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Foreign exchange regulation in Brazil and the prohibition of private offsetting of credits

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Brazilian foreign exchange regulation is historically and noticeably strict, complex, and, in certain aspects, obscure. Over the past two decades, though, along with the growth of the national economy and in the context of more integrated markets, it is possible to perceive an evolving process of liberalisation and de-bureaucratisation of rules and procedures applicable both to foreign exchange transactions and international capital flows.

In particular, regulators have been aiming at providing more flexibility for foreign exchange markets and, by the same token, simplifying procedures for registering international investments. Yet, in spite of the recent advances, reforms and further developments are constantly demanded and deemed necessary by the community of national and foreign investors and companies. Numerous rules that conflict with the recent liberalisation trend are still in place.

The prohibition of private offsetting between residents and non-residents fits perfectly in this scenario. As we shall see, it can be considered as a byproduct, on the one hand, of an old-fashioned regulatory environment and, on the other, of the obscurity of the current legal framework. Such restriction is currently considered a regulatory burden by market participants.

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Before examining the causes and rationale of the prohibition, it is useful to make brief remarks regarding the legal doctrine of private offsetting of credits (between Brazilian companies/individuals and foreign entities).

As per article 10 of Decree 9,025, dated 27 February 1946, Brazilian residents and entities are prohibited from offsetting claims held against foreign counterparts. If, for instance, a Brazilian firm holds both credits and debts against a foreign company, the parties are not allowed to settle their obligations by their net balance. Instead, they will be required to fully remit amounts involved from and to abroad with the intervention of an authorised agent (e.g., financial institutions allowed to operate in foreign exchange markets). Such remittance, as any other cross-border transaction, shall be formalised under a foreign exchange contract and, as a general rule, is subject to the Tax on Financial Operations (IOF).

Hence, regardless of the amount of the existing net balance between the claims held by counterparts, transactions have to be fully performed and individualised by agents duly authorised by the Central Bank of Brazil to execute exchange transactions.

Credit-offsetting restrictions apply only to cross-border transactions. The Brazilian Civil Code (Law 10.406, dated 10 January 2002 article 368), expressly allows private compensation of claims.

To access the rationale behind the restriction under analysis, it is important to understand that this rule was set in a completely different legal, economic and political scenario. Particularly, it is relevant to highlight that the prohibition of private offsetting of credits was first set in 1933, and, as mentioned before, is currently based on a statute (Decree 9,025) that was enacted in 1946. Noticeably, such contexts are rather different from the present one.

First of all, from the macroeconomic regulatory policy perspective, in both periods (30s and 40s), the Brazilian monetary authority was more active in exchange controls than it is today. Since there was a more intense ongoing concern regarding the depreciation of the local currency, exchange controls were used as tools to avoid monetary speculation.

In the present times, however, foreign exchange regulation is not being used anymore as a primary macroeconomic instrument designed to avoid the depreciation of the Brazilian currency. Differently from what occurred in the 30s and 40s, cross-border transfers of funds are performed without prior approval of the Central Bank. The authority is no longer previously consulted, but only notified about the execution of international transactions. Thus, regulatory concerns are more focused on the origin and destination of resources, rather than on imposing restrictions on the transactions.

Accordingly, some may say that the prohibition of private offsetting of credits goes in the opposite direction envisaged by the recent regulatory developments. That is to say, such restriction would be a vestige of a former regulatory environment, which was not completely excluded from Brazilian foreign exchange regulation and is less liberalised and flexible in comparison to recent developments. Therefore, the prohibition would neither fit nor be adequate to the present regulatory framework, which is designed towards liberalisation, simplification and deregulation.

Critiques to the prohibition of private offsetting of credits also consider the present market and business dynamics. Namely, since such restriction was set in times with much less sophisticated and intricate business structures, it is not well suited to the current economic environment. The prohibition would not be, from this perspective, compatible with a context of intense and complex cross-border transactions.

Finally, the prohibition is also questioned due to its obscurity. A first concern regarding the lack of clarity of such rule is due to its vague wording. Particularly, such perception arises from the conclusion that article 10 of Decree 9,025/46 does not specify the concept of 'private offsets of credits', nor defines which are the elements that may be considered by the authority to determine if a specific transaction may fall under such concept (private offsets of credits).

A good example is the case of the set-off clauses, which are contractual mechanisms that grant creditors the power to seize debtors' deposits when they default on a loan. The Office of Attorney-General of the National Treasury was consulted on the applicability of the prohibition of private offsetting of credits to the above-mentioned contractual clauses. In ▸▸

this case, to a certain extent, the uncertainties were due to the lack of precision of the wording of article 10 of Decree 9,025/46.

In a legal opinion published on 17 March 1982, the Office of Attorney-General of the National Treasury favoured the interpretation that set-off clauses were in fact a variation of private offset of credits, and were therefore illegal in cross-border transactions, since they would impair the performance of exchange controls by the Central Bank. (Another example of the lack of definition of the doctrine under analysis can be seen at National Financial System's Council of Appeal (CRSFN) Appeal nº 3970. In such case the Council decided that: (i) article 10 of Decree 9,025/46 is to be interpreted restrictively; and (ii) the prohibition of private offsetting of credits only applies to exchange transactions involving foreign capitals.)

Additionally, according to some the obscurity of the prohibition of private offsetting of credits would be intrinsically related to the coexistence of the two trends of rules detected in the Brazilian foreign exchange regulation, namely: (i) the more antique and restrictive, with intense exchange controls; and (ii) the more recent, more flexible and liberal. Particularly, the uncertainty would be derived, in this case, from the difficulty in the interpretation of conflicting rules.

In conclusion, the prohibition of private offsetting of credits provides a clear illustration of the complexity of exchange regulation in Brazil. It also demonstrates the importance of efforts directed at harmonising and updating regulatory frameworks according to legal, economic and political demands of both the market and the government. ■

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