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Credit risk of well-capitalized Brazilian banks tapers in the long-term despite economic challenges

by Wang Nan & Wang Anyi

- **The NUS-CRI Agg 1-year PD demonstrates a worsened credit profile in H2 2021, amidst soaring interest rates and deteriorated asset quality along with economic contraction**
- **The NUS-CRI Agg Forward 1-year PD shows the tapering credit outlook for Brazilian banks on the back of sufficient provisions and a good level of capitalization, despite a slight increase in the short term**

A contraction in Brazil's economy in Q3 2021 is casting a spotlight on the credit health of the nation's banking system. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) shows that despite the improvements witnessed in Brazil domiciled banks' (Brazilian banks) credit profiles on the back of the economic recovery in H1 2021, the rapid rise of consumer leverage and increasing policy interest rates amidst a recession and rising inflation saw the credit risk of Brazilian banks increase in H2 2021 (See Figure 1a). The Agg PD of Brazilian banks displayed an uptrend, breaching the BB- upper bound when referenced to PDiR2.0 bounds[1]. Although the impact of these economic shocks is expected to continue in the short term, the NUS-CRI Agg Forward 1-year PD (Forward PD[2]) demonstrates a tapering in credit risk for Brazilian banks in the long term supported by industry's strong capital positions and robust loss absorption capabilities (See Figure 1b).

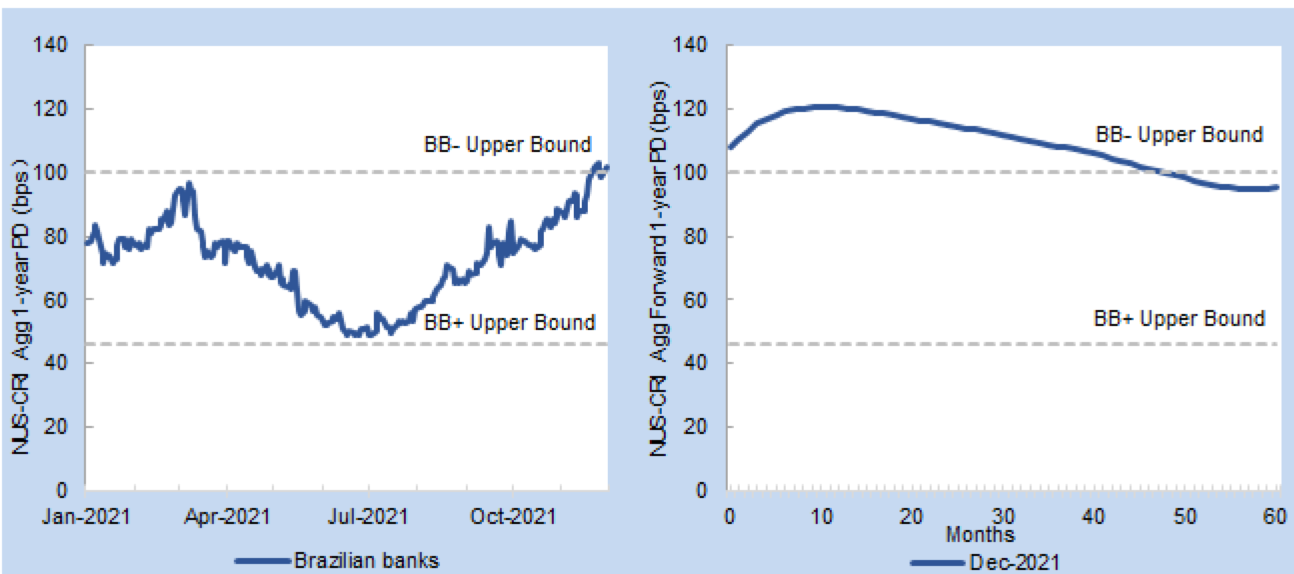

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Brazilian Banks from Jan-2021 to Nov-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Brazilian Banks as of Dec-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Brazil is being hit by both a recession and soaring prices. After three consecutive months of economic growth until Q1 2021, Brazil entered a technical recession as the economy contracted by 0.1% in Q3 2021, following a 0.4% contraction in Q2 2021. Climbing from 4.56% in Jan-2021, Brazil's 12-month inflation rate stood at 10.74% in Nov-2021 as the country witnessed a surge in fuel, transportation and housing prices. To curb overshooting

[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.

inflation, Brazil's central bank has hiked its policy interest rate (Selic) seven times this year, from 2.0% in Jan-2021 to 9.25% in Dec-2021. Continued rises in interest rates have repriced funding costs faster than the yields on Brazilian banks' outstanding loans, thus pressurizing the lending spreads[3] received by industry participants (See Figure 2a).

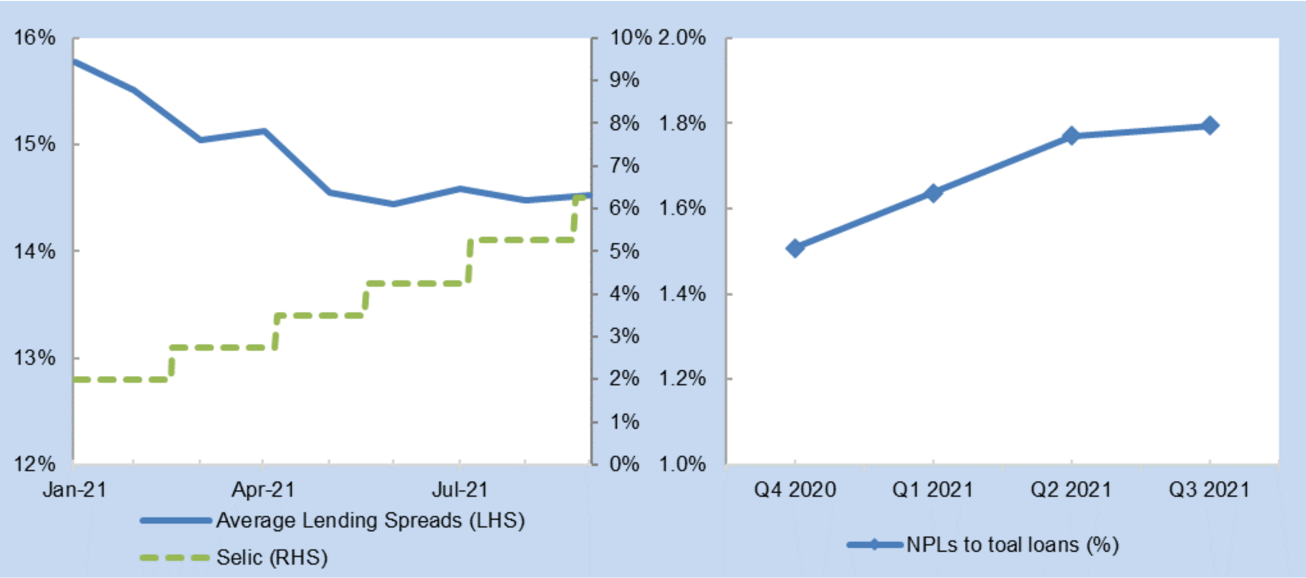

Figure 2a (LHS): Average lending spreads on the primary axis and the policy interest rate (Selic) on the secondary axis from Jan-2021 to Sep-2021. Figure 2b (RHS): NPLs to total loans (NPL ratio) for Brazilian banks from Q4 2020 to Q3 2021. *Source: Central Bank of Brazil, Bloomberg*

Furthermore, Brazilian banks face rising asset quality challenges. Although the resumption of the second phase of "Support Micro and Small Companies (PRONAMPE)" government program has improved corporate loans' NPL ratio in H2 2021, the deterioration of credit quality experienced by retail loans, which makes up around 60% of total bank credit outstanding, has contributed to an uptick in the overall NPL ratio of Brazilian banks as it marginally increased from 1.50% in Q4 2020 to 1.79% in Q3 2021 (See Figure 2b). Simultaneously, households' ability to service their rising debt has been worsening, with the household debt-to-income ratio reaching 59.90% in Aug-2021, the highest level since 2005. Therefore, a worsening asset quality, especially amidst a weak economic growth environment, may continue to pressurize the credit risk of Brazilian banks in the short term (See Figure 1b).

Worsening economic activity and another potential rate hike of 150bps in Feb-2022 may further undermine the asset quality of Brazilian banks, as well as potentially deteriorate their interest spreads. In November, the Brazilian central bank cut its GDP forecast and raised its forecasts for inflation. In the face of such economic challenges, the short-term credit risk of Brazilian banks remains high, as depicted in Figure 1b.

However, in the long term, credit risk is set to gradually decrease and stabilize for the sector. Their well-capitalized structure and adequate provisions to face expected credit losses provide buffers for Brazilian banks to withstand potential economic challenges ahead. Figure 3a illustrates that Brazil's banking system's provision is adequate to cover expected credit losses, with a total provision to expected loss ratio (expected loss provision coverage) of 1.31 for all loan portfolios. 86% of the loan portfolio belonging to financial institutions have an expected loss provision coverage ratio of over 1.00. Besides, the industry's capital adequacy ratio has increased from 15.63% in Jan-2021 to 16.76% in Sep-2021, providing ample buffer for the banking sector to absorb losses should NPLs increase in the near future.

[3] However, in spite of lower lending spreads, the negative impact on bank's profitability was evened out by lower provision for loan losses amidst economic recovery in H1 2021.

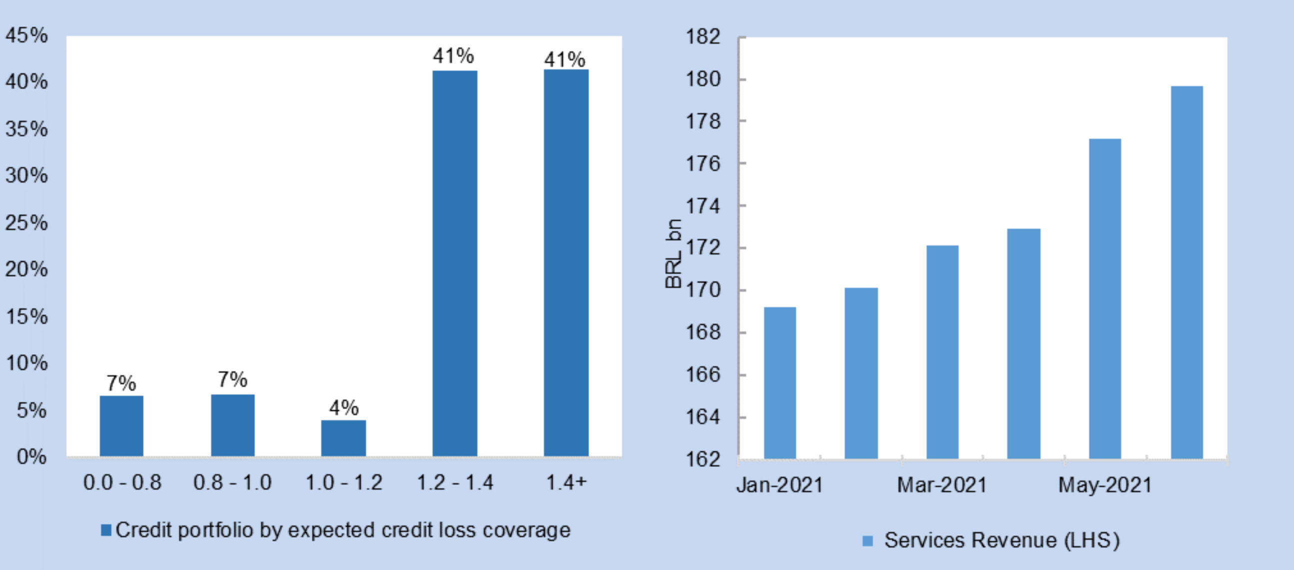

Figure 3a (LHS): Brazil credit portfolio by expected credit loss coverage as of Jun-2021. Figure 3b (RHS): Services revenue from Jan-2021 to Jun-2021. *Source: Central Bank of Brazil*

Rising services revenue[4] have also improved Brazilian banks' ability to possibly hedge downside risks from increasing interest rates (See Figure 3b). Additionally, income tax reform aimed at reducing corporate taxes is currently pending approval. Should it be approved, it will lower tax expenditure and benefit Brazilian banks' profitability in the long run. Although adverse economic conditions present challenges ahead, Brazilian banks appear well-positioned to weather these headwinds in the long term, supported by a strong capital structure and adequate provisions.

[4] Service revenue refers to the revenue from fee income that banks charge for their products and services that include asset management advice, checking account fees, overdraft fees, ATM fees, fees on credit cards, etc.

Credit News

China Evergrande heads toward default as it misses payment deadline

Dec 7. Evergrande failed to repay USD 82.5mn of interest payments on dollar bonds originally due on Nov 6 at the end of a 30-day grace period on Monday, marking its first default on offshore public bonds. This default could trigger cross-default provisions and drive defaults in other debt held by the company as well. Evergrande has managed to avoid defaults in recent months by making overdue interest payments before the end of the grace period, but last Friday, the company said that it was planning to work on a restructuring with offshore creditors on a USD 260mn debt guarantee. The stance of debt defaults has changed in China as corporate defaults have become more common, prompting China's leaders to reduce moral hazards. A commentary by the Chinese state news said that the risks associated with Evergrande were being settled and that authorities are acting to ensure a proper resolution to the ongoing Evergrande's crisis. (WSJ)

Europe high-grade bond market set for boost as cash piles shrink

Dec 13. Europe's high-grade bond markets are in for a brisk start to 2022 as companies rush to replenish dwindling pandemic cash piles before an inflation surge pushes borrowing costs higher and credit spreads widen further. Despite prevailing low borrowing costs, European investment-grade corporate debt supply dipped by more than a third this year compared with 2020 to EUR 260bn. That said, issuance could gain momentum next year, even with financing conditions set to get costlier. As central banks pare back stimulus, corporate bond markets may see wider spreads. Meanwhile, the prospect of more M&A activity could drive more funding and supply of hybrid debt. Another driver of supply could come from US issuers selling debt in euros with European Central Bank interest rates expected to remain lower for longer than those set by the Fed. The appetite for ESG debt is also expected to keep growing. (Bloomberg)

Chinese developers slump as Shimao bond plunge spooks investors

Dec 13. After a dramatic decline in a large property firm's notes, a wave of selling swept through Chinese developers' bonds and shares, raising concerns about the sector's health. Shimao Group Holdings' dollar notes fell as much as 9 cents on the dollar and the selloff spread to other company bonds. Following the slump, trading in six of Shimao's CNY bonds was suspended, with one plunging more than 50%. A Bloomberg Intelligence stock index of real estate firms slumped 2.8%, led by a 12% drop by Shimao. A major price collapse or a downfall of the company will result in a loss of confidence in cross-over investment-grade companies in China property. The consequence could be more severe than debt crises at Evergrande or Kaisa because they were of much lower credit quality. Slowing sales and a mountain of bond maturities looming in January continue to put pressure on China's real estate developers. (Bloomberg)

Junk-bond investors fear bumpy 2022 after November slump

Dec 7. Investors pulled around USD 6bn from high-yield mutual and ETFs in the two weeks ended Dec 1 as the bond market slumped in November driven by fears of rate hikes due to inflation and the spread of the Omicron variant. Although high-yield bonds are less sensitive to interest rate changes, the 'everything rally' has pushed their prices to unusual highs, thus making them more sensitive to any Fed moves than they have been historically. As US interest rates are expected to rise in 2022, further drops in high-yield bonds could be accompanied by stock declines, as they showed a 73% price-return correlation from 1997 to 2020. As more investors are seeking alternatives to the low-yield government bonds, the yield of the Bloomberg US high-yield index, which has risen to 4.7% from 4% in early November, remained below its 10-year average of 6.1%. (WSJ)

Emerging markets' pandemic-fuelled debt party is coming to an end

Dec 8. Governments and companies in emerging markets raised USD 745bn in bonds as of Dec 7, making 2021 the second-best year for issuance in the last two decades. Yet, even as borrowers rush to refinance while interest rates remain low, overall emerging-market issuance is expected to decline as interest rates rise and extraordinary pandemic spending is scaled back. Emerging markets had borrowed more heavily than ever in 2020 and now face at least about USD 478bn in dollar, euro and yen-denominated debt principal that matures next year. Despite losses in some real estate sector notes, corporate deals enabled China to comprise about 25% of the total hard-currency issuance in emerging markets this year. Meanwhile, emerging-market bond sellers issued a record USD 82.3bn of ESG debt this year, a 180% increase from 2020. (Bloomberg)

Evergrande moves toward restructuring; state swoops in to contain risk (Reuters)

Yield-hungry foreign buyers seen boosting U.S. corporate bonds (Bloomberg)

Arizona college's mega-borrowing breaks bond-market ground (Bloomberg)

Regulatory Updates

ECB studies pandemic tool tweak to use in bond-market stress

Dec 9. The ECB is currently looking at tweaking its reinvestment of bonds held in the Pandemic Emergency Purchase Programme (PEPP), which is slated to be reinvested until the end of 2023, to help countries in times of future market stress. The Governing Council is considering expanding the time period in which it rolls over maturing securities and the flexibility in geographic allocation of the purchases. This policy tweak is expected to benefit Greece, which currently has yet to meet the minimum credit ratings for the ECB's Asset Purchase Program (APP). However, should the only change be an increase in the PEPP reinvestment flexibility, markets are expected to be disappointed amid renewed financial dislocations in the euro area. (Bloomberg)

Libor fix wins house support in drive to avert market chaos

Dec 9. The US House approved measures on Wednesday to switch the most troublesome contracts in Libor to a substitute benchmark, in an effort to avoid a flood of lawsuits when dollar Libor retires. The bill will now be sent to the Senate with an unknown fate. Such proposals are seen as crucial to ensure that the US financial system isn't disrupted. The move follows similar legislation in New York that extends key dollar Libors until mid-2023. Federal legislation, such as this bill, is needed to protect some USD 16tn of deals outside New York that may last longer than 18 months and threaten financial stability. With the goal of averting disputes, the House legislation would automatically shift contracts that would otherwise face a cliff-edge scenario to a new benchmark. It also includes so-called safe-harbor provisions, designed to deter lawsuits seeking damages. Lawmakers also offered their backing after the bill's sponsor. (Bloomberg)

Poland's Hardt sees 50 basis-point rate hike in January (Bloomberg)

U.K. Covid restrictions snuff out strong bets on BOE rate hike (Bloomberg)

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