***Session 3**: Main concerns from a prudential discipline perspective*
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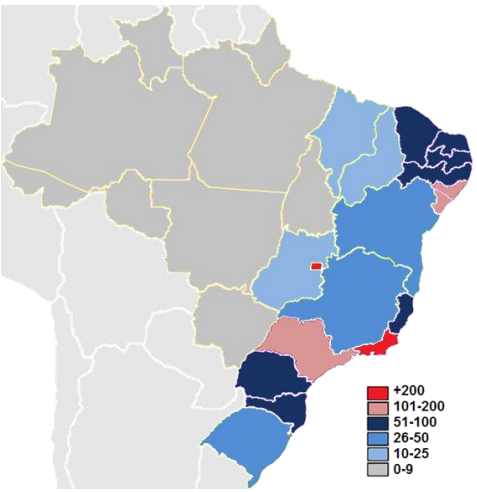
1) Brazil Demographics and BCB Organization

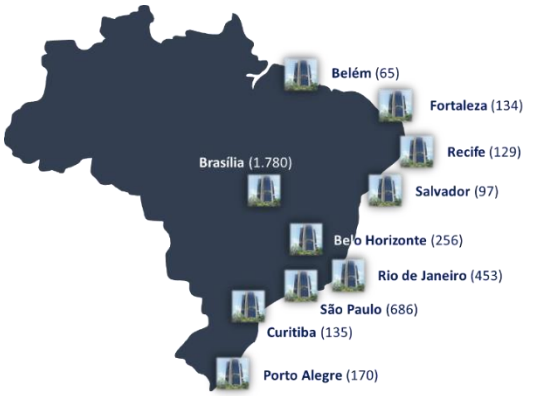
One of the largest countries in terms of territory, population and GDP

- GDP: US$ 1,799 billion (2016)
- 5th largest area: 8.5 million km^2
- 5th largest population: 206 million inhabitants (2016)

Demographic Density, 2016 (pop./km^2)

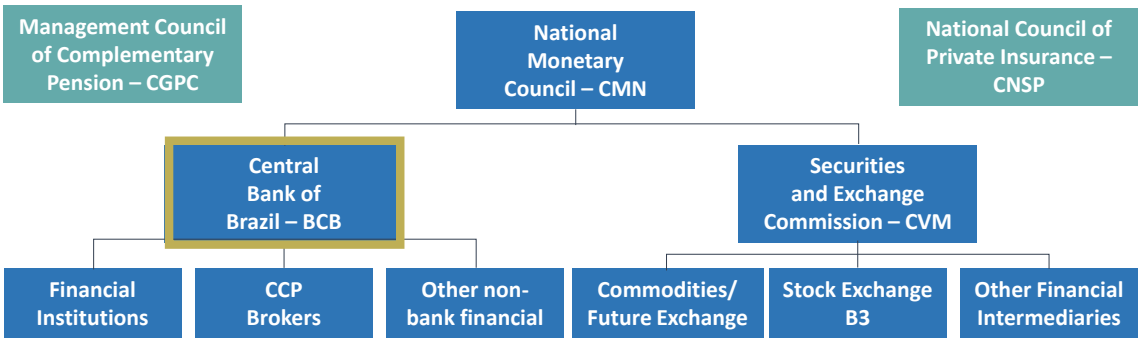


BCB – Geographical Distribution



*Employees – 3.905**
**Updated on September 30,2017*

Brazilian Financial System (National Financial System)



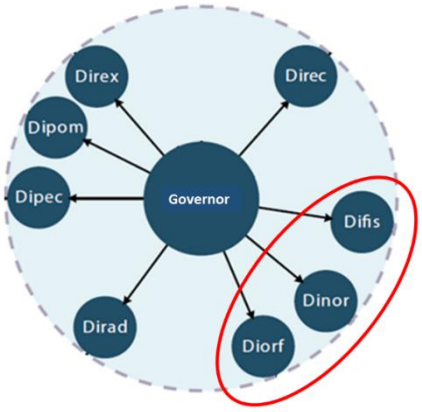
National Monetary Council (CMN)

- Composed by the Minister of Finance, the Minister of Planning, Budget and Management and the Governor of the Central Bank of Brazil
- Establishes the inflation target for monetary policy, prudential rules and credit policy

Central Bank of Brazil

- **Institutional Mission**: To ensure the stability of the currency purchasing power and **a solid and efficient financial system**.
- Monetary Policy and Financial, Regulation and Supervision are the main stream of Central Bank.

BCB – Board of Governors: Governors and Deputy Governors



Difis – Deputy Governor for Supervision
Dinor – Deputy Governor for Regulation
Diorf – Deputy Governor for Licensing and Resolution

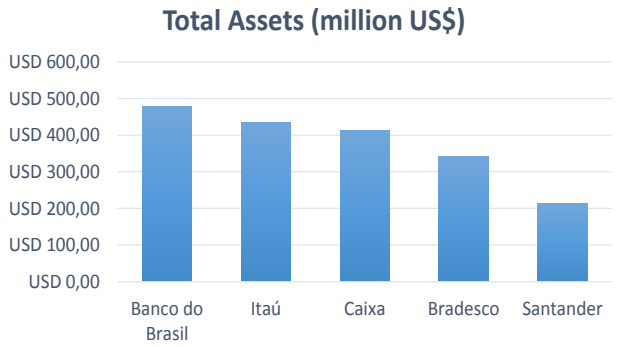
Direc – Deputy Governor for Institutional Relations and Citizenship
Direx – Deputy Governor for International Affairs and Corporate Risk Management
Dipom – Deputy Governor for Monetary Policy
Dipec – Deputy Governor for Economic Policy
Dirad - Deputy Governor for Administration

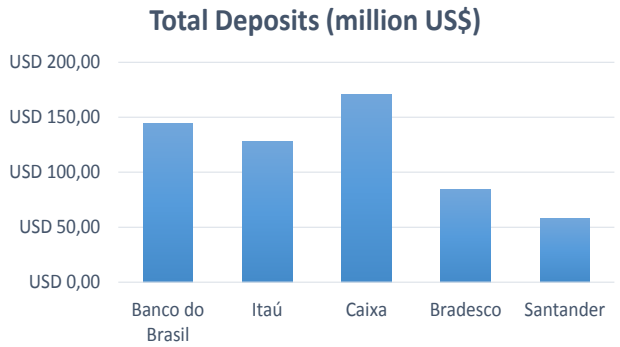
Financial System – Number of Institutions by Type

Banking Segment		Non-Banking Segment	
63	Conglomerate	186	Securities/Exchange brokerage company
9	Commercial bank	1,247	Credit unions
53	Multiple bank	217	Pool of goods and services (consortium)
5	Investment bank	116	Others
4	Development bank		
1	Savings bank		
135	**Total Banking**	**1,766**	**Total Non-Banking**
		1,901	**Total Institutions**

BCB Banking Sector (June 30, 2017)

- 135 Banks;
- 5 D-SIBs (around 80% of total assets and 85% of total deposits):
  - 2 state owned banks (Banco do Brasil and Caixa);
  - 1 subsidiary of G-SIB (Santander);
  - 2 Brazilian private banks (Itau and Bradesco).
- 5 D-SIBs total assets = US$1,762 billion





2) <u>Banking Supervision</u>

. **Difis**

- **DESIG - Financial System Monitoring Department**
- **DESUP - Banking Supervision Department**

- DESUC - Credit Unions and Non-banking Financial Institutions Supervison Department
- DECON - Conduct Supervison Department
- DEGEF - Strategic Management, Integration and Support

Financial System Monitoring Department – (DESIG)

DESIG collects data from many different sources, uses various tools to efficiently maintain databases and runs a monitoring intranet to facilitate informations sharing among divisions and with other departments of the BCB. Its function is monitoring financial system and information quality (on timely basis) is the key. The main highlights are:

1. All financial instruments issued or held by FIs must be registered in clearing houses or register centers.
2. All securities and derivatives transactions are registered and traded at clearing houses. BCB gets info daily (1-day lag).
3. All securities transactions must be settled through the Brazilian Payments System, operated by the Central Bank.
4. All loans are informed to the credit information system (SCR).
5. All FX operations and credit lines are registered online at the Central Bank.

Market Trading	Credit Operations	Forex System
. Receives data from Clearinghouses: Selic, CETIP, BM&F Bovespa, SPB and others. . 40 million registers a day. . More than 900 docs processed each month (Statments of Market and Liquidity Risks). . Produces daily macro and microprudential analysis on liquidity and market risks. . Monitors daily the securities market and the behavior of bank funding.	. Receives monthly, from all FIs: – Outstanding loans from 75 million clients. – 480 million transactions (each transactions contains 36 information items). . 4 billion transactions recorded since 2004. . Produces monthly micro and macroprudential analysis on credit risk of FIs.	. 196 licensed institutions . 9 million primary transactions a year . 70.000 transactions a day . Produces daily microprudential analysis on the foreign exchange operations conducted by FIs. . Monitors daily external funding and forex flow.

Banking Supervision Department – (DESUP)

Prudential regulation of systemically important financial institutions (SIFIs)

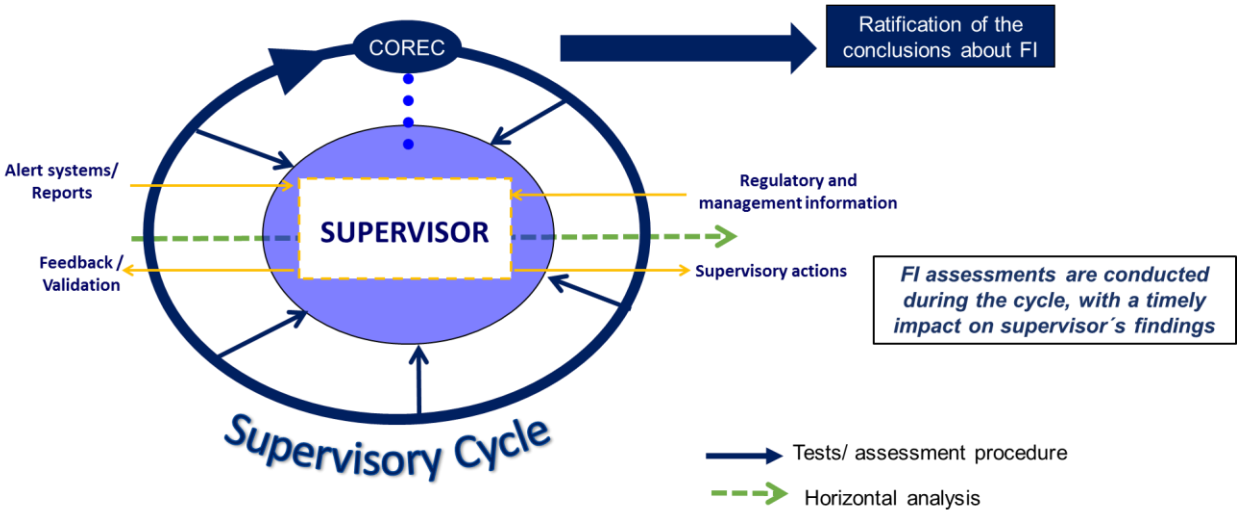
Resolution 4,553/2017, issued by the CMN, governs systemically important financial institutions (SIFIs). This rule divides Brazilian banks into five groups according to the size of the institution in terms of the Brazilian Gross Domestic Product (GDP). The main objective of this division is the reasonable application of the prudential regulations, considering the group in which the financial institution belongs to.

The segments are:

- S1 - encompasses multiple banks, commercial banks, investment banks and exchange banks larger or equal to 10% of the Brazilian GDP or that are internationally active, regardless of the size of the institution.
- S2 - encompasses multiple banks, commercial banks, investment banks and exchange banks larger or equal to 1% and lower than 10% of the GDP.
- S3 - encompasses banks larger or equal to 0.1% and lower than 1% of the GDP.
- S4 - encompasses banks lower than 0.1% of the GDP.
- S5 - includes financial institutions that are lower than 0.1% of the GDP and adopt simplified methodology for minimum capital requirements calculation (non-banking segment).

This segmentation also guides the supervision on the institutions. It should be noted that supervision is performed on a consolidated basis (Resolution 4,280/2013).

Banking Supervision Process in Brazil

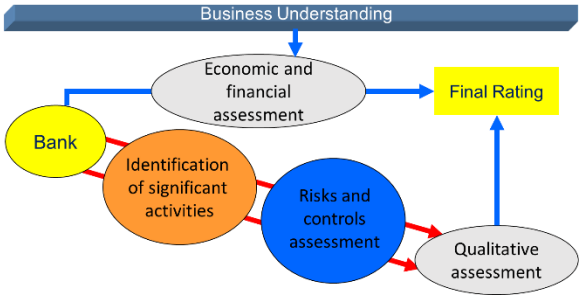


The supervisory cycle of a financial institution

The cycle duration varies from 1 year to 3 years according to the risk profile and the contribution to systemic risk. All S1 banks have a one-year supervisory cycle.

The cycle ends with the meeting of the Risks and Controls Committee (COREC) that confirms the supervisor´s assessment of the FI, assigning a grade.

Risk and Control Assessment System (SRC)



. The SRC is a continuous and dynamic process performed during the supervisory cycle that consolidates the supervisor's conclusion about the risk profile of financial institutions and banking holding companies under the supervision of DESUP.

. It considers the risks associated with the most significant activities, the quality of controls, the economic and financial conditions and the performance of the institutions.

. The rating ranges from 1 (best) to 4 (worst), divided into 10 grades. From 3^+, a capital add-on is applied to the minimum capital requirement.

Watch List

- Identification Process: Ratings - Dynamic SRC and indicators from Monitoring Department (DESIG)
- Goal: (i) Identification of banks with deficiencies: capital, liquidity, economic viability; and (ii) adoption of prompt actions by supervision.
- Classification: "attention" and "under observation"

Term of Attendance ("Subpoena")

Instrument of formalization of the commitment signed by the bank's controllers and administrators aiming the correction of serious deficiencies involving liquidity, capital or other situations that jeopardize the regular functioning of the institution.

Early Intervention - Resolution CMN 4,019/2011

Supervision may determine the adoption of preventive prudential measures (MPP) when verifying the occurrence of one of the following situations:

- Non-compliance with regulatory limits: capital, liquidity, etc.
- Deterioration of the economic and financial situation
- Risk exposure incompatible with risk management structures and internal controls
- Serious weaknesses in internal controls
- Other situations that may entail risks to the soundness of the institution, to the regular functioning or stability of the Financial System

Supervision authority can determine a broad range of preventive prudential measures (MPP), such as:

- Reduction of exposures risk;
- More restrictive operational limits;
- Suspension of: some business lines, exploration of new business lines, acquisition of participation, opening of new branches;
- Limitation to or suspension of remuneration increase, payment of variable remuneration and dividends payment;
- Assets sale

Proposal: Banking Supervision Department (DESUP).

Deputy Governor for Supervision: approves the application of the MPP.

Banking Supervision Department: accompanies the implementation of the adequacy plan (plan drawn up by the bank).

Content of the adequacy plan:

- Qualitative and quantitative goals to be achieved;
- Execution schedule; and
- Approval of the Top Management/Board of Directors.

Recovery Plan - Resolution CMN 4,502/ 2016

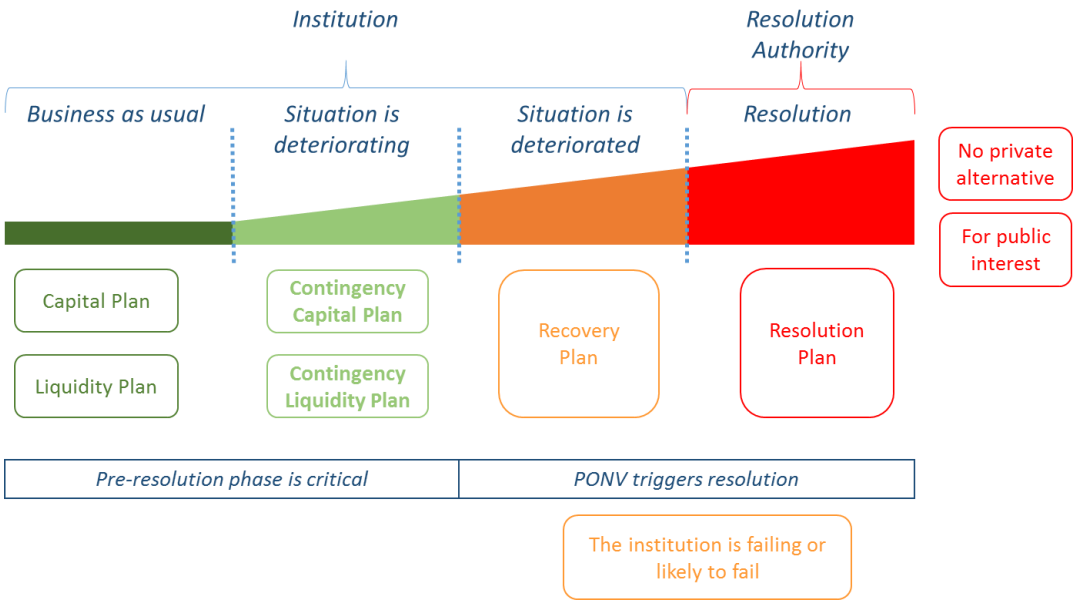
- Establishes minimum requirements to be observed in the preparation and implementation of Recovery Plans.
- Early intervention X Recovery Plan

Current Resolution Framework

Three resolution regimes:

Temporary Special Administration Regime - Raet (1987)	Intervention (1974)	Extrajudicial Liquidation (1974)
. Aims to preserve the institution's critical functions. . No payout by the Deposit Guarantee Fund (FGC).	. Suspends the bank´s operation to evaluate the possibility of its operational continuity. Not suitable for preserving critical functions. . Payout by the FGC.	. Interrupts banks' regular activities. Its main objective is to sell assets in order to pay creditors. Not suitable for preserving critical functions. . Payout by the FGC.

Our goal on recovery and resolution



3) The BTG Pactual Case - Reputation Crisis x Liquidity Crisis

The prospective business

On November 2015, BTG Pactual Conglomerate represented the seventh Brazil's largest bank in total assets (US$ 72,589 billion), with very complex corporate and organizational structures: 195 vehicles distributed in 39 countries, of which 149 were consolidated in the Consolidated Financial Statements of the Prudential Conglomerate. These vehicles included 34 commodities companies distributed in 18 countries, trading 19 products; and a Swiss Bank, which represented 40% of BTG Group´s Balance Sheet, with approximately $ 85 billion of assets under management (AUM) and presence in 21 countries from Europe, Asia and Latin America.

The Swiss Bank acquisition process had been closed two months earlier, following a one-year approval process among 18 regulators. With the acquisition, the BTG Group was on charge to manage approximately USD 150 billion of assets, mainly in the segment of Wealth Management. BTG was recognized as a successful manager of the Macro Hedge Fund GEMM with almost USD 4.2 billion of assets, based in London. Other hedge funds were based on Hong Kong and New York (USD 2.7 billion). BTG Latin America operated at Chile, Colombia, Mexico and Peru.

Besides, as an investment bank, BTG Pactual also had investments in relevant non-financial corporations such as Rede Dor, the largest hospital group in Brazil, Petrobras and others.

The arrest of BTG Pactual's CEO at the end of November 2015 triggered a run on the bank that led to the withdrawal of around US$ 10 billion in deposits and US$ 35 billion in funds redemptions. Although the bank´s governance is based on a meritocratic partnership (64 partners and 177 associates), holding almost 72% of total equity, the CEO was not just the public face of the bank: he was its founder, the dominant partner and its controlling shareholder.

BTG Pactual – Main actions

Governance *Timeline*

Day 1 (*CEO arrest*)	Appointment of Interim CEO; Share buyback program.
Day 4 (*weekend*)	New Chairman of Board of Directors; Appointment of two seniors partners to the position of CEO (co-CEOs).
Day 7	Change in the Company´s control - Top 7 Partners

Measures against reputation risk:

- Change of Corporate Control & Board of Directors;
- Committee for independent investigation;
- Repurchase of own outstanding bonds & share buyback program;
- Adopt the conduct of wide dissemination and transparency to the market;
- Follow the investment funds´ rules in redemption clauses (no fund was closed to redemption).

Measures against liquidity risk:

- Interruption of new credit operations;
- Negotiation of prepayment and sale of credit operations;
- De-leveraging of derivative operations, to release margins;
- Sale of investment in non-financial corporations;
- Credit line from Deposit Guarantee Fund (FGC) - US$ 2 billion.

Supervision – Main actions

- Recovery plan requirement;
- Enhanced monitoring of the institution – DESIG & DESUP;
- Daily monitoring of expected cash flow ;
- Monitoring recovery plan implementation;
- Early intervention with restriction to distribution of dividends, payments and loans to administrators and partners of the bank;
- Providing regular information to foreign regulators (Chile, Colombia and Mexico), mainly to Swiss regulator (daily calls);
- Swiss regulator increased the pressure on the BTG's liquidity by requiring the individual Swiss bank LCR of 120%, although local legislation required 100%.

Discussion Highlights

- Speed, magnitude and unpredictability of a liquidity crisis of this nature.
- The complexity of the corporate structure and the conglomerate can amplify the problem.
- Need for coordination and relationship with other local authorities.
- Coordination and relationship with foreign supervisors are essential, as he can put pressure on local liquidity.
- Possible contagion between the bank and the asset (step-in risk).
- Governance structure: key man risk.
- Prudential Conglomerate: consolidation of physical commodities business requires high regulatory capital e worsens the LCR.

Current Situation – Two years later

BTG Pactual Group today is much smaller:

- The main non-financial investments were sold or in process of being sold: Rede Dor, Ariel (Insurance Company) & Petrobras.
- Loan portfolio has been halved.
- Global hedge funds are at their lowest level, but local asset is increasing in AUM.
- Business is now concentrated in Latin America.
- Spin-off of commodity trading unit into a new entity named Engelhart (ECTP).
- The Swiss bank was sold in a transaction that it was combined with another Swiss Bank. Now, BTG Pactual is owner of 30% of the resulted bank and it is no longer consolidated on BTG Financial Statements.
- All regulatory rations are in good standing.

From regulatory perspective:

- BTG Pactual is classified in S1 by its international activity.
- BCB is improving prudencial and resolution regulation.
- Still need to reconcile local and foreign regulations (BCB requires monthly financial information from investments above 20% on foreign financial institutions).