Fitch Comments on Liquidity Among Brazilian Banks

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As is the case with money markets around the developed world, the Brazilian financial markets have seen a significant increase in risk aversion which has lead to a marked concentration of liquidity since mid-September 2008. Within the banking system, the most affected institutions have been domestic banks which rely primarily on funding from the institutional investors behind the concentration of liquidity. These banks, commonly referred to as the small- and medium-sized members of the financial system, have reacted proactively to rapidly changing market conditions; previously aggressive growth plans have been abandoned in favor of managing liquidity to meet the pressures on liabilities. Fitch is working closely with these banks to monitor the situation, and is comfortable that the current situation is a liquidity crisis of growing severity, but not yet a solvency crisis. The ratings of the bulk of the affected banks are largely national ratings, and fall in a range between 'A(bra)' and 'BB(bra)'. To put these in perspective, the ratings of the still strong larger banks are generally in the 'AAA(bra)' to 'AA(bra)' range; the significant gap between these ratings is indicative of the higher risks inherent in rapid growth based on institutional funding, risks that Fitch has consistently highlighted in its ratings research. Given developments in the global financial system and the increasing pressure on domestic interbank liquidity, the agency is comfortable in the short term that Brazilian authorities have in place an effective 'safety net' that will provide liquidity support such that we do not expect any bank defaults in coming weeks. The statistics from the Central Bank show that the stock of traditional cross-border trade lines has been cut in half and anecdotal evidence points to a substantial redemption of certificates of deposits (CDBs). The latter reflects a concentration of liquidity from institutional investors, in particular mutual funds, as they took advantage of the local practice of granting daily liquidity on CDBs for certain classes of investors, as well as the obligation to mark-to-market these instruments held by mutual funds. With the increased volatility, higher interest rates oblige asset managers to temporarily register a reduction in value of the quotas, therefore these fund managers prefer to substitute traditional bank CDBs with one-day repo transactions backed by Federal Government Securities that are booked at par. The brief comments that follow outline Fitch's thoughts on developments to date, and their potential rating effects, and will focus on the actions being taken by the banks and by the regulator of the system, the Brazilian Central Bank (BCB), and other authorities, such as the National Monetary Council (CMN - Conselho Monetario Nacional) and the Ministry of Finance. The small- and medium-sized banks entered the current crisis in the context of continuing execution of often aggressive growth plans, backstopped by broadening access to capital markets and institutional funding both at home and abroad; nine domestic, privately owned banks in this segment had successfully raised BRL 5.6 billion of fresh capital in IPOs in 2007. As the global liquidity crisis began to spill over into domestic markets, the banks have been rapidly cutting and/or shelving growth targets and putting in place contingency plans for access to liquidity. In addition to often significant liquidity generated by the ongoing runoff of existing loan portfolios, banks have been negotiating the sale of existing portfolios, with several transactions already having been completed with the larger banks that have been beneficiaries of the flight to quality. This flight to quality, rather than flight from the system, is common to previous crises. This capacity to perform well during repeated crises is one of the reasons why Fitch has rated the strongest Brazilian banks above the Sovereign rating. State-owned Banco do Brasil and Caixa Economica Federal, as well and Banco Nossa Caixa, from the State of Sao Paulo, which should be integrated into Banco do Brasil over the course of the next few months, are among the most active counterparties for these sales, but transactions have also been closed among private sector banks, generally between parties that have already established partnerships that had been used to fund much of the rapid production of new lending in recent years. As signs of increasing liquidity pressures became more evident, BCB has also been proactive in taking measures aimed at boosting

liquidity in the banking system. These measures began with the loosening of deposit reserve requirements on Sept. 24th, as well as permitting banks to use a portion of the remaining reserve requirements to acquire loan portfolios from small- and medium-sized banks. In addition, the Fundo Garantidor de Credito (FGC - the Brazilian deposit guarantee fund), has also been active in providing liquidity to its member banks, secured by existing loans; the FGC currently holds approximately BRL 17 billion and can use up to 15% or BRL 2.5 billion of these funds to purchase loan portfolios from applying banks up to 20% of a bank's equity. The FGC can only acquire loans to individuals, either automobile financing or payroll deductible lending, rendering FGC facility especially suitable for the small- and mid-sized banks that have focused their recent growth mainly in these two areas. Several banks have already been building liquidity through access to these facilities. On Oct. 9th, the CMN enacted Resolution 3622, which regulated the government's Provisional Measure 442 (MP 422) enabling the Central Bank to extend lines in local or foreign currency, with tenors up to a year, in exchange for trade loans or high grade bonds denominated in U.S. dollars (eligible instruments are Brazil's Global Bonds, U.S. Treasuries and other Sovereign bonds with a minimum rating of 'A'), or in exchange for loans classified within the three best categories (of nine categories) of Resolution 2682, which requires banks to rate their own exposures. In both cases, the BCB limits the funding to a year, when the portfolios would be returned to ceding banks; extends lines at market rates; and will apply haircuts ranging from 5% for high grade dollar-denominated eligible bonds and from 20% to 70% (depending on the quality and type of domestic loans submitted as guarantee). In Fitch's view, although the use of these lines are not yet necessary, the authorities have anticipated eventual future problems and laid out the guidelines for a swift and orderly resolution of problems. As in the case of inflation, when the BCB is now acknowledged as being one of the few institutions 'ahead of the curve', the experience gained with the traumatic banking problems in Europe and the U.S. forced the Brazilian authorities to set a series of measures to ease eventual liquidity problems and to be again 'ahead of the curve'. Unlike the situation in many of the more developed markets, the valuation of bank assets is not under question in Brazil, allowing for the effective and rapid implementation of programs and facilities which aim to provide liquidity secured by these assets. The loan portfolios being sold are generally made up of payroll deduction lending ('consignado') and, to a lesser degree, automobile financing, and have generally performed well to date. As highlighted above, Fitch views the current situation as a liquidity crisis, and takes comfort that the measures taken to date demonstrate a determination on the part of regulators to ensure that the system retains access to liquidity and their awareness of the risks of spiraling contagion that any bank failure could bring about. The several measures taken by the authorities in a short period of time show that they are absolutely aware of the severity of the world crisis and its potential impacts in Brazil, and that they have the willingness and capacity to swiftly enact measures to counteract the negative effects. Our current ratings are indicative of Fitch's views on the relative creditworthiness of individual banks within this fluid and rapidly changing environment. Clearly, the measures being taken by banks to prioritize liquidity come at often significant costs, and translate to the unwinding of what had been often significant loan and asset growth over recent years. Going forward, rather than attempting to 'rate the volatility' of current events, Fitch's ratings will focus on the fundamentals of its rated banks over a rating horizon more in line with their medium- and long-term relative creditworthiness. The agency's approach during current market volatility will be to continue to closely monitor individual banks' current and prospective liquidity positions to verify that the steps being taken are effectively creating the liquidity necessary to work through pressures on bank liabilities. Contact: Peter Shaw +1 212-908-0553, New York or Maria Rita Goncalves + 5521 4503 2600, Rio de Janeiro . Media Relations: Jaqueline Carvalho, Rio de Janeiro RJ, Tel: +55 21 4503 2623; Tyrene Frederick-Mack, New York, Tel: +1 212-908-0540.