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How to make bankers richer: The Brazilian financial market with public and private banks

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Abstract

In this paper, the literature on state-owned banks (SOB) and on the determinants of high spread and profitability of Brazilian banks are briefly reviewed. Then the paper proceeds to present the hypothesis that the way state-owned banks have interacted with public-owned banks in the market is partially responsible for such high profitability and interest rates spreads of Brazilian banking system. A model is presented to explain how this interaction can generate this profitability and spreads. The results also show that governments that stretch social policies are those that are most likely to raise profitability and spreads. Furthermore, the model also shows that if the government is generous with employees of state-owned banks, it will also contribute to the profit performance of private banks and high interest rates spreads. An empirical test for this hypothesis is developed. It tests if the expected profitability of privately owned banks rises when there is a reduction in the expected profits of state-owned banks. The results confirm the major hypothesis.

JEL classification: G21; G32

Keywords: State-owned banks; Bank spreads; Bank profitability

1. Introduction

The Brazilian banking market has the peculiarity of being comprised of privately owned banks (POB) and state-owned banks (SOB) competing in the same market. Most commercial operations are performed indistinctively by any of these two types of agents and customers can rely on all

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of them to obtain most of their regular banking services. In December 2003, state-owned banks were responsible for 42.43% of total deposits, and they had 37.23% of total assets of all banks in Brazil. They were also responsible for 32.73% of total credit to companies and consumers.[2] The largest Brazilian bank, Banco do Brasil, is a state-owned bank. These data indicate that the state-owned banks' stake of the market is not marginal.

Many countries also have SOB,[3] as there was a widespread idea among economists that there were several market failures in the banking sector, so that public ownership of banks could improve social welfare.[4] The major market failures presented are (i) intrinsic potential instability[5]; (ii) asymmetric and costly information; (iii) the existence of social externalities emerging from private investments; and (iv) individual minimum scale demand for access to financial services, what tends to exclude poor and isolated populations from such market.[6]

SOBs in Brazil are actually state-controlled banks, as they are all companies whose shares can be freely negotiated in the market.[7] Nevertheless, governments are the major shareholders. This assures them control on the banks' governance and helps them rely on these banks to obtain most of their banking services, as they do not have to go through public competitions for their acquisition. Brazilian legislation that regulates governmental purchases allows the public sector to buy goods and services directly from these state-controlled companies, without having to engage in a public competition. The Federal Government controls the five major state-owned banks.[8]

Brazilian private banks are among the most profitable in the world. Particularly, their profitability is high when compared to other sectors. Some bank shareholders have created companies that work parallel to the banks, providing services to their own controlled banks, so that they can disguise part of their profits.[9]

Brazilian banks also have one of the highest interest rate spreads in the world.[10] The level of these spreads has raised many social concerns, as it has reduced the share of credit to total GDP, and consequently, harmed local development.[11] Very often, the profitability of banks and the interest rates spreads are considered to be part of the same phenomenon, although this is not necessarily true.

The good performance of banks has been attributed to a number of factors. First, there is the oligopolistic structure of the banking market.[12] Second, the excessive financial risk of operating

[2] Data are from Brazilian Central Bank.

[3] For data on several countries and group of countries, see La Porta, Lopez-de-Silanes, and Shleifer (2002).

[4] The classical work by Gershenkron (1962) is always mentioned as a source defending state intervention on the banking sector.

[5] See, for example, Stiglitz (1994).

[6] These market failures are extracted from the justifications for state intervention on the banking sector, presented by Yeyati, Micco, and Panizza (2004).

[7] For more details on the characteristics, attributes and working of SOB in Brazil, see Neto (2004). Such scheme of operation of SOB are also common in many countries, as can be seen from the data collected by La Porta et al. (2002), if their data on the several levels of state controls of banks are compared.

[8] They are Banco do Brasil, Caixa Econômica Federal, BNDES, Banco do Nordeste, and Banco da Amazônia.

[9] This partially explains why their profitability is small in spite of their high net interest margins, as pointed by Belaisch (2003) and Singh et al. (2005).

[10] See for example Antunes, Cavalcanti, and Villamil (2005).

[11] Many recent studies have pointed that financial development increases growth. See for example Beck, Levine, and Loayza (2000) and La Porta et al. (2002).

[12] This is the view defended by Belaisch (2003), although Nakane (2001) had found evidence that there is no cartel and there is some competition on the Brazilian banking market. Nevertheless, he rejected the hypothesis that there is perfect competition, what led to accept the hypothesis that there is some market power by banks working on local market.