

## Doing Business in Brazil

The discovery of  
rare opportunities  
for financial  
institutions





# Beyond the wild landscape

History shows that the troubled times tend to offer key lessons to financial institutions. The 1920's crises stimulated a stronger regulation in capital markets, for instance. Recent financial scandals initiated processes focused on transparency all over the world. The recent global credit crisis will also leave important lessons. One of them should be the urgency of devoting more attention to some alternative markets, including those distant from the most developed economies.

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## Understand the large, regulated, and sophisticated financial sector in Brazil

In a certain way, such new markets – especially emerging ones – may contribute to show that, beyond the turbulent landscapes of our times, there are new scenarios, new prospects, new opportunities. More than ever, financial institution leaders will try to understand how the emerging countries work.

Brazil, as a key emerging market, is no longer known only for its natural beauties, but also as a country really attractive to foreign investments. There is a growing number of investors and organizations interested in studying a country whose expansion has been fuelled by increasing domestic demand, sustained monetary easing, stock market development, continued credit growth, and improving labor-market conditions.

Under globalization, there is no place where one would be completely free from the impacts of an unprecedented crisis, as the one we still live nowadays. There are markets, however, where the chance of growth, renewal and recovery are stronger. Certainly Brazil is one of them.



This is one of the reasons why Deloitte decided to offer this publication to global financial institution leaders who want to achieve superior, sustained performance. Doing Business in Brazil reports market scenarios, trends, regulatory environment and other fundamental aspects to enable one to understand the large, regulated, and sophisticated financial sector of this country.

**I hope you find this study useful and informative.**

Clodomir Félix, Deloitte Financial Services Lead Partner in Brazil

# The Brazilian financial system

## Market overview

Brazil has a dynamic banking sector that represents about 6% of GDP (insurance services included). Following the trend dating to the second half of 2004, banking institutions have continued targeting their investments to credit operations. The volume of financial system credit increased from 24% of GDP in 2004 to 34% in December 2007.

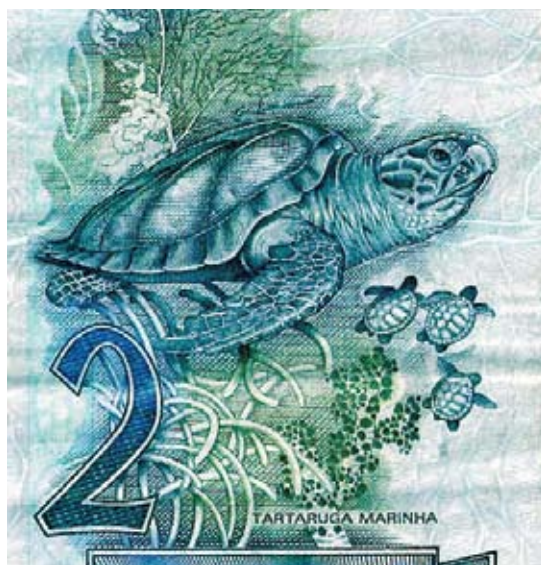
The banking sector had approximately 2500 firms by the end of 2007 (including holding companies, savings, commercial, development, and investment banks). The banking financial institutions provide services to the public through the following dependencies: branches, advanced service posts (PAA), banking service posts (PAB), electronic banking service posts (PAE), cooperative service posts (PAC) and correspondents, in addition to collection and payment banking posts (PAP) and rural credit advanced posts (PACRE), the last two no longer authorized by the Central Bank.

By 2007, there were about 18 thousand branches, representing an increase of 12% versus the position of 1996. Though bank branches are the main type of service point, both regarding scope of services and free access by the general public, since 2002 the number of dependencies of this type grows more slowly than electronic service posts. This was an expected outcome in view of the technological advancements introduced by the need felt by institutions to cut costs, what triggered a deep rationalization of

operating procedures by financial institutions. Another explanation for the lower pace of growth experienced by bank branches is the reorganization processes implemented by large network banks in the wake of acquisitions that took place in recent years. The network of correspondents increases faster than the number of branches too. They provide services that are structurally different and non exclusive of each other. Correspondents within the country constitute a further instrument for democratization and decentralization of financial services. Taking the physical, population and economic aspects, mechanisms that may facilitate the flow of funds between financially assisted municipalities and those that do not count on traditional assistance represented by bank branches and service posts is vital.

Regarding the widening of branches network, the number of new dependencies authorized to operate was expressive in 2006 (1,448 were bank branches). In the period, 6,839 correspondents in the country were authorized (disregarding the hiring of correspondents that are not subject to Central Bank authorization), what stresses the importance assumed by such mode of service to the population in recent years. Despite the investment in Brazilian financial market have been concentrated on short term operations and linked to the Selic (benchmark rate), the capital market has been growing rapidly albeit from a relatively low base. The volume of primary capital market offers, including stocks, debentures and promissory notes registered at the Securities and Exchange Commission (CVM) totaled R\$89.4 billion in 2007, compared to R\$16.3 billion in 2004. The process of monetary policy easing reinforced investor expectations about the economy. Since then, the volume and total value of private issues of stocks and private bonds has grown rapidly, and this may be expected to continue.

The insurance, (open) private pension and capitalization market is composed of approximately 160 companies. Insurance companies make up the majority (72 percent), while 17 percent are entities exclusively dedicated to offering open private pension schemes and 11% are dedicated to capitalization plans. At the end of 2007 total premiums within the insurance sector had reached R\$68.6 billion, making



Brazil the largest insurance market in Latin America. There were more than 370 closed pension funds holding \$260 billion in assets.

### Brazil at a glance

The effectiveness of the macroeconomic policy adopted by the government was decisive for Brazil to get back on the track of recovery, easing inflationary pressures.

Brazilian economic indicators	Forecast				
	2005	2006	2007	2008	2009
GDP growth (%)	2,9	3,7	5,4	5,0	3,6
Inflation IPCA – end-of-period (%)	5,7	3,1	4,5	6,3	5,0
Interest rate – end-of-period (% per year)	18,0	13,3	11,3	14,8	13,8
Exchange rate – end-of-period (R\$/US\$)	2,34	2,14	1,77	1,65	1,75
Foreign trade balance (US\$ billion)	44,8	46,1	40,0	23,6	13,0
Foreign direct investment, net (US\$ billion)	15,1	18,8	34,6	34,6	30,4
Net public sector debt (% of GDP)	46,5	44,7	42,9	40,6	39,1

Source: Deloitte Brazil Research (according to Central Bank of Brazil)

Note: Median of market expectations in 09/12/2008

- **The path of growth** – The economy has remained with a low growth and a relatively high rate in comparison of world economic figures and has needed infra-structure investments. The growth of industrial sector – one of the most important sectors in terms of job creation – has been complemented by strong commodity prices and exports. This sector (about 30% of the GDP) is capable of sustaining a higher rate of growth (4%-5% yearly growth), depending on foreign demand and a weaker currency.
- **Positive evolution in the Brazilian equity and financial markets** – Changes in the regulations at Bovespa stock exchange led to an equity boom, with Novo Mercado – a set of corporate governance rules similar to those of U.S. Changes started in 2000 and in 2005 legislators simplified procedures for non-residents. Improvements in macro indicators fostered declines in yields of Brazilian sovereign bonds. Brazil has the largest Latin market for hedge funds.

- **Growth Acceleration Package for 2007-2010** – Federal government announced US\$236 billion growth acceleration package. The proposition is to promote growth without compromising macro stability.
- **The country of renewable fuels** – The International Energy Agency estimates that bio-fuels will represent 6% of the energy matrix by 2020 and Brazil is the second-largest producer and largest exporter of ethanol.
- **Fiscal policy, debt sustainability and structural reforms** – The fiscal policy is based in successive and high non financial public sector primary surpluses. The federal government has adopted Tax-Benefit System to reduce inequality and poverty.
- **Micro reforms and market regulation** – Governance Reform and institutional changes in Brazil to maintain the stable market rules.
- **Sovereign risk and investment grade** – The fundamentals of the economy and the international liquidity generated consistently positive flows of external resources, raising the international reserves stock to comfortable levels. The government has refinanced the debt at lower interest rates and longer maturities and made net repayments on its external debt, reducing the country's risk perception. This strategy improves the perception of international of risk classification agencies.
- **Developments on Mercosul and international trade arrangements** – Gas nationalization in Bolivia is a challenge for energy matrix. The challenge of Mercosul and South America: towards union or disintegration and driving growth. Chinese trade impact on Latin American Emerging Markets: trade alliances, shared gains, asymmetric hopes and competitiveness.
- **International scenario** – A significant change in the Brazilian external position and the domestic improvement mitigate the impact of adverse external scenario characterized by heightened uncertainties, financial markets volatility and economic activity deceleration.

## Banks

The past several years of sustained economic growth have helped to bolster Brazil's banking sector, compounding the positive effects of years of reforms. Loans to the private sector and consumers have increased dramatically, and banks have reaped the rewards from providing these services. The sector is well regulated and supervised, following international best practices and guidelines. In addition, the existence of a well-developed secondary market as a hedge to systemic risk, a modern payments and settlement system, and stringent capital requirements all serve to buttress the financial structure from the ups and downs of international markets. These, combined with the participation of foreign institutions, have helped the sector weather multiple domestic and regional crises, including the Mexican-sparked debt crisis of late 1994, the Brazilian Real devaluation of early 1999, the Argentine debt and banking crisis of 2001.02 and the Brazilian crisis of confidence before the presidential elections of late 2002. Many local analysts believe the sector will also withstand any negative effects from turmoil in the international capital markets, which started in late 2007.

Ample liquidity, lower interest rates and increased consumer demand for credit have left Brazil's commercial banks – along with their much smaller Chilean counterparts – the most solid and profitable financial institutions in Latin America. Banks are also providing services to Brazil's large poor population, most often in the form of micro and payroll loans.

Growth in demand for personal credit was fostered through a combination of loans with lower interest rates and larger durations. Annual interest rates charged on personal credit transactions declined from 52.1% at end-2006 to 43.9% at end-2007 (which is still a very high level in real terms); average duration expanded by 2.4 months to 14.7 months. By contrast, average corporate credit duration expanded by 1.4 months, to 9.3 months, and average interest rates decreased by 3.3 percentage points, to 22.9%.

Capital-adequacy ratios remained well above the minimum level set by authorities under the Bank for

International Settlement's (BIS) recommendations – the BIS recommends a capital-adequacy ratio of 8%. The central bank requires a ratio of at least 11%, and most of the larger banks had ratios well above this level. The latest stress tests, conducted by the central bank during 2006, confirmed that financial institutions would be well positioned in the event of an extreme variation in interest rates, exchange rates or credit risk.

The central bank's November 2007 Financial Stability Report details the legislative and regulatory changes that are being implemented to comply with Basel II requirements. The Central Bank had previously stated that Brazil's banking sector would be Basel II compliant by 2009; however, it is unclear whether the banks will be ready to meet this deadline.

For the past several years, prudent economic management in the form of healthy fiscal and monetary policies, together with an improved current-account position, made the financial system less vulnerable to external pressures. As a result, the country has benefited from less volatile exchange and interest rates but has seen a steady appreciation of the currency.

According to the Economist Intelligence Unit and the National Association of Investment Banks (Anbid), banks are expected to be profitable during 2008, but will be partly constrained by downward pressures on fee income stemming from growing competition and increased regulatory pressures. At end-2007 the Central Bank announced new regulations on bank fees, which came into effect in April 2008. The number of standard fees will be reduced from 55 to 20, and they will have to become more uniform in order to increase transparency for consumers. The Central Bank also established that banks will have to offer more free services and will only be allowed to raise fees every six months.

The financial system has been undergoing a modernization process since 1988. At the heart of the reforms has been the creation of multipurpose banks (*bancos múltiplos*) and increased foreign participation in commercial banks. Most state banks have been sold

to foreign and domestic institutions, although the two largest public-sector federal banks still account for 34% of the banking system's total assets. The banking sector has continued the trend towards consolidation that began in 1994, following the government's Real Plan to defeat hyperinflation. Commercial banks play the leading role in Brazil's financial structure. The segmentation of the sector has led to the formation of financial conglomerates, usually with a commercial bank serving as the mainstay of the group and selling the products of the other group members, including investment banks, insurers, and leasing and finance companies.

At the federal level, the government maintains a host of financial institutions that carry out certain functions, such as subsidising mortgages and engaging in development banking for particular industries and specific regions of the country. The state-owned Banco do Brasil – the country's largest financial institution – plays a key role in financing agricultural production throughout the entire country, especially for small farmers who generally do not meet commercial-bank loan requirements. In recent years, Banco do Brasil has increased its export-financing portfolio and stepped up banking services provided to lower-income Brazilians.

São Paulo serves as Brazil's principal financial and commercial centre. Brasília, the capital, is the seat of most government bodies. Some state agencies, banks and associations continue to have their headquarters in Rio de Janeiro, which was the national capital before 1960.

### Banks – Opportunities

- The Brazilian financial sector is large and sophisticated. The foreign-owned banks represents only 20% of total assets.
- Economic stabilization, deregulation process, opening of the market to foreign insurers have impacted the insurance market.
- Brazil has a efficient capital markets and portfolio investment. Changes in the regulations at Bovespa stock exchange led to an equity boom, with Novo Mercado – a set of corporate governance rules similar to those of U.S. Changes started in 2000 and in 2005 legislators simplified procedures for non-residents.

### The industry in 2007

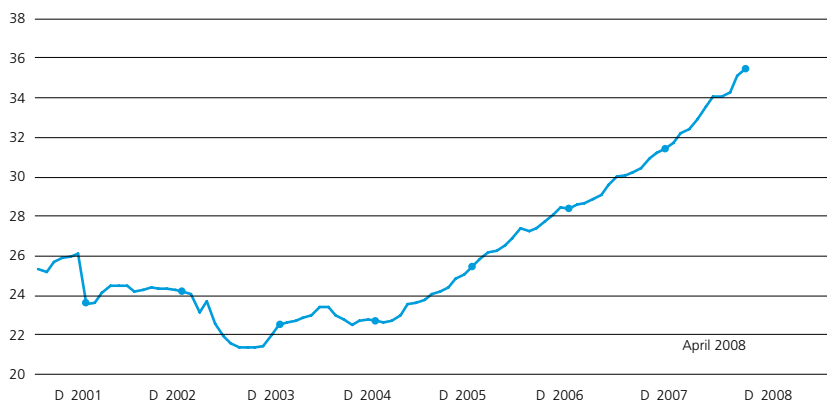
Country data	
Total GDP (US\$ billion)	1,295
GDP per capita	6844
Inflation rate (%)	4.5
Interest rate (% per year)	11.25
FSI dimention	
% of GDP	6.5
Banks – total landing to the private sector	43.7
Insurance and pension funds – premium, net contribution and plans	3.3
Capital market – securities offerings (stock, corporate bonds etc)	6.5

Source: Deloitte Brazil Research

Bank credit to the private sector rises rapidly in face of moderate inflation. The credit operations have been fuelled by improving in labor-market conditions and the interest rates cuts.

### Financial system credit operations

% of GDP



Source: Deloitte Research (according to Central Bank of Brazil)

## Banks – Global players

The strong position of the Brazilian domestic private institutions

Global Ranking	US\$ billion		Location	Last Reported
	Market Cap	Sales		
1 ICBC	205,9	52,3	China	June 2008
2 HSBC Holdings plc	184,7	92,4	UK	June 2008
3 CCBC	168,2	41,6	Hong Kong	June 2008
21 Bradesco	48,0	25,7	Brazil	June 2008
28 Itaú	47,9	19,8	Brazil	June 2008
42 Banco do Brasil	29,1	23,2	Brazil	June 2008
75 Unibanco	13,9	10,5	Brazil	June 2008
81 Banco Santander	12,7	9,2	Brazil	June 2008

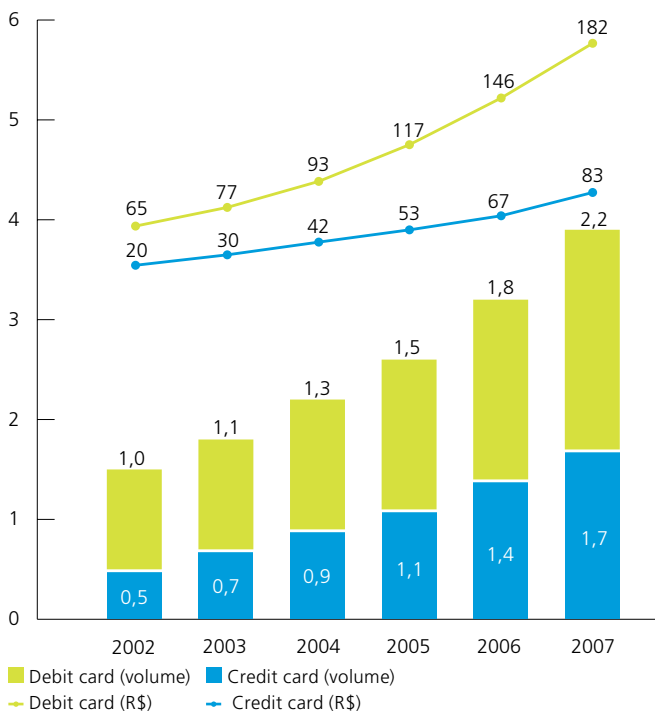
Source: Reuters, Factiva

Note: Based on publicly traded company data

## Payment system

In the last years, payment cards have presented the highest growth rate among the payment instruments used in Brazil.

Payment instruments  
Billion

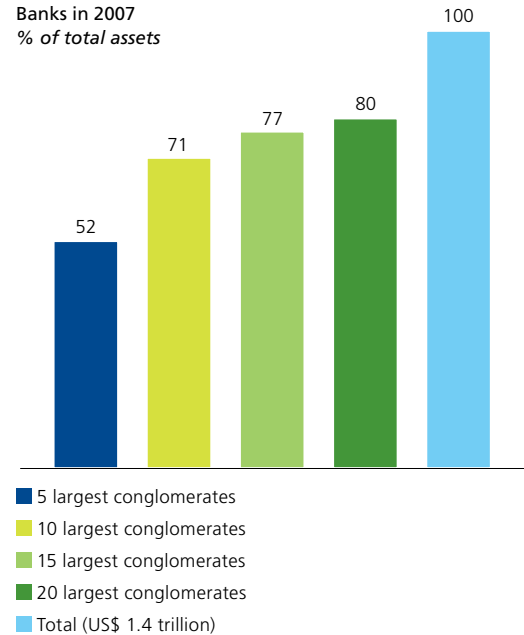


Source: Deloitte Brazil Research (according to Central Bank of Brazil and Brazilian banks, acquirers and card administrators)

## Local players

Only a few players are at the top

Banks in 2007  
% of total assets



Source: Deloitte Brazil Research (according to Central Bank of Brazil)

## Insurance

Brazil is the largest insurance market in Latin America and ranks 20th globally (by total premiums in 2005), according to the latest information from the National Federation of Private Insurance Companies (FENASEG). The Brazilian private insurance market remains proportionally small, despite the potential that exists for growth given the country's large population and stable economy. Premiums were equivalent to a modest 2.7% of GDP in 2007.

According to local press reports, analysts expect that the market will begin an upward trend as firms consolidate and the reinsurance market is opened to competition. There is a considerable degree of vertical integration between insurers and banks, with many of the larger banks – for example, Banco Bradesco, Banco Itaú, Unibanco and Banco Santander – offering a full line of insurance services. Large, stand-alone insurers include Porto Seguro, Sul América and Brasilprev.

The poor development of the sector stems from the high inflation and chronic macroeconomic instability that characterized Brazil until the mid-1990s. Such conditions made it impossible for individuals to make long-term financial decisions or to have any confidence in those who might promise to provide for them. As inflation expectations have eased over the past several years, the insurance market has started to respond. Insurance premiums amounted to R58.6bn in 2007, almost 17% above the figure for the previous year, according to the regulatory agency for the sector, the Superintendency of Private Insurance (SUSEP). Life insurance (including health insurance plans) amounted to 53% of total insurance premiums in 2007. Automotive insurance amounted to 25%, and property insurance amounted to 5,7%.

The insurance industry has performed well since pension reform in 2004, primarily in the life and pension sectors and with products aimed at small companies and individuals. Notably, the sector has benefited from the continued growth of a new life insurance plan, known as VGBL (Vida Gerador de Benefício Livre), originally offered as an alternative pension plan by Bradesco. VGBL is a long-term savings product, similar to a 401(k) plan, but created for individual employees rather than employers. A VGBL pays out funds to policyholders while they are still alive and includes several incentives, such as annual dividend payments and the ability to direct how a policyholder's funds should be invested. Following on Bradesco's success, several other leading financial firms, such as Banco Itaú and Unibanco, now offer VGBL policies as well.

Compared with regular pension plans, VGBL has a lower limit for monthly or annual contributions, and income tax is due only on capital gains at the time of withdrawal. The plan is attractive to taxpayers who already use their 12% deduction for social-security payments on other types of social-security programmes and are not able to benefit from the tax discount provided for regular pension-plan contributions. VGBL premiums reached R20.2bn in 2007, a sharp increase from R15.3bn in 2006. VGBL policies amounted to 34.5% of total premiums in the insurance industry in 2007, according to SUSEP.

**Foreign participation** – The few remaining restrictions on the entry of foreign companies to the insurance market are slowly being eliminated. Companies are free to enter the market in association with a Brazilian company already operating in the area, but to operate independently they need authorization from the government. Some foreign financial firms, including ABN Amro (Netherlands) and HSBC (UK), have avoided this difficulty by acquiring integrated domestic financial groups.

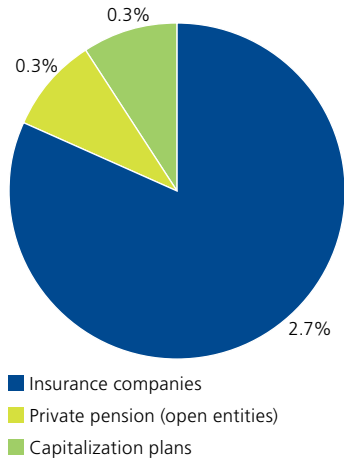
The government announced the sale of the state-owned reinsurance company IRB-Brasil Resseguros in 1997, and attracted the interest of major foreign companies, including Swiss Re, Munich Re, Transatlantic Re and Cologne Re. In addition to being a monopoly reinsurer, the company was also the reinsurance regulator. In a recent bid to open the sector to new companies, the government approved Supplementary Law No. 126/2007 in January 2007, which hands reinsurance regulation over to the National Council of Private Insurance (CNSP). SUSEP is responsible for sectoral supervision.

The new legislation allows three types of companies to begin operating in the reinsurance market in Brazil. "Local" reinsurers have registered offices in Brazil and are incorporated with the sole purpose of conducting reinsurance transactions. "Admitted" reinsurers have registered offices abroad and a registered representative office in Brazil. "Eventual" reinsurers are foreign reinsurance companies with registered offices abroad but without a representative office in Brazil. These firms must be registered with SUSEP to conduct reinsurance transactions in Brazil.

**Insurance – Market dimension**

The insurance market has enjoyed a strong growth recently, mainly in the life insurance segment. The pension sector is divided between open and closed entities. Reforms are gradually spurring the growth of private pension funds (open entities).

Insurance and pension dimension (% of GDP)

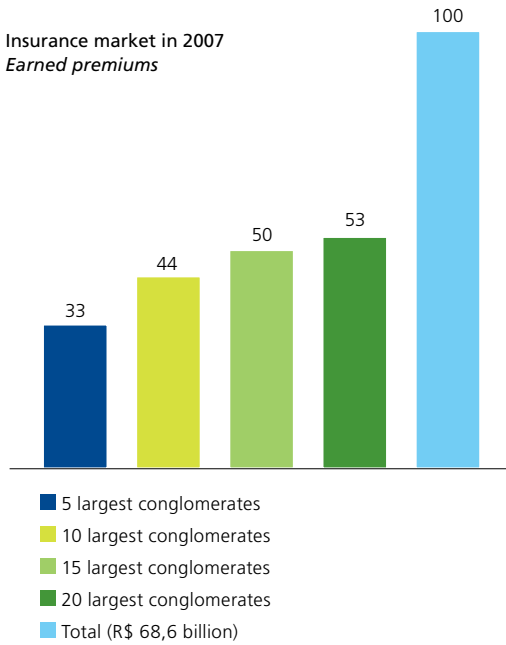


Source: Deloitte Brazil Research (according to Fenaseg and Susep)  
 Note: Insurance (premium); Private pension (net contribution); Capitalization plans (bonds)

**Insurance – Market consolidation**

- The market will begin an upward trend as firms consolidate and the reinsurance market is opened to competition.
- There is a considerable degree of vertical integration between insurers and banks.

Insurance market in 2007 Earned premiums

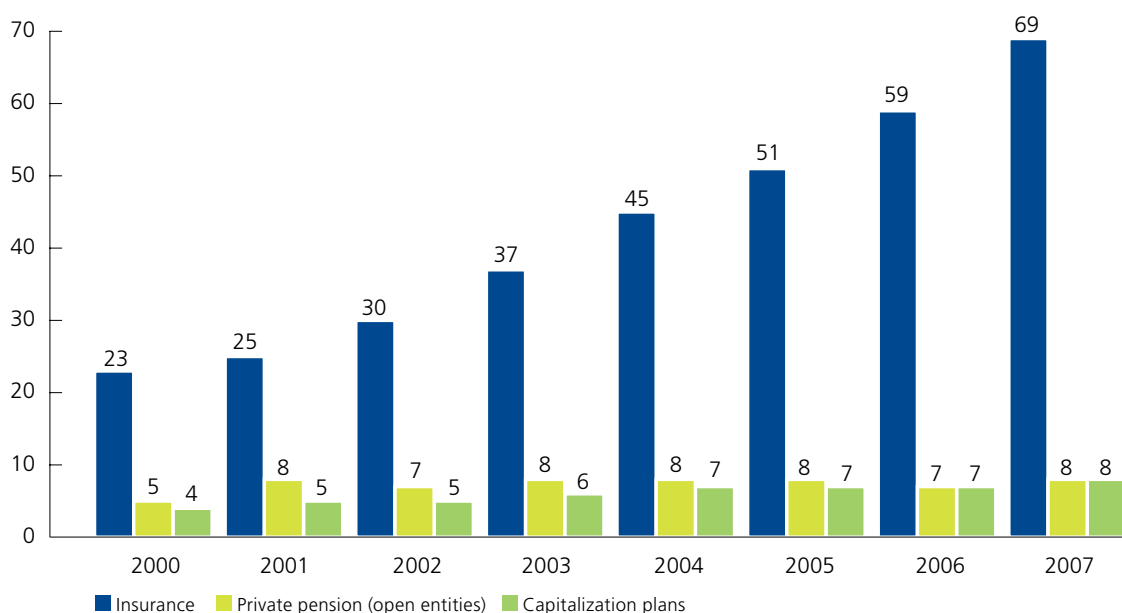


Source: Deloitte Brazil Research (according to Fundação Getúlio Vargas – FGV)

## Insurance – Market evolution

Driven by a strong rise in purchases of life insurance, which is reflecting strengthening real incomes and increased confidence in macroeconomic stability, the Brazilian insurance market has been expanding rapidly since 2003.

Insurance companies and pension funds  
(R\$ billion)



Source: Deloitte Brazil Research (according to Fenaseg and Susep)  
Note: Insurance (premium); Private pension (net contribution); Capitalization plans (bonds)

## Insurance – Market players

Foreign companies are free to enter the market in association with a Brazilian company already operating in the area, but to operate independently they need authorization from the government.

Main insurance-companies (R\$ billion)		
Top 10 conglomerate	Earned premium	% Composition
Bradesco	6.9	22.9
Sul América	6.6	21.7
Porto Seguro	3.4	11.3
Itaú	3.0	9.8
Unibanco AIG	2.8	9.1
Mapfre	2.4	8.0
Tokio Marine	1.6	5.2
Aliança do Brasil	1.3	4.2
Allianz	1.3	4.2
Caixa	1.1	3.7
<b>Top 10</b>	<b>30.3</b>	<b>100.0</b>
<b>Total Insurance</b>	<b>68.6</b>	<b>44.2</b>

Source: Fundação Getúlio Vargas – FGV  
Note: Conglomerates

# Regulatory environment

## Background

The Brazilian financial supervisory system has developed gradually, primarily during the second half of the twentieth century, and mostly in response to various pressures, financial crises, and changes in the nature of financial services over time.

In the mid-1960s, following the implementation of the macroeconomic stabilization plan, the *Government Plan for Economic Action*, a need for restructuring the financial system was identified, leading to the passage of the “National Financial System Law, which continues to be the principal legislation underpinning the Brazilian financial markets. The act established the National Monetary Council (CMN) through which all major monetary and financial resolutions are issued today, and which includes the Minister of Finance, the Minister of Planning and the Governor of the Central Bank.

The Central Bank of Brazil (BCB) was also created by Law 4.595/64. The BCB is an autonomous federal institution that took over the functions of a monetary authority. These functions were previously performed by the Currency and Credit Superintendence (SUMOC), Banco do Brasil (BB) and the National Treasury. Although some improvement was achieved through the creation of a formal Central Bank, the institutional process was not complete. The BCB became the currency issuing bank, but acted according to the needs of the BB. The BCB was the bank of banks but was not the only holder of deposits from financial

institutions since many institutions placed their voluntary reserves in BB. Nonetheless, the BCB was the government’s financial agent in charge of managing the federal public debt. It was not the cashier to the National Treasury since this was also a function of BB.

The 1960s and 1970s saw reforms aimed at fostering the emergence of a capital market and enhancing supervision through the 1976 establishment of the Securities Commission (CVM).

By the 1980s, Brazil was experiencing rapid inflation and a prolonged economic crisis, leading to a drastic fall in demand for bank loans, increases in liquidity, and significant decreases in credit volume. However, financial institutions succeeded in maintaining relatively high profits due to income from non-interest-bearing deposits. While banks’ assets became increasingly concentrated in highly-liquid government securities, the government abolished the charter requirement for setting up new institutions and authorized the incorporation of multi-purpose banks, which led to an increase in the number of banks.

Then, in 1985, the government further reorganized the financial supervisory structure. The main change was the removal of the financial linkages and overlapping functions between the BCB, the BB, and the National Treasury. In 1987, the automatic transfer of funds from the BCB to the BB was eliminated, which had hampered the BCB’s management. Through 1988, full monetary authority was progressively transferred from the BB to the BCB, while atypical activities carried out by the BCB (such as those related to economic incentives and administration of public debt) were transferred to the National Treasury.

The 1988 Constitution continued the clarification of the BCB’s role, explicitly assigning to the BCB the responsibility of issuing currency and specifying that its board, which is appointed by the President, requires Senate approval. The 1988 Constitution forbade direct or indirect granting of loans to the National Treasury and called for a Complementary Law of the National Financial System to replace the National Financial Systems Law of 1964.



Brazil experienced further economic strains in the early 1990s. In July 1994, inflation rates reached almost 46 percent per month and the Real Plan was enacted to cut inflation. A systemic crisis was eminent; seven small banks filed for bankruptcy. In 1995, after 13 other bankruptcies, the BCB intervened at the *Banco Economico* (a large Brazilian bank) to avoid a bank run. To address this crisis, in late 1995, the government announced a strategy that included a commitment to bear the costs of losses instead of the banks' creditors in order to encourage mergers and acquisitions of the banks facing difficulties.

In response to the bank failures, a further, more fundamental restructuring of the banking system safety net was implemented. Prudential regulations were enacted and supervision was strengthened to ensure safety and soundness of the financial system. In addition, other changes were instituted, including a direct line of liquidity and the creation of a deposit insurance scheme. In April 2002, the payment system (*SPB*) was reformed. Within the new system framework, the BCB would not accept negative balances on the reserve accounts of any bank at any time.

As for insurance, Brazil's government has regulated all insurance and reinsurance operations since 1966. It created the National System of Private Insurance, which was formed by the National Private Insurance Council (CNSP), the Private Insurance Superintendence (SUSEP), Brazil RE and companies that operate in private insurance as well as qualified brokers. In 1967, the National System of Capitalization was created. In 2003, SUSEP began a modernization process based on the IAIS Core Principles.

In 2007, Complementary Law 126 eliminated the previous state monopoly of reinsurance. CNSP became the regulator for co-insurance, reinsurance and retrocession transactions with regulatory supervision provided by SUSEP. Brazil RE would continue to operate as a local reinsurer only.

Closed pension funds have been regulated since 1977 when these funds were designated as depository institutions. The law was updated in 1998 and 2001

with general rules to define the relationship between the government bodies and their respective pension entities.

### **Statutory framework**

The fundamental law of Brazil's financial system is the National Financial System Law (Law 4.595/64), effective since 1964, creating the CMN and the BCB. The CMN was given the responsibility for formulating monetary and credit policies, whereas the BCB is responsible for executing those policies. Resolutions can be issued without Congressional approval if they comply with the existing law.

Law 6.024/1974 deals with issues of intervention and judicial liquidation. Related to this law is Executive Act number 2.321/87 which institutes the Special Temporary System of Administration. Together these two pieces of legislation allow the BCB to place companies into administration and remove or replace a company's board of directors.

Law 7.492/1986 defines financial crimes and related penalties. This includes, but is not limited to, unauthorized bond issuances, omission of relevant information and fraud against the supervisory process. Law 9.613/1998 defines money laundering crimes and associated penalties. Law 9.613 established the COAF (Council for Financial Activity Control) which is responsible for the enforcement of anti-money laundering activities.

Law 9.447/1997 increased the formal powers of the BCB, allowing the BCB to take preventative measures, such as requiring capitalization, transfer of shareholder control and/or stockholder structure reorganization (acquisition, merger or split-up). Various other legislative actions provide the BCB additional powers and establish standards within the financial services industry.

The main laws that guide the securities industry are Law 6.385/1976 (the "Securities Law") and Law 6.404/1975 (the "Corporation Law"), amended through Law 9.457/1997 and Law 10.303/2001 respectively.

SUSEP was created by Decree-Law 73/1966 and Decree 60.459/1967. These decrees regulate capitalization companies and, along with Complementary Law 109/2001, set the guidelines for pension funds, which is supplemented by other laws dealing with SUSEP's prudential functions.

In 1998, Constitutional Amendment 20 provided legislative guidance for complementary pensions. Additional guidelines were addressed in Complementary Law 109/2001. Article 74 of this law established the Complementary Pension Council (CGPC) as the primary regulator and establishes the Complementary Pension Secretariat (SPC) as the provisory supervisor. MPAS Resolution 01/1986 established the oversight for closed pension fund entities. Standards including prudential limits are further described in Complementary Law 109/2001 and CMN Resolution 3.121/2003.

**Non-statutory elements**

Many of the Brazilian financial market operators have established self-regulatory components. For banking activities, the Brazilian Federation of Banks (FEBRABAN) has components of self-regulation which include principles of transparency, fair competition, confidentiality, and compliance with formal rules and regulations.

Within capital markets, the National Association of Investment Banks (ANBID) established in 1998 five codes for self-regulation relative to investment funds, public offerings, qualified services to capital markets, private banking activities and the qualified certification program.

The National Association of Financial Market Institutions (ANDIMA) was established in 1971 and its members include commercial, multiple and investment banks, as well as stockbrokers and securities distributors. The group has a formal Code of Ethics as well as formal standards of conduct.

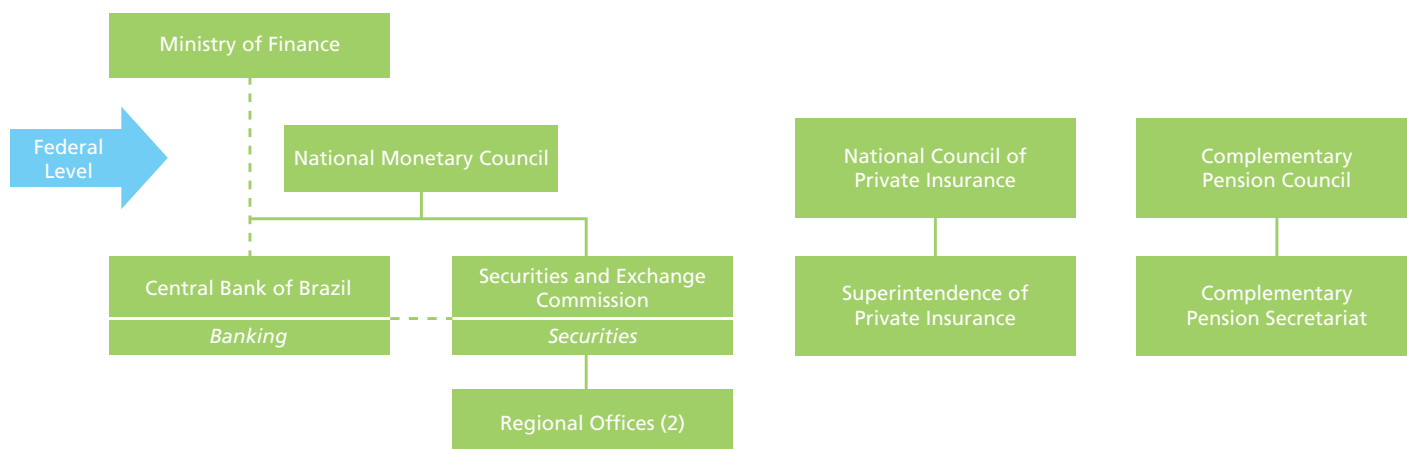
Within the insurance industry, there is a published Code of Ethics of the National Federation of Insurance Companies (FENASEG) which addresses general principles, institutional responsibility, social responsibility, ethics and internal relations, ethics and consumer relations, fraud and money laundering, and established a Market Discipline and Ethics Council.

**Institutional structure**

**National Monetary Council** – The National Monetary Council (CMN), in addition to management of liquidity, protection of the currency and coordination of monetary, fiscal and credit policies, has supervisory responsibilities which include:

- Guiding the allocation of funds by financial institutions
- Improving financial instruments and institutions
- Monitoring financial institution liquidity and solvency.

**Regulation and supervision entities**



The CMN has authority to draft regulations implementing the laws issued by the National Congress. The rules issued by CMN, typically referred to as “Resolutions”, must be adhered to by all the members of the financial system, including the BCB and the CVM.

The CMN is comprised of the Minister of Finance (Chairman), the Minister of Planning and the Central Bank Governor, all of whom are appointed by the Brazilian President.

**Central Bank of Brazil (BCB)** – The BCB is responsible for maintaining national currency purchasing power as well as monitoring the stability of the financial system. It has the formal authority for supervision of all financial institutions as well as licensing responsibilities.

As the monetary authority, the BCB acts as the lender of last resort. The BCB has the authority to intervene as necessary and liquidate financial institutions if there is a threat to the safety and soundness of the financial system.

The BCB has seven main areas of operations, each run by a Deputy Governor: administration, bank liquidation and privatization, international affairs, monetary policy, supervision, financial system regulation, and organization and economic policy. The BCB generates income from its activities as monetary policy executor and from the Treasury budget. Any profits are returned to the Treasury and any losses will be covered by the Treasury. Approximately 97 percent of its budget in 2006 was generated from interest income.

**The Securities Commission (CVM)** – The Securities Commission oversees and supervises the stock market and other securities activities (debentures, commercial papers, stock index futures, stock options, over-the-counter markets). The CVM also supervises the institutions operating in the capital markets as well as the listed companies. The CVM has the legal duty to protect securities holders against fraudulent issues and/or illegal actions, as well as ensuring fair trading practices including access by the public to accurate and relevant information.

The CVM is overseen by one governor and four deputy governors, all of whom are appointed by the President of Brazil. The CVM is funded through the central government’s annual budget; however, on average, 91 percent of its income was derived from supervision fees, debts and fines. (CVM - Annual Report 2005).

**National Council for Private Insurance (CNSP)** – The CNSP (National Council for Private Insurance) establishes the guidelines and regulations for the private insurance market. It is run by the Minister of Finance (its chairman) and representatives from the Ministry of Justice, the Ministry of Social Security, the BCB, the CVM, and the Superintendent of SUSEP.

**Superintendence of Private Insurance** – The Superintendence of Private Insurance (SUSEP), an autarchy created by the Decree-law 73/66 directly linked to Ministry of Finance, is the executive body of the politics delineated by the CNSP and is also the insurance commissioner, responsible for the supervision and control of the insurance, open private pension funds and capitalization markets in Brazil.

SUSEP’s objectives are to ensure that market participants remain solvent and to promote customer protection. SUSEP has four main departments: administration, actuarial techniques, economic control, and supervision. SUSEP’s annual budget is a portion of the government’s annual budget. Fees and fines collected from supervised institutions accounted for approximately 59% of their 2006 income. The Complementary Pension General Council supervises closed pension funds in conjunction with the SPC and is funded via receipts from the Treasury.

#### **Enforcement and prosecution**

The BCB has broad powers to take actions to safeguard banking activities and depositors and creditors with the goal to maintain financial stability. These powers include warnings, fines, suspensions and temporary disqualifications. When a situation of non-compliance with minimum capital and net worth requirements or excess risk is identified, one measure that has been taken by the BCB has been

the commitment by the institution's management through a commitment letter to implement specific restructuring or capitalization plans.

The CVM has similar powers within the securities industry. The Law 6 385/76, which governs the securities market, states that CVM shall perform the duties provided for under the Law in order to "protect securities holders and market investors... against illegal acts of officers and controlling shareholders of publicly held corporations, or managers of securities portfolios". Law 6 385 requires that the accounts of listed companies, and other companies regulated by CVM, be audited. There are a number of applicable requirements under relevant laws and rules that seek to ensure the independence of external auditors in Brazil. In that regard, external company audits may only be carried out by audit firms or independent accounting auditors registered with the CVM. These auditors are subject to the rules of the CVM and the Federal Accounting Council, and also the Independent Auditors' Institute, with regard to professional conduct. The BCB adopts the same procedure for financial institutions. The CVM may impose penalties on auditors and audit firms, including warnings, fines, suspension or cancellation of authorization or registration, where they acted in breach of the securities or company laws and regulations.

SUSEP improves quality of the regulation and the veracity of supervision of the insurance sector. Regulatory improvements include, for the new life insurance products, a requirement for prudent actuarial evaluations; a draft requirement for a solvency margin etc.

#### **Framework for coordination**

Coordination between the governor of the BCB and Minister of Finance occurs through the CMN. Membership of the CMN allows for sharing of information related to supervisory actions of the BCB. Coordination between the BCB and the CVM is based on standards set by the CMN.

In addition, the BCB has two agreements in place with other agencies addressing matters of coordination

and cooperation: an agreement between the BCB and the CVM of February 2004, which concerns exchange of information and other activities to better perform respective tasks; and, an agreement between the BCB and the SUSEP of July 2005, concerning the coordination of activities and information exchange.

#### **International coordination**

The BCB works closely with other international supervisory agencies and has formal agreements with various countries, including Germany, Argentina, Bahamas, Spain, USA, Cayman Islands, Mexico, Panama, and Paraguay.

The CVM participates in international financial services working groups, such as the International Organization of Securities Commission (IOSCO), the Council of Securities Regulators of America (COSRA), and the Enlarged Contract Group on the Supervision of Investment Funds (ECG).

The SUSEP is also pursuing implementation of enhanced international practices through participation in the International Association of Insurance Supervisors (IAIS). The SPC has been exchanging information with the OECD regarding implementation of practices relative to the closed pension funds.

#### **Current issues**

There are some issues regarding financial system regulation that are currently being considered by Brazilian regulators and policymakers. In addition to ongoing efforts relating to Basel II implementation, another area of reform within banking is related to bankruptcy (Intervention and Liquidation Law 6.024). Consideration is being given as to how best to align the existing financial system resolution with new corporate bankruptcy law and to achieve better alignment with international practices.

The opening of the insurance market is another issue under discussion. In January 2007, Complementary Law 126 eliminated the previous state insurance monopoly. The regulation of co-insurance, reinsurance and retrocession transactions is now assigned to the CNSP, supervised by the SUSEP. The Act authorizes

three different types of reinsurance companies to operate in Brazil: the local re-insurer, the admitted re-insurer (re-insurer with registered offices abroad and with a representative office in Brazil), and the eventual re-insurer.

Another topic under discussion is competition within the banking industry. The BCB has the authority to approve mergers and to investigate conduct. However, the main antitrust authority in Brazil, the Administrative Council for Economic Defense (CADE), appointed by the Judiciary, is responsible for judging competition within the banking sector. To address this overlap of duties and responsibilities, the government presented a bill which is under consideration by Congress. The bill calls for the Brazilian System of Defense of Competition (SBDC) to oversee mergers of financial institutions only if there is no systemic risk related to the merger. If the merger could impact the soundness of the financial system, the BCB will retain ultimate authority.

Another issue under discussion is the Competition Protection Code (CPC) established in 1990. From 1990 until June 2007, there was confusion in the marketplace as to the applicability of the CPC to banking consumers. Banks had claimed it was not applicable; however, the Federal Supreme Court ruled against the banks' claims and confirmed that the CPC does apply to banking consumers.

## Accounting principles

### Law 11,638

The accounting principles and standards generally applicable in Brazil are established by Brazilian Corporation Law and interpretation statements issued by IBRACON – Instituto dos Auditores Independentes do Brasil, or the Brazilian Institute of Independent Auditors, the Brazilian accounting professional body. Those accounting principles and standards, in the case of listed companies under the jurisdiction of the CVM, are complemented by certain additional instructions issued periodically by the CVM. Such standards differ in certain material aspects from the accounting principles and standards generally accepted in the United States of America.

In addition, the CVM and other regulatory entities such as the Superintendence of Private Insurance (SUSEP) and the Central Bank provide additional industry specific guidelines.

On December 28, 2007, Law No. 11,638 was enacted that alters, revokes and adds new provisions to the Brazilian Corporation Law, especially with respect to chapter XV, Fiscal Year and Financial Statements. Law No. 11,638 was designed primarily to update accounting practices as contemplated in Brazilian Corporation Law, so as to enable the convergence of Brazilian accounting practices with accounting standards generally accepted in the international capital markets, and contemplates broad changes to accounting practices generally accepted in Brazil as they relate to statutory accounting practices and procedures. Law No. 11,638 also allows the CVM to issue new accounting standards and procedures, applicable to public companies in Brazil, in conformity with such international accounting standards.

The financial statement provisions of the Brazilian Corporation Law are applicable to all companies incorporated as *sociedades anônimas*, including public companies (*companhias de capital aberto*) registered with the CVM. Law No. 11,638, however, introduces a new requirement for certain other large companies not incorporated as *sociedades anônimas* to prepare

annual financial statements in accordance with the financial statement provisions of Brazilian Corporation Law, including those new provisions introduced by Law No. 11,638, and requires that these financial statements be audited by an independent auditor registered with the CVM. Such large companies, as defined therein, are entities or group of entities under common control, that have more than R\$240 million of assets or more than R\$300 million of gross revenues, both measured as of and for the prior fiscal year. Furthermore, private companies (*companhias de capital fechado*) subject to the financial statement provisions of the Brazilian Corporation Law may choose to prepare such financial statements in accordance with standards issued by the CVM.

The changes and requirements introduced by Law No. 11,638 are effective for fiscal years beginning on or after January 1, 2008 however are subject to additional interpretation and regulation by applicable regulatory agencies (which in the case of the Issuer shall be the Central Bank) and accounting standards bodies in Brazil.

#### **IFRS x Brazilian Gaap**

These Listing Particulars contain financial information relating to Banco Daycoval, which has been prepared in accordance with Brazilian GAAP. There are certain significant differences between Brazilian GAAP and International Financial Reporting Standards (IFRS), which incorporates all existing International Accounting Standards (IAS), that are relevant to the financial information presented herein. The following is a summary of some of the principal differences; however, this summary does not purport to be complete and should not be construed as exhaustive. In reading this summary, prospective investors in the Notes should also have regard to the following considerations:

Future differences between the Brazilian GAAP and IFRS resulting from future changes in accounting standards or from transactions or events that may occur in the future have not been taken into account in this summary and no attempt has been made to identify any such future events, ongoing work and decisions of the regulatory bodies that promulgate the BR GAAP and IFRS can affect future comparisons

between the BR GAAP and IFRS, including the current differences disclosed in this summary, this summary, does not purport to be complete and is subject to, and qualified in its entirety by, reference to the respective pronouncements of the Brazilian and International accounting professional bodies. Prospective investors should also consult their own professional advisors for an understanding of the differences between the BR GAAP and IFRS and how those differences might impact the financial information presented herein.

The accounting principles and standards generally applicable in Brazil and applied by Banco Daycoval in the presentation of the financial statements included in these Listing Particulars are established in accordance with the Brazilian Corporation Law, and interpretative statements issued by the IBRACON (Instituto dos Auditores Independentes do Brasil), the Brazilian Institute of Independent Auditors, the Brazilian accounting professional body. Those accounting principles and standards, in the case of listed companies under the jurisdiction of the CVM, are complemented by certain additional instructions issued by the CVM. In addition, the CVM and other regulatory entities such as the Central Bank, the banking regulator, and the Private Insurance Superintendency (SUSEP), the insurance sector regulator, provide additional industry specific guidelines.

On December 28, 2007, Law No. 11,638 was enacted that alters, revokes and adds new provisions to the Brazilian Corporation Law, especially with respect to chapter XV, Fiscal Year and Financial Statements. Law No. 11,638 was designed primarily to update accounting practices as contemplated in Brazilian Corporation Law, so as to enable the convergence of Brazilian accounting practices with accounting standards generally accepted in the international capital markets, and contemplates broad changes to accounting practices generally accepted in Brazil as they relate to statutory accounting practices and procedures. Law No. 11,638 also allows the CVM to issue new accounting standards and procedures, applicable to public companies in Brazil, in conformity with such international accounting standards.

The financial statement provisions of the Brazilian Corporation Law are applicable to all companies incorporated as public companies registered with the CVM. Law No. 11,638, however, introduces a new requirement for certain other large companies not incorporated as *sociedades anônimas* to prepare annual financial statements in accordance with the financial statement provisions of Brazilian Corporation Law, including those new provisions introduced by Law No. 11,638, and requires that these financial statements be audited by an independent auditor registered with the CVM. Such large companies, as defined therein, are entities or group of entities under common control, that have more than R\$240 million of assets or more than R\$300 million of gross revenues, both measured as of and for the prior fiscal year. Furthermore, private companies subject to the financial statement provisions of the Brazilian Corporation Law may choose to prepare such financial statements in accordance with standards issued by the CVM.

The changes and requirements introduced by Law No. 11,638 are effective for fiscal years beginning on or after January 1, 2008 however are subject to additional interpretation and regulation by applicable regulatory agencies (which in the case of the Issuer shall be the Central Bank) and accounting standards bodies in Brazil.

Brazilian standards differ in certain material respects from IFRS. Unlike IFRS, under the BR GAAP there are no specific principles relating to certain matters such as: business combinations; financial instruments; accounting and reporting for research and development costs and leases. The level of disclosure in the Notes to the financial statements may also differ significantly.

#### **Anti-Money Laundering Law**

Pursuant to the Brazilian anti-money laundering law, financial institutions must:

- identify and maintain up-to-date records regarding their customers;

- maintain internal controls and records;
- record, for a five-year period, any transaction or set of transactions performed by individuals or entities pertaining to the same economic group involving Brazilian and foreign currency, securities, metals or any other asset which may be converted into money that exceeds R\$10,000;
- review transactions or proposals with characteristics which may indicate the existence of a crime;
- keep records of transactions involving checks for a period of 5 years;
- inform the appropriate authorities (without the customer's knowledge) of any transaction or set of transactions performed by individuals or entities pertaining to the same group of companies, which involves amounts exceeding R\$10,000; and
- communicate to the appropriate authorities, within 24 hours, any suspicious transaction.

In addition, the Brazilian anti-money laundering law created the Financial Activity Control Council. The main role of the Council is to promote cooperation among the Brazilian governmental bodies responsible for implementing national anti-money laundering policies, in order to avoid the performance of illegal acts and frauds.

In 2006, in addition to the rules mentioned above, the Central Bank issued a new regulation whereby financial institutions must follow certain special procedures concerning banking transactions of public politicians. Therefore, the financial institutions also must:

- Identify public politicians, or members of their families, when reporting a suspicious transaction involving such individuals to the Central Bank; and
- Structure their internal procedures in order to identify public politicians and their sources of funds used for certain transactions. The financial institutions may consider the compatibility of such transactions with the information available in their systems regarding such person's assets.

Additionally, the Central Bank has adopted specific regulations to prevent financial transactions in connection with terrorism. Therefore, financial institutions must inform the Central Bank of any transaction involving:

- Osama bin Laden and members of Al-Qaeda and Taliban, observed the list of persons and entities published on: <http://www.un.org/Docs/sc/committees/1267/1267ListEng.htm>
- Saddam Hussein and his employees related with Iraq's old government, observed the list of persons and entities published on: <http://www.un.org/Docs/sc/committees/IraqKuwait/IraqSanctionsCommEng.htm>
- all other people with terrorists connections.

#### **Ombudsman Department**

Central Bank of Brazil Resolution No. 3477/07 establishes that financial institutions and other entities authorized to operate by the Central Bank of Brazil are required to create an Ombudsman Department, independent from Internal Audit, and compatible with the nature and complexity of their products, services, activities, processes and systems.

The Ombudsman Department needs to meet the aspects addressed by said Resolution, taking into consideration efficiency in responding to clients' complaints and opinions, internal handling of deficiencies identified in operating processes, staff training, semiannual reporting to the Central Bank of Brazil, and adding value to the Bank's business and internal control through appropriate reporting to Senior Management on the nature of these demands.

Minimum criteria to assess the appropriateness of the Ombudsman Department structure, systems and procedures pursuant to the requirements of Resolution No. 3477/07 of the National Monetary Council. These criteria will be assessed in relation to the specific situation of each institution and, according to the schedule set by said Resolution as subsequently amended.

1. The financial institution shall prepare and disclose policies and procedures for the Ombudsman Department.
2. The institution shall analyze the complexity of the products, services, activities, processes, and systems, and formally determine the structure of the Ombudsman Department. This structure shall contemplate the following aspects:
  - Number of staff members and their functions and responsibilities (organization chart);
  - identify the systems to be used to gather, register, handle and detail the complaints made and the related solutions;
  - describe the routines and procedures to forward and resolve complaints.
3. The complaint control system must be included in the context of the general controls environment of the institution, including, when applicable, the IT environment.
4. The Ombudsman Department must be separated from the Internal Audit Department.
5. The institutions shall:
  - Disclose the existence, purpose of and how the Ombudsman Department can be used, on their website, and through electronic or printed institutional communication to their clients or at their facilities.
  - Permit client access to the Ombudsman Department through communication channels, including by individuals with disabilities or reduced mobility.
  - Offer toll-free services to individuals and small companies, and the toll-free number should be advertised at their branches, the branches of correspondents, accredited companies, websites, communication channels to advertise products and services, registered in bank statements, electronic or hardcopy receipts, contracts with clients, publicity and advertising materials, and other documents sent to clients and registered in the UNICAD (information system on entities under the supervision of the Central Bank).

6. The following institutions may outsource client service and assistance:
  - Investment banks, microcredit companies, development banks, investment promotion agencies and mortgage companies not part of financial conglomerates through arrangements with professional associations to which they are affiliated;
  - Securities brokers and dealers not part of financial conglomerates through arrangements with stock or futures and commodities exchanges;
  - Individual credit cooperatives through an arrangement with a central credit cooperative to which they are affiliated.
  
7. The institution's bylaws or articles of incorporation shall include:
  - duties of the Ombudsman Department;
  - criteria for the appointment and dismissal of the ombudsman and term in office;
  - express commitment of the institution to create conditions to permit the Ombudsman Department to operate transparently, independently, impartially and objectively, and ensure the Ombudsman Department's access to information to prepare replies to the complaints received;
  - the bylaws shall be updated on the first time they are amended after the creation of the Ombudsman Department and the articles of incorporation shall be amended by April 30, 2008.
  
8. The appointment of the Ombudsman and the officer responsible for the Ombudsman Department, before the Central Bank, must comply with the restrictions and requirements below:
  - The officer responsible for the Ombudsman Department may hold another position, except officer responsible for managing third-party funds;
  - In the case of full-service banks, commercial banks, savings and loans banks, leasing companies, and credit, financing and investment companies, the Ombudsman cannot hold any other position except that of officer responsible for the Ombudsman Department;
  - If the same person is appointed to both the ombudsman and officer positions, such person is interdicted from holding any other position.
  - The data on the officer responsible for the Ombudsman Department and the ombudsman must be input into the UNICAD system, and the officer shall observe consumer rights regulations.
  
9. The institutions shall abide to qualification rules for the staff of the Ombudsman Department, as follows:
  - All Ombudsman Department staff members must take and pass a certification exam within two years after the date of National Monetary Council Resolution No. 3477, which is July 26, 2007.
  - The institutions are responsible for the periodic updating of the knowledge of the Ombudsman Department staff.
  
10. The institutions shall maintain control systems to register complaints received to keep a history of the calls received, client data, and actions taken.
  
11. In performing its duties, the Ombudsman Department shall receive and register the complaints in accordance with the following requirements:
  - Analyze and formally follow up client complaints unresolved by regular client service;
  - Disclose to the complainants the deadline for a final response, which cannot exceed 30 days;
  - Propose to the board of directors or the executive board the implementation of corrective actions or the improvement of the procedures and routines as a result of the analysis of the complaints received;
  - Prepare and send to internal audit, the audit committee or the board of directors, or in the absence thereof, the executive board of the institution, a quantitative and qualitative report at the end of each six-month period on the activities of the Ombudsman Department.

12. The officer responsible for the Ombudsman Department shall prepare a semiannual report containing the following items:
- A descriptive section addressing:
  - An assessment of the effectiveness of the Ombudsman Department work, including with regard to the institution's commitment to satisfactorily develop the Ombudsman Department's mission;
  - Adjustment of the Ombudsman Department's structure to comply with the legal and regulatory requirements, with evidence of identified deficiencies hindering the development of its activities, including as to the number of employees and attendants, logistics in place, equipment, facilities, and routines used;
  - Detailed report on complaints sent to the Board of Directors or the Executive Board, on frequency, how unaccepted proposals are forwarded and the related rationale, proposals already implemented and proposals accepted but not yet implemented, and the related implementation deadlines;

- An assessment of the compliance with the mandatory certification exam of the ombudsmen;
- Statistical section containing information on the complaints registered in the period, divided by institution in the case of financial conglomerates, individual and legal entity, state of the branch involved in the complaint, and subject, classification according to the result of complaints (warranted, unwarranted, warranted and resolved and warranted but unresolved), as well as complaints by month and total for last twelve months and a comparison with the same period of the previous month, showing the corresponding percentage variation.

#### Basel II – Impacts in Brazil

The New Basel Accord establishes more complex and extensive requirements for allocation capital that will have significant impacts on the financial institutions. BACEN (the Central Bank of Brazil), by means of Bulletin No. 16,137/07 changed the schedule for implementation of the Basel New Agreement in Brazil, adjusting Bulletin No. 12,746/04.

Basel II – Schedule for implementation

	2007	2008	2009	2010	2011	2012
<b>Credit risk</b>		<ul style="list-style-type: none"> <li>Management framework implementation</li> <li>Key points for internal standards database</li> </ul>	<ul style="list-style-type: none"> <li>Approach criteria based on internal classification</li> <li>Disclosure of authorization process for Internal standards</li> </ul>	<ul style="list-style-type: none"> <li>Authorization for basic approach based on internal classification</li> </ul>	<ul style="list-style-type: none"> <li>Authorization for advanced approach based on internal classification</li> </ul>	
<b>Market risk</b>		<ul style="list-style-type: none"> <li>Eligibility criteria for internal standards</li> <li>Disclosure of authorization process for internal standards</li> </ul>	<ul style="list-style-type: none"> <li>Authorization for use of internal standards</li> </ul>			
<b>Operational risk</b>	<ul style="list-style-type: none"> <li>Portion of capital requirement</li> </ul>		<ul style="list-style-type: none"> <li>Key points for use of internal standards</li> </ul>		<ul style="list-style-type: none"> <li>Eligibility criteria for internal standards</li> <li>Disclosure of authorization process for Internal standards</li> </ul>	<ul style="list-style-type: none"> <li>Authorization for approach based on internal standards</li> </ul>

■ Changed dates    ■ Unchanged dates    ■ First-time disclosed dates

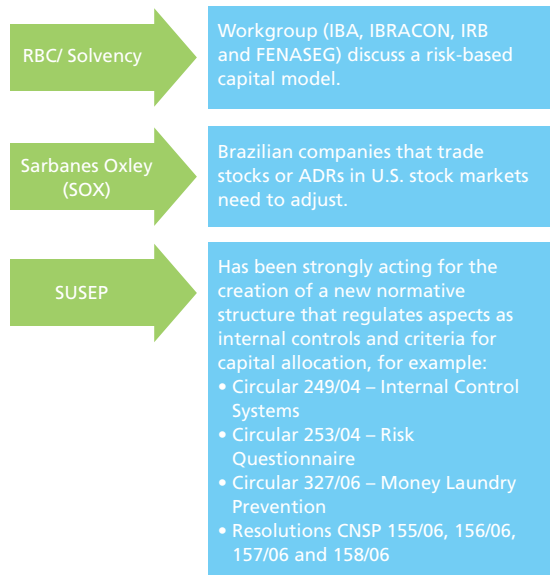
**Main Challenges – What should the institutions do?**

- Assess gaps in connection with the regulatory requirements.
- Define the most appropriate approach for allocation of capital/capital allocation.
- Prioritize and manage all initiatives related to Basel II.
- Prepare and/or review corporate strategies and policies.
- Qualify the team.
- Promote corporate awareness.
- Select / develop application systems and/or supporting tools.
- Make available all required data for calculation of capital.
- Certify risk management processes.
- Disclose information to the market.

**Solvency**

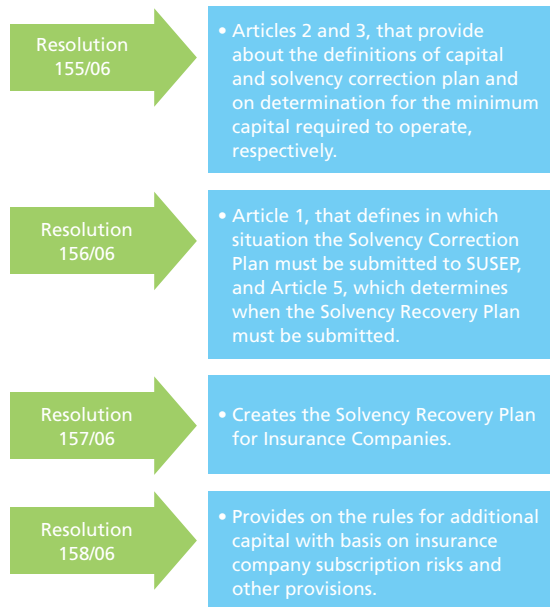
**Effects on the Brazilian insurance market** – Even though Solvency II is not regulated in Brazil, there is a tendency that this issue will attract more and more attention in the country. The minimum capital and solvency margin are determined by the National Council of Private Insurance – CNSP. The criteria established by CNSP take into account the magnitude of the operations, when they make reference to premiums issued, and the experience on payment of claims. Limitations: not taken into account the quality of the subscribed risk, the quality of the re-insurance contracted, the credit and market risks involving assets that guarantee the reserves, the reserve constitution risks, nor other business operating and legal risks.

**Solvency – Regulatory impacts on the Brazilian insurance market**



**New regulations**

From the new publications, the following points are worth to be highlighted:



## Impacts of the new regulations

Current situation	What changes	New regulations
<ul style="list-style-type: none"> <li>• <b>Resolution no. 073/02</b> – Provides on the minimum capital for insurance and companies and private equity funds and private pension open entities incorporated under the form of stock companies, and other provisions.</li> </ul>	<p>As of 01/01/08 this Resolution shall be amended by Resolution CNSP no. 155/06. As of 01/01/08 this Resolution shall not apply to insurance companies. The capital base shall comprise the sum of the fix portion corresponding to the authorization to operate with elementary branches and individuals, plus the variable portion for operation in the same branches in each of the Country regions listed in the Table of Variable Portion by Region.</p>	<ul style="list-style-type: none"> <li>• <b>Resolution no. 155/06</b> – Provides on minimum capital required to authorize insurance companies to operate and other provisions.</li> </ul>
N/A	<p>The insurance companies that show insufficient adjusted net worth as compared to the minimum capital required of up to 30%, shall submit to SUSEP a Solvency Correction Plan – PCS.</p>	<ul style="list-style-type: none"> <li>• <b>Resolution no. 156/06</b> – Solvency Correction Plan.</li> </ul>
N/A	<p>The insurance companies that show insufficient adjusted net worth as compared to the minimum capital required between 30% to 50%, shall submit to SUSEP a Solvency Recovery Plan – PRS.</p>	<ul style="list-style-type: none"> <li>• <b>Resolution no. 157/06</b> – Solvency Recovery Plan</li> </ul>
N/A	<p>The insurance companies that show insufficient adjusted net worth as compared to the minimum capital required between 30% to 50%, shall submit to SUSEP a Solvency Recovery Plan – PRS.</p>	<ul style="list-style-type: none"> <li>• <b>Resolution no. 158/06</b> – Additional Capital with basis on Subscription Risks</li> </ul>

### Corporative governance

Brazil's Corporations Law (Lei das Sociedades Anônimas, No. 10,303) entered into effect in March 2002, with the goal of improving minority shareholders' rights, promoting stronger corporate governance and improving disclosure rules. The country's Securities Commission (Comissão de Valores Mobiliários – CVM) published its own set of voluntary recommendations on corporate-governance practices in June 2002.

The Corporations Law alters Law 6,385, of 1976, which created the CVM and continues to regulate it. The CVM remains responsible for monitoring publicly held companies and issuing regulations concerning the type and frequency of information that they must make public – including management reports, financial statements, accounting standards, independent audit reports and minutes of meetings.

The legislation provides for fines and other punishments related to “crimes against the capital markets” that fall under the jurisdiction of the CVM. It states that market manipulation through engagement in fraudulent transactions may result in jail time of 1–8 years, and fines of up to three times the amount of the undue advantage gained by engaging in the fraudulent activity. The misuse of privileged information can result in imprisonment of 1.5 years and fines of up to three times the amount of the undue advantage.

The law also establishes that the CVM may enter into agreements with similar entities in other countries, or with international entities, for assistance and co-operation in investigations of market manipulation both in Brazil and abroad.

The legislation requires that preferred stock holders (those without voting rights but with priority for

dividend payments) receive dividends at least equal to common stock holders (those with voting rights). It also establishes that the number of preferred shares without voting rights, or subject to restriction on voting rights, may not exceed 50% of all issued shares.

The CVM's recommendations on corporate governance are not mandatory, and non-compliance is not subject to punishment. However, the commission hopes that companies will indicate their level of adherence and the reasons for non-compliance, if that is the case, in their annual filings. As of March 2008, however, the CVM had not released data on which companies were non-compliant. (The local stock exchange, Bovespa, announced that at end-2007 it had 156 companies listed that had voluntarily adhered to more stringent corporate-governance rules.)

According to the standards, a company should release quarterly management reports. General shareholders' meetings should take place at times that facilitate attendance. All relevant issues suggested by minority shareholders should be included in the agenda, and notices for the meetings should contain accurate and complete information about topics to be discussed. If a company has foreign depository receipts programmes, such as American Depository Receipts (ADRs) or Global Depository Receipts (GDRs), meetings should be called at least 40 days in advance.

A board of directors is charged with protecting the company's assets, ensuring the attainment of corporate objectives and guiding management towards maximum returns on investments. It should have 5–9 technically qualified members, two of whom should have financial expertise and be responsible for examining accounting practices. An audit committee, comprised of members of the board of directors with experience in finance and including at least one board member representing minority shareholders, should supervise audits to ensure their independence from the firm. The board of directors should prohibit or restrict hiring of the company's auditor for other services that may present conflicts of interest.

All board members should have a one-year mandate with the possibility for re-election, and as many members as possible should be independent of the company's management. Preferred shareholders should be allowed to elect a representative to the board. Company byelaws should specify that if dividends are not paid for three years, all non-voting shares will acquire the right to vote. Disagreements between the company and its shareholders should be resolved via arbitration.

The board should evaluate the performance of the chief executive officer annually. It should also ensure that transactions between related parties are clearly reflected in financial statements. Service contracts and loan agreements between related parties should not be allowed.

The CVM also recommends that investors interested in purchasing a controlling share of a company should offer the same price for the controlling group of shares to all other shares.

# How banks are taxed in Brazil

Here is a snapshot of tax law to help those who work in the tax department of a global bank which may be thinking of investing in Brazil:

## Corporate tax

The standard rate is 15%. FSI and other companies pay tax on worldwide income; non-resident companies pay tax only on Brazilian-source income. A bank is resident if its place of effective management is in Brazil. In addition to corporate income tax, banks are subject to income surtax at a flat rate of 10% on profits of more than R\$240,000 (\$134,000) annually. The government imposes a social contribution on net profits at a rate of 9%. This brings the effective rate to 34%.

## Capital gains

The government treats capital gains of banks and other companies as income, but it may place restrictions on offsetting capital losses against ordinary income. It taxes individual gains at 15%. Non-residents' capital gains from investments registered with the central bank are subject to a 15% withholding tax.

## Investments in the financial market

The longer the investment term, the lower the withholding tax rate.

For interest income and capital gains derived from investments in the financial market, the withholding tax rates vary, depending on the term for which the investor has held the investment. The guidelines for the withholding tax are:

- 22.5% on income or capital gains derived from financial investments held for up to 180 days
- 20% on income or capital gains derived from financial investments held for between 181 days and 360 days
- 17.5% on income or capital gains derived from financial investments held for between 361 days and 720 days
- 15% on income or capital gains derived from financial investments held for more than 720 days

These withholding tax rates are final, except for legal entities that are subject to corporate income tax.

## Administration and compliance

Legal entities are charged corporate income tax on a quarterly basis. They may choose to be assessed annually. In that case they make 12 monthly advance payments of tax. They base their advance payments on an estimate of their liability which is based on a percentage of monthly turnover. The percentage varies according to the nature of the industry.



Additional tax information	
<b>Withholding taxes</b>	dividends 0%, interest and royalties, 15%.
<b>Tax treaties</b>	Brazil has more than 25 tax treaties.
<b>Dividends</b>	Dividends are not taxable.
<b>Revenue protection</b>	There is transfer-pricing, controlled foreign companies (CFC) and general anti-abuse legislation.
<b>Groups</b>	There is no provision for group taxation.
<b>Incentives</b>	Incentives are regional and industry-based. There are incentives for exporters and technology companies. Few tax incentives are available for banks, except for technology companies.
<b>Other main taxes</b>	Banking (CPMF) tax, excise tax, inheritance and gift tax, municipal urban property tax, social contribution tax, social tax on imports, social security and rural property tax contributions, transactions tax, tax on services, urban real estate transfer tax.

### Minimising tax in acquisitions: two classic examples

Those in the tax department of a global bank that is interested in investing in Brazil, should be aware of a number of tax planning techniques which reduce the effective tax rate of an acquired and/or merged entity in Brazil. The two examples below are classic, but there are many more.

- The offsetting of existing tax losses (NOL): Brazilian tax law allows the offsetting of NOL under certain conditions, limited to 30% of each year's taxable income. A legal entity must pay income tax (and social contribution tax) on at least 30% of its taxable income each year. There is no statute of limitation to offset NOL. It can be carried forward indefinitely. However, no carry back method is allowed in Brazil. One way of getting around the 30% limitation is to exceed that percentage on the termination of a company (in a merger situation for example), applying a more aggressive interpretation of the issue that that which the letter of the law provides.

Banks should consider the use of this technique carefully. Some decisions of the Federal Administrative Tax Court have ruled against it. On the other hand, the Court has also made favourable decisions on the issue. Companies should bear this in mind, when evaluating a target with substantial NOL for potential acquisition.

- The utilisation of goodwill (in Portuguese, *agio*) paid on an acquisition: Under certain conditions, Brazil allows the classification of portions (sometimes the totality) of paid goodwill on an acquisition, as an itemised deductible amortisation expense. To enjoy this deduction, an upstream or downstream merger between the acquiring company and that which is being acquired, is mandatory. The goodwill amortisation period should not exceed one-sixtieth of the total deductible goodwill amount per calendar month. Banks have often employed this technique when acquiring other banks. To reap the benefits of such planning, the surviving company should be the one that makes enough taxable income to absorb the goodwill amortisation.

# Technology requirements

**The local financial network**

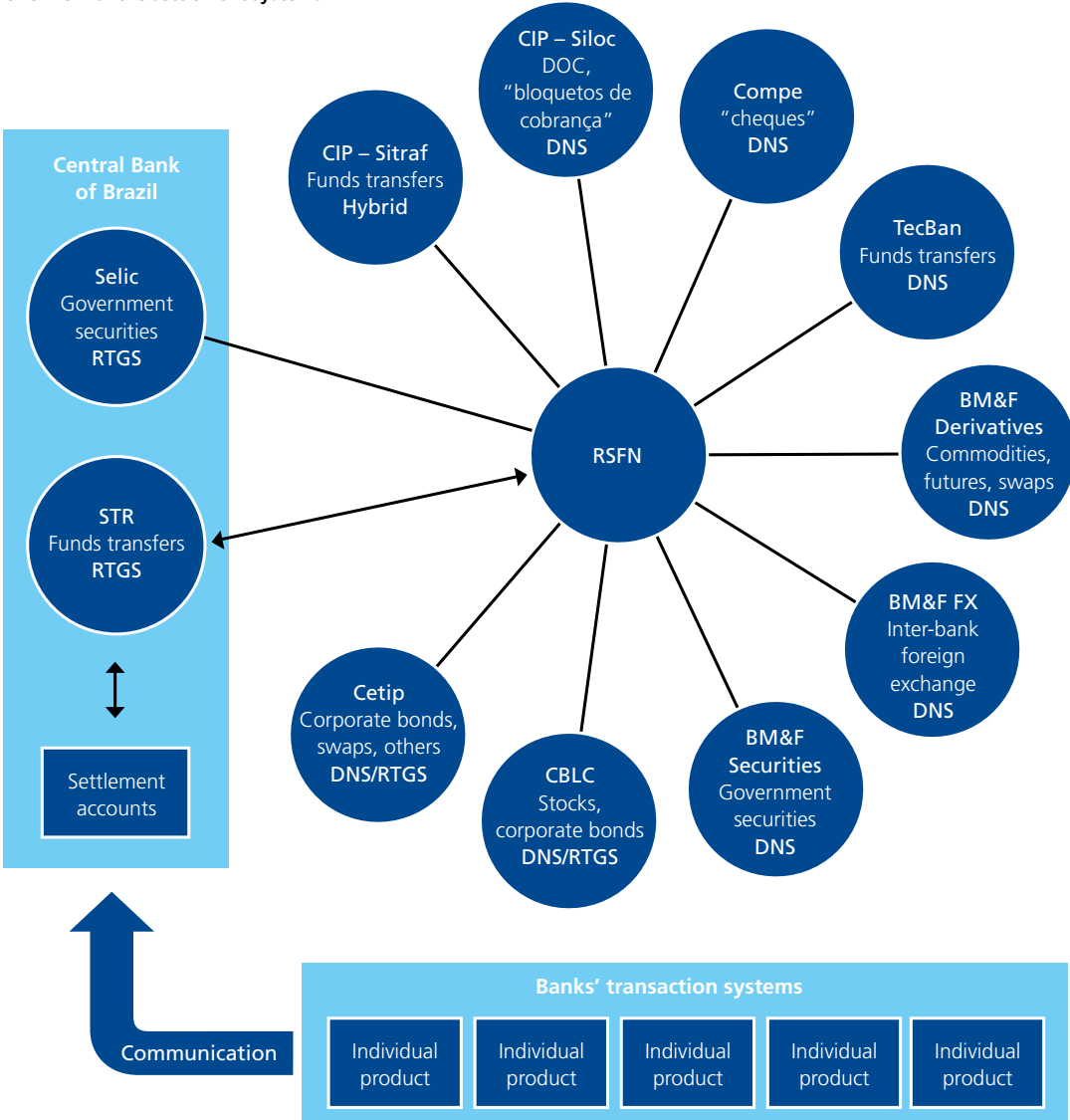
Banks must be linked to the RSFN (Rede do Sistema Financeiro Nacional – National Financial System Network) in order to manage and operate settlements in all clearings in all modes (RTGS and DNS).

Typical bank processing systems are product-driven, creating a broad range of processors that must be linked to RSFN. The typical bank setup builds access to

clearings for each individual processor generating an array of connections that requires dedicated personnel and resources.

Market experience shows that a unique access point to the RSFN within the bank’s structure, where all processors are connected and which transactions go through would be the best solution. This solution can be built within the bank or use third-party solutions.

**Overview of the settlement systems**



# How to establish a financial institution in Brazil

According to the Brazilian law (Resolution 3.040 and Circular 3.317), the business plan that Brazilian and foreign applicants need to develop, in order to operate in the domestic financial system, must met certain conditions, such as:

## Resolution 3.040

- Market analysis, describing in what market segments the financial institution will be focusing on”
- SWOT Analysis
- Definition of main products and services to be provided and public targeted;
- Strategic goals;
- Capital structure to be adopted by the financial institution, indicating the source of funds and assets/liabilities evolution over time;
- Definition of corporate governance patterns, such as remuneration and incentives policies;
- Description of the main procedures for controlling risks associated with the financial institution’s operations, such as operational risk, credit risk and market risk;
- Internal and external auditing procedures and specifications;
- Organizational structure, clearly indicating the responsibilities and attributions of each organizational level;
- Description of the criteria to be utilized for selecting top management;
- Specification of the information technology infrastructure;

- A detailed economic and financial feasibility analysis report;
- Describe the main premises used in the business plan (e.g.: growth rate, customers income, interest rate);
- Definition of the time frame needed to initiate activities after authorization.

## Circular 3.317

- Amount of foreign participation in the total capital of a local subsidiary of a financial institution (not applicable to branches);
- Importance of the entrepreneurship for the Brazilian economy, listing all benefits that could be gathered by the local financial system, such as new technologies, greater variety of products and services, incrementing competitiveness and so on;
- Detailed description of existing activities of the foreign investor in the Brazilian financial system, including any participation in local economic groups;
- Relevance of the local operations to the strategic plans of the foreign investor, including added-value analysis on any existing operations in Brazil;
- Risk rating classification of the applicant, including the entire economic group, if applicable;
- Indication of any financial institutions that maintain direct or indirect relations with the financial institution domiciled abroad;
- Indication of regulatory bodies that supervise the financial institution domiciled abroad, if applicable;
- Other information considered relevant for the analysis by the Brazilian government on the issue.

## The steps to establish a bank in Brazil

	Business plan elaboration	Business plan evaluation by Central Bank of Brazil (Bacen)	C.B. of Brazil’s approval of the establishment of a financial institution	Presidential decree	Pre-operational phase	Start of the operations in Brazil
Phase description/ objectives	Elaborate a business plan, according to the Brazilian law (Resolution 3.040), to be submitted to Bacen	In this phase, the central bank evaluates the reasonability of the business plan, and requests additional information	After the business plan approval, the Bacen publishes the financial institution’s authorization	The authorization emitted by Bacen has to be confirmed by the President of Brazil, through a presidential decree	All the operational aspects, such as IT infrastructure, risks and control policies, tax requirements, etc., must take place according to the time frame established in the Business	Once that all the operational aspects have been observed, the bank cans effectively start its operations with Brazilian clients

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