Weekly Credit Brief Apr 26 - May 02 2022

Brazilian banks remain in deep water as rising household leverage threatens credit risk outlook

by NUS-CRI Market Monitoring Team

- **Rising household leverage levels, in conjunction with the rising average cost of financing, could pressurize the asset quality of Brazilian banks, especially as inflation levels and policy interest rates run rampant**
- **Brazil's central bank's new regulation to promote open banking may dampen earnings in the short run, but provide long-term opportunities due to its intended impact on credit growth**

As economies around the world move towards monetary policy tightening in an effort to mitigate sky-high inflation levels, Brazil continues to deal with the two-pronged threat of inflation driven by both domestic and international sources. Around the world, supply shocks on key commodity markets and supply chains, which are primarily driven by the ongoing Ukraine-Russia war and lockdowns in China, continue to drive imported inflation in Brazil. Closer to home, a depreciating real has further exacerbated headline inflation levels that hit 11.3% in Mar-2022. In the context of the prevailing macroeconomic conditions, Brazilian banks' credit risk profile has been worsening since the middle of last year, and may continue to deteriorate over the next 12 months trending closer to the BB- upper bound when referenced to PDiR2.0 bounds[1], as showcased by the NUS-CRI Aggregate (median) 1-year PD (Agg PD) in figure 1a and NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) in figure 1b. Despite Brazilian banks' strong capitalization and liquidity levels allowing some reprieve at the beginning of 2022 as interest rates increased, the industry continues to face headwinds pertaining to regulatory changes by the country's central bank, Banco Central do Brasil (BCB), which aimed to reduce household leverage and prompt competitive and transparent lending practices across the sector.

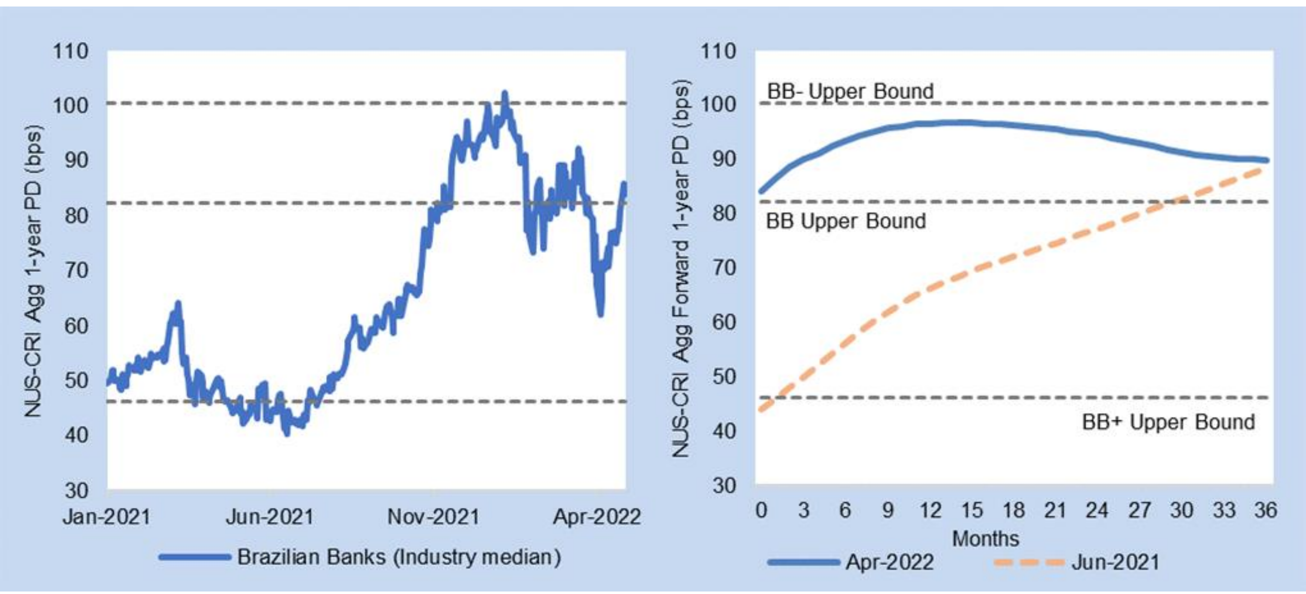

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Brazilian Banks from Jan-2021 to Apr-2022 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Brazilian Banks as of Apr-2022 and Jun-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

In line with rising inflation, Brazil's central bank has raised policy interest rates (Selic) twice since the beginning of 2022 to 11.75% in Mar-2022 (See figure 2a). However, the economy still battles the impact of high borrowing costs as domestic growth, though positive after entering a technical recession at the end of Q3 2021, remains low in Q4 2021 at 0.5%. Rising Selic rates, especially since the beginning of 2022, may have provided some relief on interest income earned by Brazilian banks. The median net interest margin for Brazilian banks has already increased marginally to 5.7% in Q4 2021, up from 4.9% in Q1 2021, and may further improve in 2022 should the current Selic rate, which is expected to remain at similar levels given the rising inflation woes faced by the country, persist.

However, rising inflation levels, as well as the resultant increase in borrowing costs, may provide some headwinds for the country's financial network. The impact on Brazilian banks comes primarily from the country's domestic household loan segment. Specifically, credit extension through credit cards, for which default rates have increased to 36% in Jan-2022, could pressurize the asset quality of Brazilian banks. Furthermore, due to the country's high borrowing costs, the average cost of outstanding loans by Brazilian banks, specifically those used to fund non-financial corporates' working capital needs, has increased by close to 10 percentage points from Jan-2021 to Feb-2022, reaching 33.97%, while concurrently the debt burden of the domestic households continues to increase, with the household debt to income ratio crossing the 50% threshold at the end of 2021 (See Figure 2b). Though Brazilian banks continue to provision well (median loan loss provision to total loans in the sector decreased marginally from 3.4x to 2.2x between Q1 and Q4 2021 respectively) and have strong capital ratios (median tier 1 capital ratios remain robust at 13% throughout 2021), a potential increase in default rates from the consumer retail and working capital loans segment, especially as household debt levels and cost of financing increase, could hamper their loss-provisioning capabilities and impact earnings in the short term.

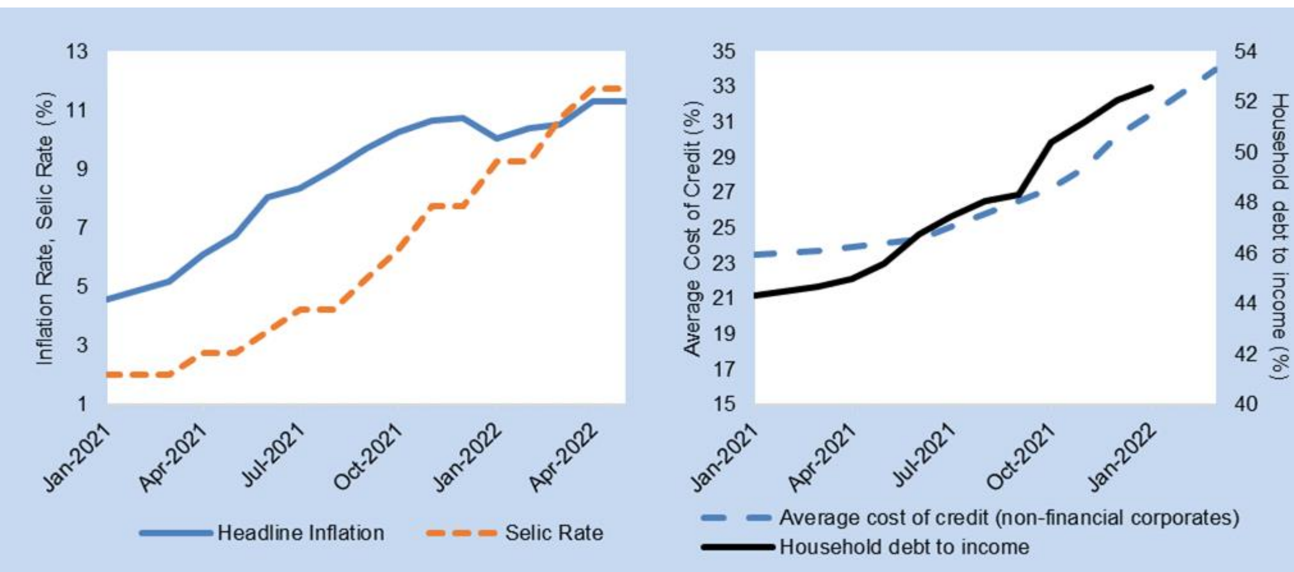

Figure 2a (LHS): Headline inflation levels and overnight Selic Rate from Jan-2021 to Apr-2022. Figure 2b (RHS): Average cost of credit for non-financial corporate's working capital needs (LHS) and household debt to income ratio (RHS). *Source: Bloomberg, Central Bank of Brazil (BCB)*

Furthermore, regulatory challenges pertaining to the central bank's effort to raise competitiveness in the domestic financial sector may create woes for Brazilian banks' earnings in the latter part of the year. BCB's latest regulation known as open banking requires banks to share the credit and investment information of borrowers in their portfolio with their competitors while concurrently publicizing their fees so that consumers are able to compare costs before choosing a lender[3]. The introduction of this regulation threatens to upend the rising interest income, derived from existing non-transparent practices, of Brazilian banks, possibly elevating their credit risk in the short term, as suggested by the Forward PD in figure 1b.

In addition to the regulatory changes impacting the industry's competitive landscape, Brazil's government is also planning to raise taxes for Brazilian banks and financial institutions in H2 2022, directly affecting short-term profitability. High CSLL tax for financial institutions domiciled in Brazil proves to continuously be a structural risk to the profitability of Brazilian banks in the long term. However, in this instance, such a long-term impact on credit risk outlook may remain muted (as suggested by the Forward PD in figure 1b) should the government stick to its plan of using the additional fiscal revenue to aid debt refinancing of MSMEs that have been severely

[3] This includes information such as loan-repayment histories and individual credit-risk assessments of household consumers. Another intended impact of this regulation is to spur credit growth in the economy as lenders may be more likely to borrow given further information about borrowing rates across different lending institutions.

hit by the economic crisis and the pandemic. This may potentially mitigate an uptick in corporate defaults arising from this loan segment, and improve the banking system's asset quality from a risk-weighted perspective.

With the economy grappling with the fourth-highest inflation levels across other G20 countries, it may be unlikely that the BCB is going to lower benchmark Selic rates in the near future. Brazilian banks may therefore need to ensure that they continue to keep ample provisions and strong capital bases to deal with a potential worsening in their asset quality. Furthermore, structural risks arising from the new open banking regulations, which have the secondary aim of fostering a wider network of non-banking lending institutions, may reduce Brazilian banks' consumer base, and vis-a-vis impact earnings, as households and corporations may have increased access to cheaper sources of financing. Should the banks be successful in adapting their business to these new regulations, they may benefit from an increase in their interest income in the long run as credit growth gathers steam as intended.

Credit News

Bond traders face week that threatens to shatter any market calm

May 01. More volatility is expected in the bond market following the Fed and the Treasury Department's policy announcements to control inflation amid global economic uncertainty. The market is also divided between those who see a growing risk of slowing growth coupled with sticky inflation and those who expect the Fed to hike rates high and fast enough to trigger a recession, with each faction pricing in the risk and adding to the volatility of bond prices. US 2-year yields have been steadily rising for 9 months, meanwhile, 10-year yields are hovering not far below 2.98%, the highest benchmark rate since December 2018. (Bloomberg)

UK launches post-Brexit shake-up of insurance rules

Apr 28. After the EU's move to change the legislation governing insurance companies in September, the UK had also finally put forth its proposal which marks the industry's first divergence in EU rules since the Brexit. The reforms package includes a reduction of the risk margin by 60-70%, which would free up capital for redeployment in new or additional business. The proposal also includes a matching adjustment allowing insurers to reduce their long-term liabilities if they invest in certain long-term projects. Lastly, the proposal includes the easing of reporting and other administrative requirements on insurers. With the combination of reforms, the industry is given more elbow room to increase exposure to illiquid and long-term investments such as green infrastructure projects. (FT)

Bond start-ups boom in India selling retail clients on high yield

Apr 29. Over the course of the pandemic, India has witnessed the launch of many new financial technology start-ups catering specifically to retail investments in debt. These ventures guarantee a higher return and have a low minimum investment amount in order to facilitate retail investment. The firms are benefiting from the central bank's efforts to increase retail participation in sovereign debt. However, for investors investing in corporate debt, the risks are higher. Although the start-ups claim to have high standards of due diligence, lighter scrutiny by authorities allows them to take higher risks. (Bloomberg)

Russia makes bond payment in dollars to avoid default

Apr 29. Despite having sufficient resources from oil and gas revenues, Russia has been grappling with the likelihood of default driven by tightened US sanctions. Just days before the end of the 30-day grace period, Russia remitted payment on two dollar-denominated bonds. Payment for said bonds was initially blocked in April prompting Russia to insist on settling the debt in rubles in retaliation. However, doing so would violate the terms of the bonds and constitute a default. Nonetheless, Russia reversed its decision and routed the payment through bank accounts not directly under US sanctions, and pending clearance and processing in compliance with US and UK sanctions. (WSJ)

RBI report calls for guarantee mechanism to boost bond market

Apr 29. A report by the Reserve Bank of India's research team suggests that a credit enhancement mechanism providing a guarantee on corporate bonds may improve risk perceptions and increase participation in the country's bond market which suffers from the lack of liquidity. An active corporate bond market will further India's growth by providing capital to corporates. However, as of now investment limits remain underutilized due to liquidity concerns. 30% of foreign investors' limits are used for investments in sovereign debt as opposed to 19% in corporate debt. A credit enhancement mechanism will increase investment in corporate bonds by helping trim investors' risk expectations. Currently, mutual funds are the only major participants in the secondary bond market, indicating that participation from retail investors and institutional investors like pension funds can be increased. (Economic Times)

Bonds, pounded by inflation concerns, get a lift—from inflation (Bloomberg)

American Express eyes ESG bond market to fund eco-friendly cards (Bloomberg)

Bonds are suddenly getting love from investors hedging recession (Bloomberg)

Regulatory Updates

Russia cuts interest rate as economy reels from war in Ukraine

Apr 29. Shortly after western governments imposed sanctions on Russia, its central bank responded with a series of defensive measures to support the ruble and slow the rise in consumer prices, including hiking rates up to 20% and capital controls. While these measures steadied the ruble, the shortages of goods and services, especially those provided by foreign businesses, continue to drive prices higher. Hence, the central bank decided to shift its focus from controlling inflation to stimulating economic growth by cutting rates to 14%, the second time since Feb 28. The move is expected to encourage local companies to invest in locally produced replacements for imported goods and strengthen Russia's goal of becoming self-sufficient. However, the central bank recognizes that the sanctions will continue to inflict significant economic damage resulting in a decline in GDP of between 8% to 10% (WSJ)

BoE official proposes overhaul of global capital rules for banks

Apr 27. A senior official at Bank of England, recently proposed an alternative and simpler regulatory system for global banks which may make it easier for banks to lend during crisis. The proposal outlines a system with a simple common equity threshold which could to be lowered during a downturn to facilitate lending. Banks tend to reduce lending during a crisis in a bid to protect their capital levels and to avoid shareholder backlash. As per the system proposed, any capital above the minimum level will be available to lend during a crisis period, with no negative implications for banks. (FT)

BOJ extends unlimited bond buying into meeting this week (Bloomberg)

ECB rate hike possible but not likely in July, Guindos says (Bloomberg)

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