account they are very limited and do not offer access to services like credit facilities. Such limitations have a positive side though. They provide a natural "exit door" to the extent that as people move the social ladder up their financial needs increase and they will find that simplified accounts do not serve them anymore.

The second issue is related to sustainability. Simplified bank accounts work under the pretext that any fees charged for keeping and using such accounts should be low (or even nonexistent) to make them affordable to the poorest. Serving this market, however, is costly. Thus, unless private banks can see some opportunity for cross subsidization or an opportunity to differentiate products across different customer segments, they will not make much effort to offer such accounts.

There is a marked difference between the Brazilian initiative and the South African experience with Mzansi accounts in this respect. In South Africa, the initiative was not a result of a direct government mandate or regulation. It was a private initiative led by the "big four" banks. Even though the accounts are not unprofitable, there are issues of relative profitability (profitability relative to nearest equivalent products) that may jeopardize the future sustainability of Mzansi accounts (as reported by Hanouch and Ketley case study).

In Brazil, there is no private bank offering such accounts. Unlike the Mzansi accounts, no maintenance fees can be charged on simplified accounts in Brazil. This restriction makes them unprofitable. One key structural difference between Brazil and South Africa is that public sector interference in the financial sector has been heavy in Brazil not only in terms of regulation but also in terms of direct provision by state-owned banks, as we highlighted in Part I. Another important difference between the two experiences is the clear connection between this initiative and the distribution and payment of social benefits by one state-owned bank in Brazil.

The last reason is a crucial one for the sustainability issue. The arrangement of having the same FSP performing the social benefit payments and offering simplified accounts to the same public works as a 'second best' solution to the sustainability problem since it allows the state-owned bank to reap some economies of scope.

Other countries in the world use FSPs to make payments of social benefits to some target population, although not necessarily by one single FSP. A possible lesson from the Brazilian experience is therefore the possibility of offering simplified accounts to such beneficiaries as a way to extend income transfer programs to embrace financial inclusion actions.

2.6 Policy recommendations

The predominant role played by CEF in the provision of simplified bank accounts is related to the fact that this FSP also makes the payments of various social benefits in the country. We see this arrangement as a 'second best' solution to the sustainability issue. But, there is a 'first best' solution, which involves having private banks also making social benefit payments to the poor (and being remunerated for that). There is no clear justification for the CEF monopoly on this. A model where private banks participate can be adopted for the payment of social security and retirement pensions. If private banks are engaged in the payment of social benefits, they could also offer simplified accounts to the beneficiaries. Economies of scope would make this option attractive to private banks. In other terms, bringing private FSPs to distribute *Bolsa Familia* benefits can be the carrot for them to offer simplified accounts and even to promote other financial inclusion aims of the program.

Another set of recommendations is related to data collection (Principle 10). The link between *Bolsa Familia* and simplified accounts can be useful in this respect. Registries for *Bolsa Familia* are very detailed and well organized. Small additions to the questionnaire could be made to include information on financial practices by the beneficiaries. Questions related to how the accounts are used, the frequency of use, and qualitative surveys with the beneficiaries would help bridge a significant gap in Brazil with respect to available information and statistics.

The total failure of simplified savings accounts also calls for attention. Product design issues may be at the heart of this issue. The main issue from a policy perspective would be to devise products and actions to encourage savings by the poor. The low take up of simplified savings accounts show that the current format of this product does not seem to be the way to reach this goal. An entire different approach seems to be warranted. It is beyond the scope of this paper to indicate which should be the best policy strategy in this regard.[46] So, for the moment, the immediate recommendation is to scrap simplified savings accounts from the legislation on simplified accounts and rethink the whole strategy related to savings by the poor.

3. Payroll bank loans

3.1 Context

Payroll bank loans (*Crédito Consignado em Folha de Pagamento* – hereafter payroll or consigned credit) are personal loans with both principal and interest payments directly deducted from the borrower's payroll check. In practice, this type of credit turns future borrower income into collateral to the operation.

Credit with wage deduction is not a novelty in Brazil. This practice began in the 1990s, with support of Law 8,112 of December 1990, which allowed payroll loans to servants and retirees of the public sector. More recently, Law 10,820 of September 2003 has regulated payroll credit also for private sector employees and for social security beneficiaries (retired workers and pensioners) of INSS (Social Security National Institute) program. Since then this type of credit has recorded huge expansion.

[46] One possibility could be mechanisms of commitment savings. Commitment savings rely on compulsory mechanisms of periodic contributions to a savings account plus restrictions on withdrawals until the balance reaches some amount or for some period of time. The literature has pointed out that they are an effective way of encouraging savings by the poor. See, e.g. Ashraf, Karlan and Yin (2006) for Philippines or Brune et al. (2011) for Malawi.

Table 18 shows total balances (stock) for personal loans in constant values. Personal loans focus essentially on the financing of consumption, but without tying the credit to the purchase of any specific good. Thus, the borrower can allocate the loan freely as he or she wishes.

Consigned credit is currently the largest and most dynamic portion of personal loans. Furthermore, despite the intention of Law 10,820 of September 2003, the participation of private-sector workers in this market is still very restricted.

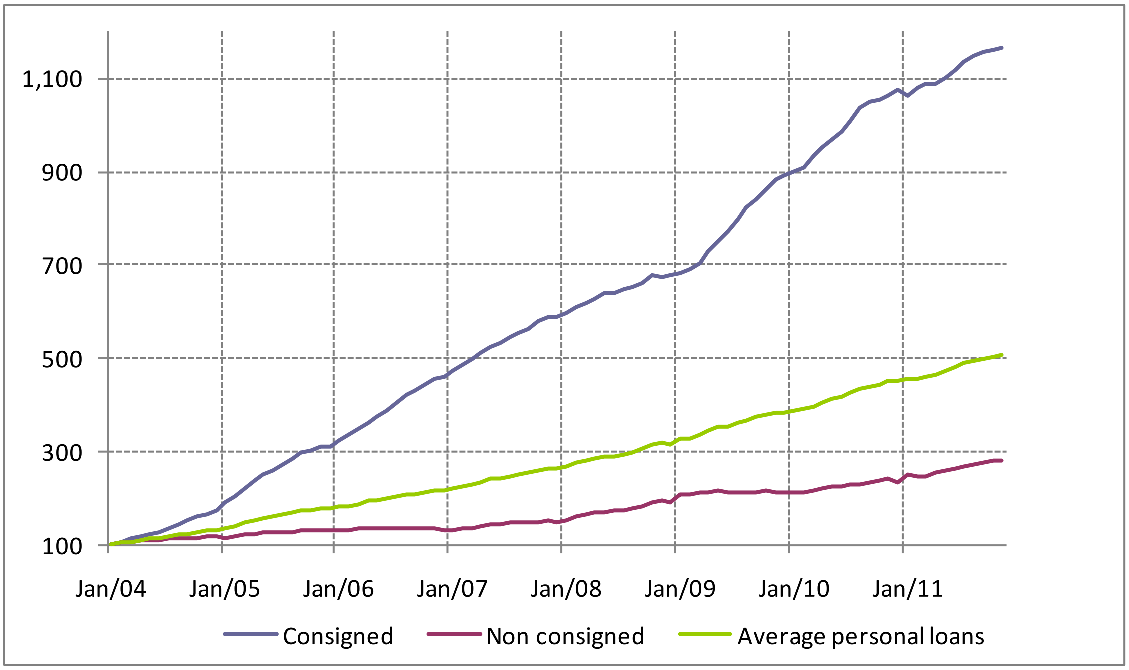
Table 18: Personal loans outstanding balance – consigned and non consigned credits (R$ million, constant values)

End Year	Consigned loans			Non consigned personal loans	Total personal loans	% consigned
	Public sector*	Private sector	Total			
2004	19,997	3,479	23,476	46,205	69,681	33.7
2005	37,272	5,079	42,351	52,143	94,493	44.8
2006	54,556	7,802	62,358	52,531	114,889	54.3
2007	69,654	10,546	80,200	59,242	139,443	57.5
2008	79,846	12,514	92,360	75,862	168,222	54.9
2009	104,335	16,748	121,083	83,781	204,864	59.1
2010	125,299	21,198	146,497	93,734	240,231	61.0
2011**	135,957	22,591	158,548	111,949	270,497	58.6

Constant values of November 2011
* Loans to active and inactive civil servants and retirees and beneficiaries of INSS.
** Values in November 2011.
Source: Central Bank of Brazil

In 2004 the consolidated balance of personal loans totaled R$ 69.7 billion, of which R$ 23.5 billion corresponded to loans with wage deduction. Seven years later, these consigned credits totaled R$ 158.5 billion, showing an increase in real terms of 575 percent in the period or 31.4 percent average per year. In the same period the non consigned personal loans has also experienced pronounced growth but at less impressive rates, with a real increase of 142 percent since 2004 (or 13.5 percent average per year) which amounted to R$ 111.9 billion in November 2011. These differences in personal loans components dynamics can be seen in Figure 12.

Figure 12: Recent evolution of personal loans – consigned and non consigned credits stock in constant value (Index, January 2004 = 100)



Source: Central Bank of Brazil

As a result of this higher growth of payroll loans, their share on total personal credit has risen considerably, from 33.7 percent in 2004 to 58.6 percent in November 2011. The majority of these operations are performed with public sector employees/retirees, which owns approximately 86 percent of total payroll bank loans.

3.2 Problem(s) the initiative aims to address

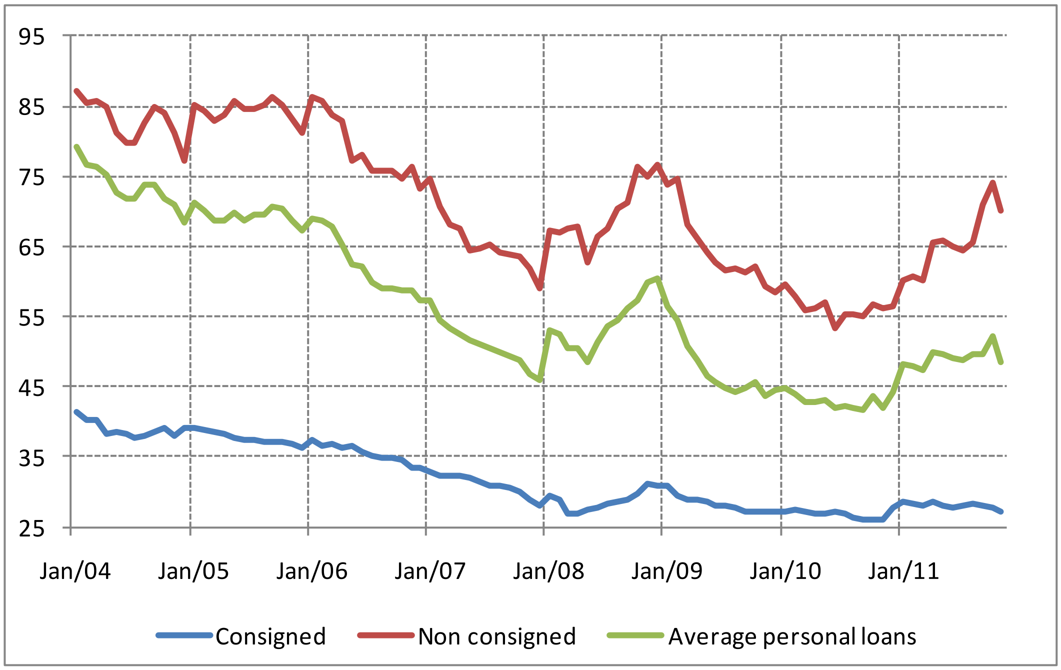
Payroll bank loans are important to improve financial access since this initiative considerably ameliorates the information asymmetry problems associated with credit operations.

Two technical features of consigned credit ameliorate the problem of information asymmetry to this effect on informational problems. First, as we have already mentioned, in this type of credit the loan installments are deducted directly from the worker's wage. Therefore the borrower's present and future income works as collateral for the loan. Furthermore, the Law mandates that the total expenditure with consigned credit installments do not exceed the maximum limit of 30 percent of the worker's income.

According to Coelho et. al. (2010), the use of salaries and benefits as collateral considerably reduces the probability of strategic default. At the same time, the limit on consignable margin eliminates the risk of over-borrowing, leaving financial institutions only with the idiosyncratic risk of borrower's death. Therefore, the wage consignation mitigates both hidden information and moral hazard problems, reducing consequently credit risk [Coelho et. al. (2010), p. 3].

In practice, we can observe that interest rates charged on payroll loans are much lower than the average recorded in the personal credit market (Figure 13). The overall trend is for reduction in the lending rates for both types of personal loans, but the interest rate for consigned loans has consistently remained below that for non consigned personal loans. According to Central Bank data, in November 2011 the consigned loans average interest rate was 27.2 percent per year compared to 70 percent per year charged on other non consigned personal loans operations. This fact could be seen as evidence of the beneficial effects of wage consignation on the credit risk, resulting in lower costs for borrowers.

Figure 13: Interest rates on personal loans (% per year)



Source: Central Bank of Brazil

Lower credit risk due to better collateral is a significant factor in a country where collateral recovery is very costly due to an inefficient Judiciary, as is the case in Brazil (see our discussion in Part I). Thus, in addition to the information asymmetry problem that the innovation aims to deal with, consigned loans also deal with institutional problems, such as those from the judicial system which might not enforce properly creditor's rights. Thus, this innovation can also be seen as a market-oriented second best solution to institutional obstacles.

In fact, several recent empirical studies have associated the lower levels of interest rates charged on this market with the lower risk and greater assurance provided by the salary consignation [for example, Costa and De Mello (2006), Rodrigues *et. al*. (2006) and Coelho *et. al*. (2010)].

3.3 Relation to the Taskforce Principles

Principle 2 (Building up of soft infrastructure):

Law 10,820 of September 2003 added a significant legal innovation, allowing the installments discount on payroll. In practice, this measure creates a new type of collateral that can be used in credit operations, developing a new and dynamic market for bank loans. Costa and De Mello (2006) found strong evidence to the importance of legal support for the consigned credit market development since, previous to the approval of this legislation, there was a question mark on whether labor income could be pledged in credit contracts.

The issue was taken to the high courts in Brazil due to allegation that wage and pension income could not be offered as collateral according to current legislation. The high court decision was reached in June 2005 with the understanding that consigned loans does not represent (in legal terms) pledge of wage as collateral.

Principle 5 (protecting low-income and small customers against abuses):

Problems with information asymmetry are at the root of FSP’s actions. As a result of problems of adverse selection and moral hazard, the pricing of financial services are made under imperfect conditions. Generally, the losses tend to be more severe for the low-income and small customers who have greater difficulties in offering guarantees for their loans. In this sense payroll bank loans borrowers have more guarantees - represented by the discount on the payroll, enabling greater protection against abuses by FSPs.

Another element to protect borrowers is the limit on the amount that can be pledged for loan repayments. Such a limit works towards controlling over-indebtedness problems for the borrowers.

The legislation for consigned loans to pensioners and retirees ask also for previous disclosure of interest rates, fees, number and value of installments, to increase transparency to the borrowers.

Principle 4 (ensuring safety and soundness of FSPs):

From the standpoint of the FSPs, the lower credit risk associated with payroll loans makes this initiative compliant with Principle 4. Payroll loans limit credit default due to strategic behavior (moral hazard) by the borrower, which makes it less risky from the view of the FSPs. Moreover, the upper limit on the borrower’s income that can be pledged for repayment of such loans also reduces the risk assessment of this product.

The main remaining risks are associated to events like death or unemployment. Given the age profile of pensioners and retirees, the risk of death is not implausible. To cover for such risk, the consigned contracts with pensioners and retirees include an insurance in the event of death.

Regarding the risk of unemployment, such risk is more associated to private workers than for civil servants. Civil servants admitted through public admission tests have job stability. For private workers, FSPs have right to 30 percent of compensations paid for dismissal. In the event that such share is not enough to cover for the remaining obligations, the FSP and the borrower renegotiate the contract.

Principle 1 (promoting entry of and competition among financial firms)
Principle 8 (balancing government's role with market financial-service provision):

The establishment of Law 10,820 of September 2003 was followed by a rapid support of financial institutions. According to Takeda and Bader (2005), before the approval of the Law, only the state-owned bank Caixa Econômica Federal had allowance to operate with beneficiaries of INSS. Banco of Minas Gerais (BMG) was the first private commercial bank to enter in this market in September 2010. Just over a year later, twelve other financial institutions were already operating with payroll loans. Currently, 66 FSPs have agreements with INSS to provide consigned loans (position in January 2011). Therefore, the private sector has contributed to the success of this initiative by joining the new legislation and creating a competitive environment in the concession of these personal loans.

A recent (January 2011) legislation from the Central Bank forbids FSPs from making exclusive deals which may prevent or restrict customer access to loans offered by other FSPs. One of the intended targets of such legislation was some cosigned loan contracts between a financial institution and local governments, giving exclusive rights to the financial institution to offer such loans to the civil servants of that particular jurisdiction.

Another competitive impact of payroll loans may have occurred in the non-consigned segment of personal loans. The availability of a less expensive alternative for borrowers may have led to the reduction in lending rates in the non-consigned segment, as seen in Figure 11. As a result, the spread rate between non-consigned and consigned loans has shrunk to 30 p.p. in 2010 (against 45 p.p. in 2005).

Principle 10 (ensuring data collection, monitoring, and evaluation):

As for the previous initiatives, Principle 10 is not ideally addressed by payroll loans. Aggregate data for the entire market is released by the Central Bank. More disaggregated data is compiled by the Central Bank but is not public available. Individual data on the borrower side is non-existent.

3.4 Assessment of success

The main source of information on payroll bank loans is provided by the Central Bank of Brazil on its *Monthly Report on Monetary Policy and Credit*. The data comprises monthly balances borrowed by private and public sector workers (as in Table 17), being a portrait of overall consigned credit market performance. These figures are reported monthly making a time series starting in January 2004.

In addition, from a sample of the 13 largest banks in the personal loan segment, *Monthly Report on Monetary Policy and Credit* provides a more detailed picture of the consigned credit market. This research is reasonably representative, reaching about 70 percent of the total market. Data is collected on a monthly basis and concerns (i) total balances borrowed by private and public sector workers; (ii) total new payroll loans and (iii) average interest rates charged on consigned, non consigned and total personal loans.

Monthly Report on Monetary Policy and Credit is the best available public source of data on the payroll loans market. However, data are highly aggregated, allowing only a very general assessment of this segment evolution.

INSS releases monthly aggregated data for consigned loans for pensioners and retirees. Apart from the total number and amount of such loans granted on each month, INSS also discloses such information with some disaggregation.[47]

One method in which they disaggregate the data is by the value of the benefit received by the borrower (in multiples of the national minimum wage). Table 19 shows the latest information (for November 2010). If the amount of the benefit paid by INSS has some correlation with the income of the beneficiary, one can infer that consigned loans to pensioners and retirees have a good focus on the poorest. Thus, 54.9 percent of the INSS consigned loan operations in November 2010 went to beneficiaries earning up to 1 minimum wage. The amount of the loans to such beneficiaries represented 42.1 percent of the total.

Table 19: INSS consigned loans – Operations in November 2010

Benefit Paid	**Number of operations**		**Amount (R$ million)**	
		%		**%**
Up to 1 MW	398,505	54.9	921.76	42.1
Above 1MW up to 3 MW	206,816	28.4	634.28	29.0
Above 3 MW	121,313	16.7	631.82	28.9
Total	726,634	100.0	2,187.85	100.0

MW is minimum wage
Source: INSS

The INSS data is information also disaggregated by state. Table 20 shows the latest information (November 2010). There is no clear indication that INSS consigned loans contribute to regional descentralization. The number and amount of operations follow closely the regional distribution of the population in Brazil. If anything, the balance is actually in favor of the richer Southeast and South regions.

Table 20: INSS consigned loans – Operations in November 2010

Region	**Number of operations**		**Amount (R$ million)**		**Memo**	
		%		**%**	**% GDP**	**% Population**
Northeast	199,857	27.5	573.14	26.2	13.1	27.9
North	33,639	4.6	101.64	4.7	5.1	8.3
Middle-west	31,633	4.3	96.43	4.4	9.2	7.4
Southeast	337,291	46.4	1,042.58	47.6	56.0	41.8
South	124,214	17.1	374.06	17.1	16.6	14.6
Brazil	726,634	100.0	2,187.85	100.0	100.0	100.0

GDP in 2008; Population in 2010.
Source: INSS, IBGE.

[47] INSS has apparently stopped releasing this information through their website (visited in January 2012).

There is some evidence that the expansion of INSS consigned loans and the network of bank correspondents are linked. Loureiro (2011) reports that the number of bank correspondents per capita is higher in municipalities with larger shares of INSS pensioners and beneficiaries after controlling for other municipality characteristics.

Other more disaggregated data sets are not public, such as the Credit Information System (SCR) of Central Bank of Brazil. SCR is a general registration made by financial institutions and contain the main features of all credit transactions over R$ 5000. This information is the main starting point for academic studies that have examined in greater depth the payroll loans market [for example, Costa and De Mello (2006) and Rodrigues et. al. (2006)].

There is no available data from the borrower side. Thus, impact studies for this initiative cannot be properly conducted. However, using household data from the annual Brazilian Household Survey (PNAD) for the years 2002, 2003, and 2005, Madeira *et al*. (2010) showed that access to consigned loans to INSS pensioners and retirees significantly increased entrepreneurial activity for this group, a result consistent with the view that the availability of this new credit instrument may have alleviated credit constraints in the form of limited commitment.

The success of payroll loans can be explained by factors related to both supply and demand in this market. On one hand, financial institutions invested heavily on their expansion. The main reason is that the low risk involved in consigned operations makes this segment highly profitable. The good quality of these loans has led to an active secondary market for buying and selling the consigned loans portfolios. This type of operation has proved particularly attractive to smaller banks that obtain good returns selling their credit rights to large banks. A measure of commercial banks' interest in this market is the large entry of new players, as described above.

On the other hand, from a demand perspective, payroll bank loans match with the borrowers needs since they have significant advantages in terms of loan costs. Between 2004 and 2011, the consigned operations average interest rate was about 50 percent of that charged on other personal loans operations (Figure 8). In a study related to INSS consigned loans, Gigliucci (2011) reports a pattern of diffusion of this innovation where substitution away from more expensive lines of credit was the main factor of expansion in the period from September 2005 to September 2007.

A problem in the functioning of payroll loans is the low participation of private sector employees. The wage consignation in credit operations with private sector workers is allowed since Law 10,820 approval in September 2003. However, the participation of this segment in payroll loans has kept steadily below 14 percent (Table 17). The main explanation for this low participation is the greater volatility caused by the higher job turnover in the private labor market [Chu et. al. (2007)]. Civil servants have better job stability and the income flow for pensioners and retirees is not subject to fluctuations.

Private sector workers represent the large majority of labor force in Brazil (approximately 90 percent). Thus the expansion of consigned credit necessarily must consider the inclusion of this segment. The Brazilian Central Bank has expressed concern with this fact, pointing out possible solutions as formal mechanisms for transfer of the consignment for future jobs in the case of borrower displacement [Chu et. al. (2007)].

Another important dimension for possible expansion of this market is that it only reaches the formal segments of labor markets. According to IBGE's latest household survey [IBGE (2009), table 4.8], only 43.4 percent of those occupied people in 2008 were employed in formal jobs and, therefore, could qualify for consigned loans.

3.5 Potential for replication and possible lessons

The general idea of deducting loan repayments directly from payroll can certainly be replicated in other countries. Informational problems are characteristic of FSPs' activities anywhere. Given this general feature, the implementation of payroll bank loans may help increase financial access outside Brazil as well. For example, the case study for Mexico mentions a similar initiative in mortgage markets by the Mexican government agency INFONAVIT (*Instituto del Fondo Nacional de la Vivienda para los Trabajadores*).

As previously mentioned, successful replication leads to the analysis of issues that may be more country specific. Amongst those, an important element that enabled payroll loans to take off in Brazil was a clarification by the courts that labor income could be pledged in credit contracts.[48] This element is certainly a pre-condition for the successful implementation of this initiative, and each country may have different perspective on this legal matter.

Another important country specific element that determines the extent of outreach for this initiative is the relevance of the formal segment of labor markets in the country. Brazil is not particularly well endowed in this aspect although the recent trend has been towards increasing formalization.

3.6 Policy recommendations

Consigned loans are currently restricted to personal loans. There is no particular reason for this limitation. Other types of loans could also benefit from the lower credit risk embedded in such innovation, with a resulting reduction in lending rates. This could help to increase access to credit. One possibility is to extend it to mortgage markets, similar to the Mexican experience with INFONAVIT.

One shortcoming of this initiative in Brazil is the low uptake by private workers. The main reason for this problem is the higher volatility in the labor income of this group as compared to the civil servants and to pensioners and retirees. One solution to this problem is to make consigned loans portable across jobs. In other words, the displaced borrower can take the consigned loan to his/her new job instead of terminating the contract (as it is the case today). The current legislation on consigned loans

[48] The issue was that the Civil Law mentions that wages cannot be offered as collateral; the high court understanding in a 2005 decision was that in consigned loans wages are not being *legally* pledged as collateral.

discriminates against high job turnover situations, creating some paradoxes like reinforcing credit constraints for youngsters (who usually face high job turnover) or limiting the speed of credit growth when the economy is booming (when job turnover increases) [Chu et. al. (2007)].

Final remarks

Social inclusion has been an important issue in Brazil in the last decade or so. Political support and policy initiatives in different social areas have been widespread. One such area is financial inclusion. Access to financial services has recently increased in Brazil.

The qualitative change in the macroeconomic environment has been a contributing factor to expanding financial access in Brazil, with effects on both demand and supply. In addition, some recent microeconomic reforms, such as the implementation of the New Bankruptcy Law, have also played an important role in this area. Finally, it should be mentioned the restructuring in the banking sector in nineties, had direct impacts on the soundness of the financial system and on the competitive landscape bringing new players into the market. Some of the new actors were directly involved in the provision of financial services to the poor like the microcredit organizations.

In the same direction, many policy actions were taken to expand financial access to the poor. Some of these actions were examined here: correspondent banking, simplified bank accounts, and payroll bank loans. The list also includes actions taken towards credit cooperatives, microfinance, and special lines of finance for small and medium firms.

Overall, these actions played a big role in improving financial access to the poor. Lack of more detailed data makes difficult to properly evaluate these actions but the aggregate evidence seems favorable. The attendance to the task force Principles has not been full and some question marks related to the still prominent role played by the public sector remain.

If there is one lesson that makes the Brazilian experience illustrative, it is the overarching nature of the actions taken. If social benefits payments have to go to the poor, one has to make sure that neither geographical barriers nor expensive bank fees represent prohibitive constraints, hence the combination of bank correspondents and simplified accounts. If credit products to the poor are underdeveloped then one possible reason is that they lack good collateral. To circumvent this problem, at least for those workers with formal jobs, payroll loans are a less costly (to the borrower) and less risky (to the lender) solution.

In summary, Brazil took actions addressing a variety of market failures or imperfections ranging from geographical barriers to lack of collateral, informational problems, high costs, etc. Actions were taken towards people living in isolated regions, in rural areas, and in poor urban areas. Actions were taken for financial services ranging from payments to savings, deposits, and credit. Actions were taken for those with formal jobs but also for those who live on social benefits (including retirement benefits). And so on.

There is certainly still a long way to go in terms of bringing financial access to the poor. In Part I, we identified some of the main areas where overall improvements need to be done, whereas in Part II, we concentrated the recommendations to the initiatives studied. A summary of the main policy recommendations follow:

Part I

<u>Business and institutional environment</u>:

- Promotion of a broad tax reform to ease fiscal pressure on the financial intermediation services.
- Simplification of procedures required by regulatory authorities, such as the number of procedures to enforce a contract.
- Changing the legal codes to speed up the judgments.
- Clarifying campaigns with the judges on the economic costs of non-strict enforcement of credit contracts.

<u>Public sector participation</u>:

- Implementation of a credible program for reducing directed lending.
- As a second best solution, government should allow prices or quantity allocated to be set by the market in directing credit for specific groups.
- Substitution of the strategy of directed credit for more market oriented measures, such as the creation of partial guarantees to financial excluded groups.
- Creation of a credible program for reducing compulsory requirements.

<u>Data, financial literacy and other problems</u>:

- The Central Bank of Brazil should consolidate data on financial access in Brazil.
- Sequence of the *Financial Inclusion Report* (Banco Central do Brasil 2010b), including new variables as time series on the regional distribution of the main channels of delivery of financial services.
- Sequence of the IPEA (2010)'s report, with a greater scope of information and in partnership with the Central Bank.
- Inclusion of questions on financial issues in the household survey conducted by IBGE (PNAD).
- Creation of a broad financial literacy program with the families supported by the government social programs.
- Increase in the disclosure of prices and fees charged by financial institutions.
- Increase in disaggregation in the geographical financial inclusion plans.

Part II

<u>Bank Correspondents</u>:

- Increase in the list of products and services provided by bank correspondents. For example, inclusion of insurance and microinsurance products and services.
- Use of bank correspondents as a way to diffuse financial education initiatives.
- More and better publicly available data on the client usage of bank correspondents

<u>Simplified bank accounts</u>:

- Allow private banks to distribute and pay social benefits as a way to attract them to supply simplified accounts.
- Use registries of *Bolsa Familia* to improve data collection and to perform impact studies for simplified bank accounts.
- Redesign simplified savings accounts with the goal of encouraging savings by the poor.

Payroll bank loans:

- Extend consignado loans to other types of loans. In particular, extend them to mortgage loans.
- Make consigned loans portable across jobs, i.e., allow displaced borrowers to take their consigned loan to their new jobs.

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