

# INFRASTRUCTURE DEBENTURES: HIGHER DEMAND THROUGH REGULATORY REFORM

Redefining the target audience of infrastructure debentures to ensure the adequacy of the instrument and larger investment volumes

Brazil's Infrastructure Debentures were created in 2011 with the objective of stimulating private financing for new projects. Domestic individual as well as foreign investors are exempted from income tax on the coupon payments by these debentures. These rules need now to be reviewed.

## BACKGROUND AND POLICY DEVELOPMENTS

- In June 2011, a Federal Law created the so-called infrastructure debentures, with the objective aimed at stimulating private financing for infrastructure projects of national interest. To receive this classification, debentures must have a minimum weighted average tenor (duration) of four years and pay interest based on a fixed interest rate, a price index, or Brazil's Reference Rate, as well as have their proceeds mandatorily invested in priority infrastructure projects.
- One of the main characteristics of infrastructure debentures is the income tax exemption for domestic individuals and foreign investors. Infrastructure investment funds and Receivables Investment Funds (locally known as FIDCs) may also be eligible for the tax exemption, provided they meet some legal requirements. In total, there are currently 19 such funds with a net equity of BRL 1.137 billion (approximately USD 331 million) and a FIDC with net equity of BRL 420 million (approximately USD 122 million).
- Since the law was created until August 2016, only BRL 22.8 billion (approximately USD 6.6 billion) in infrastructure debentures have been issued, which is far below the required amount to finance infrastructure projects in Brazil. Considering only the debentures issued with effective tax exemption for individual investors, the volume raised was only BRL 16.7 billion (approximately USD 4.9 billion).

## FURTHER READINGS

- ANBIMA. *Financiamento de Longo Prazo: incentivos tributários*. Found at [http://www.anbima.com.br/informe\\_legislacao/2014\\_021.asp](http://www.anbima.com.br/informe_legislacao/2014_021.asp).
- *Secretaria de Acompanhamento Econômico*, Ministry of Finance. *Boletim Informativo Debentures de Infraestrutura*. Found at <http://seae.fazenda.gov.br/assuntos/Infraestrutura/boletins>.
- Czerniakowski Delbem, Fayga. *Impacto do Benefício Fiscal no Apeçamento das Debentures de Infraestrutura*. Available at <http://hdl.handle.net/10438/17388>.

## CFA SOCIETY BRAZIL VIEWPOINT

- The tax exemption for individual investors introduced a distortion in the valuation of debt instruments available in Brazil and pushed away investors such as pension funds, institutional investors, and investment funds due to the low yield in comparison with other instruments with similar credit risk.
- Institutional investors are precisely those with greater ability to finance infrastructure projects, possessing financial capacity, adequate risk measurement tools and risk-return analysis capabilities.
- In addition, the purchase of infrastructure debentures by individual investors may not meet basic suitability requirements, as these investors might not understand completely the risks of this type of financing. These are long-term investments which require expertise in risk monitoring, participation in bondholders' meetings, and ability to deal with illiquidity in the secondary market.
- To seek higher demand for these instruments, the tax exemption for individual investors must be eliminated. In exchange, a subsidy should be given, in the same amount, to the issuers of infrastructure debentures. The yield offered in the market by these debentures will be higher, and the financial effect will be neutral to individual investors, issuers, and the government. The higher yield will attract higher demand from institutional investors and these debentures will be better positioned to compete with instruments that offer no tax exemption or that carry a lower credit risk.
- Such changes in the tax and regulatory environment do not eliminate the distortions caused by the introduction of taxes and subsidies, but they allow the infrastructure debentures to become more attractive to investors with greater investment capacity. These are fundamental reforms for the development of the Brazilian capital markets and for the financing of the infrastructure sector in Brazil.