Brazil Viewpoint

Five questions on the credit squeeze and one conclusion: rate cuts will come earlier

21 March 2023

GEM Economics
LatAm | Brazil

Look for credit conditions to further tighten

All signs point to a deterioration in the Brazilian credit markets. Along with higher rates, corporate leverage is rising, consumers are falling behind on loan payments, and more companies are filing for bankruptcy. The economy will likely keep weakening and unemployment will remain high. As we expect further tightening of credit conditions, we answer five key questions on credit markets and update our rates outlook.

Expect the easing cycle to begin earlier

We are revising our end-2023 selic forecast to 11%, from 11.75%. We believe the BCB will frontload the easing cycle and cut rates starting in May (instead of August). Still, we expect a total of 425 bp in cuts to reach 9.5% by end-2024. One caveat: the earlier easing is conditional on the terms of the fiscal framework proposed by the new administration.

Q1: Where does domestic liquidity stand?

Banks' liquidity ratio remains above 1 (banks still have enough liquid assets on their balance sheets to absorb potential losses). However, this ratio is close to historical lows. Also, M1 growth has been negative for 18 months.

Q2: What is the financial leverage situation?

Following the removal of pandemic support measures and the 1175bp increase in interest rates, the credit environment became more challenging. Consumer indebtedness reached 49.4% of disposable income and businesses searched for alternative funding.

Q3: What is happening with non-performing loans?

Economic slowdown and high rates are leading to a pick-up in consumer NPLs 6.1% in Jan (from 4% in Apr/21). NPLs for SMEs reached 3.4% in Jan (from 1.9% in Dec/20).

Q4: What effect did Americanas have on credit markets?

Banks are tightening credit standards, cost of funding is increasing, and demand for local corporate bonds has declined since the retailer disclosed accounting irregularities.

Q5: How tight are financial conditions?

Financial conditions remain tight despite the recent reduction in the 1-year ex-ante real rate at the beginning of March. External financial stability concerns have led to lower expectations of rate hikes by the Federal Reserve ahead and lower commodity prices.

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Credit: The Post-Honeymoon Blues

A credit crisis often follows a period in which lenders are overly lenient. Banks increase lending, often to borrowers with questionable ability to repay, resulting in higher delinquency rates. While banks may increase rates for those able to repay their loans, the rise in borrowing costs hinders consumer spending and leads companies to cut back on growth plans including hiring, The shrinking credit supply is usually followed by a prolonged recession.

Brazil's credit market has faced many challenges in the past decade including alternating economic policies, an impeachment and the pandemic. After peaking at 54% of GDP in December 2015, outstanding credit shrank in real terms for three consecutive years, on the back of the worst recession in Brazilian history. It was only in December 2022 that total credit was able to recover to its peak level. However, in the past few months increasing concern of a credit squeeze has emerged, particularly after the Americanas episode. In this piece, we present five questions (and answers) to better understand the status of the Brazilian credit sector.

We expect credit markets to show further deterioration ahead given ongoing high interest rates, a weakened economy and an expected increase in unemployment. While public banks may lend more, private banks are tightening credit standards. With this in mind, we now expect the Brazilian Central Bank to begging cutting interest rates in May (from our previous call of rate cuts starting in August). The earlier cutting cycle is conditional to the presentation and approval of a credible fiscal plan by the government.

1. Where does domestic liquidity stand?

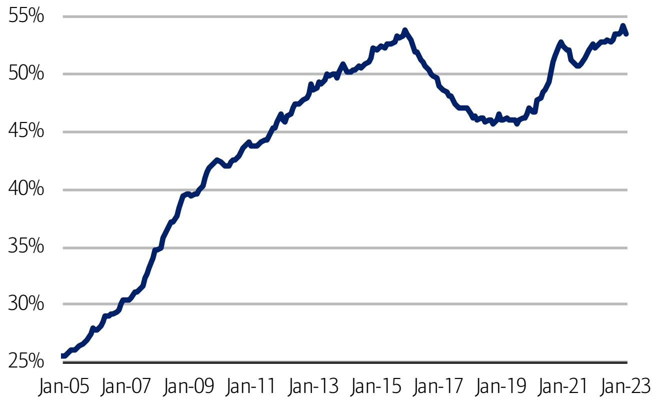
Though no indicator on its own provides a full picture of liquidity, we tried to gauge it by taking into account several metrics. Thus we conclude that liquidity appears to be weakening.

The term liquidity is used here as an indicator of the ease of financing in financial markets. It encompasses both funding liquidity (the ease of raising cash by selling new obligations to investors) and market liquidity (the ease of raising cash by selling assets). Thus liquidity is dependent on the actions of private investors, financial institutions, and the Central Bank.

Financial institutions provide market liquidity to securities markets through trading activities and provide funding liquidity to borrowers through lending. Much of this lending, though not all, is provided by banks. In the Brazilian financial sector, banks' liquidity ratio currently remains above 1 (see Exhibit 2)[1], meaning they still have enough liquid assets on their balance sheets to absorb potential losses in stress scenarios and to comply with regulations. However, this ratio is close to historical lows.

[1] Brazilian Banking System Liquidity Ratio measures whether banks (in aggregate) have enough liquid assets to cover their short-term (21 business days) cash-flow needs in a simulated stress scenario, defined and calibrated by the Brazilian Central Bank. Such cash outflows arise from the run-off of maturing or redeemable liabilities, losses from market risk exposures, for instance, margin calls and derivative pre-settlements, and other contractual outflows maturing in the next month. A ratio above 1,00 indicates that the banking system has enough liquid assets for such scenario. For explanations for the semi-anually movements and for further calculation details, please see the Financial Stability Report (https://www.bcb.gov.br/en/publications/financialstabilityreport).

Exhibit 1: Total outstanding credit back to the peak
As % of GDP



Source: BofA Global Research estimates, BCB

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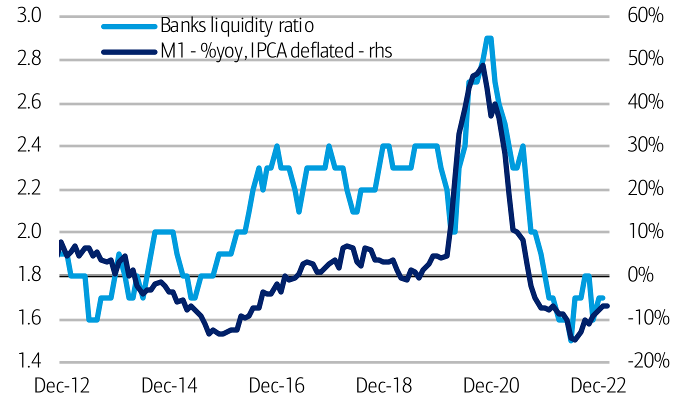
Exhibit 2: Liquidity seems to be on a downward trend
Banks liquidity and M1 ratio declining



Source: Brazilian Central Bank

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The terms and conditions in which the central bank provides funding is another factor that affects liquidity. During the pandemic, the Brazilian Central Bank (BCB) ensured that funds would reach those that most needed it the most given that consumers were unable to obtain funding at sufficiently attractive conditions. Along with this intervention, BCB increased the asset side of its balance sheet, with larger monetary base. As support measures were reverted, both monetary base and demand deposits contracted. In real terms, up until February 2023, M1 growth has been negative for 18 months.

2. What is the financial leverage situation?

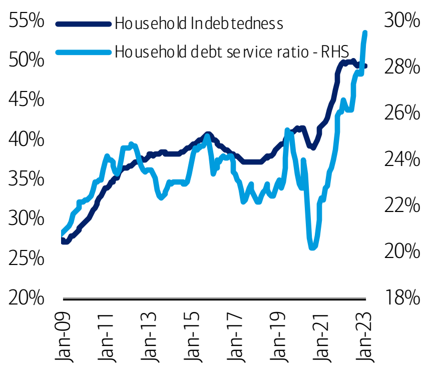
With the reduction of excess liquidity, following the removal of support measures implemented during the pandemic – the 1175bp increase in the base interest rate included – the environment became more challenging. Consumer indebtedness reached record high levels, while businesses diversified their funding sources.

Households are grappling with higher debt levels

According to BCB, in January 2023, 29.5% of household disposable income was committed to debt service of which almost 10p.p. was for the payment of interest due that month. Before Covid, that figure was 23%. Household indebtedness also increased sharply reaching 49.5% of 12-month accumulated disposable income, from 25.5% in December 2019. Families' purchasing power deteriorated with higher inflation and loan conditions worsened with higher spreads and consumers faced difficulty paying off the debt they accumulated (Exhibit 3).

Exhibit 3: Indebtedness at record high levels

Debt service accounts for almost 1/3 of families' disposable income



Source: BofA Global Research estimates, BCB.

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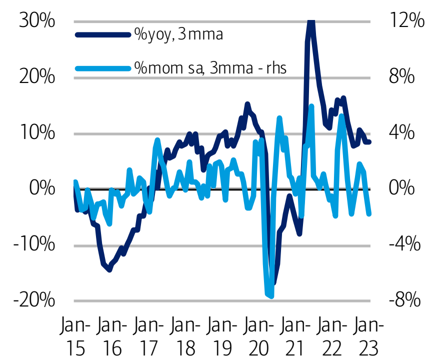
Exhibit 4: New credit to families slowing

Non-earmarked concessions marginally contracted in real terms



Source: BofA Global Research estimates, BCB.

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Exhibit 5: Savings withdrawal growth is up

%yoy, 3mma

Source: BofA Global Research estimates, BCB.

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The rather uninviting conditions for borrowers led to a slowdown in lending to households starting in 2H22. Household credit granting growth is decelerating gradually. However, at the margin, after disregarding inflationary effects, new concessions momentum is negative (see, Exhibit 4). With inflation and debt service eroding consumer purchasing power, savings withdrawal is picking up pace. This is a particularly concerning development given that savings accounts are an important source of funding for the financial sector, notably for housing loans.

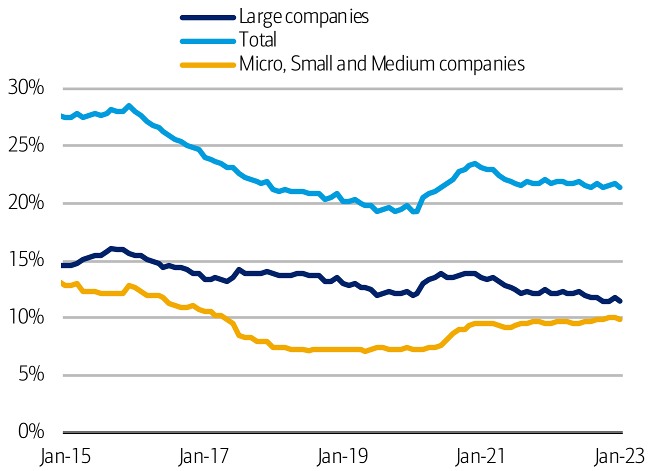
On a positive note, the *Desenrola* debt renegotiation program, a Lula campaign promise, should improve consumers' financial leverage going forward. With a R$10bn fund from the National Treasury, the program aims to reach 37million people and renegotiate up to R$50bn in debt. Those who earn up to two minimum wages (R$2,640.00 per month) will be eligible to participate in the initiative. Regulatory advancements should further stimulate household credit (for more, see: Appendix 1).

The wheel is running dry for corporates

Corporate credit is also showing signs of a downturn. As the pandemic spread, the government launched several programs to support companies as mobility restrictions took place and economic activity came to a halt. Programs such as *Pronampe* (Support Program to Micro and Small Enterprises) were crucial to increasing the flow of credit among the most vulnerable sectors. The credit granted could be used for investments and working capital. The financial institutions had R$15.9bn in the Operations Guarantee Fund (FGO), paid by the National Treasury, as collateral for credit operations.

Therefore, corporate credit penetration began to surge in the 1H20, rising from 20.4% of GDP in March to 23.5% in December of that year (Exhibit 6). Bankruptcies also dropped 24.9% yoy by the end of 2020, demonstrating the effectiveness of government support and the positive impact of lower interest rates (Exhibit 7). While default rates were already declining prior to 2020, the measures allowed that trend to continue even amid the negative economic situation. MSMEs (Micro, Small and Medium Enterprises) were the main target – and beneficiary -- of the support agenda, and delinquencies among this sector fell from 4.16% in May 2020 to 1.91% by December 2020, according to the BCB.

Exhibit 6: Corporate credit escalated during the pandemic
Credit penetration (% of GDP)



Source: BofA Global Research, BCB.

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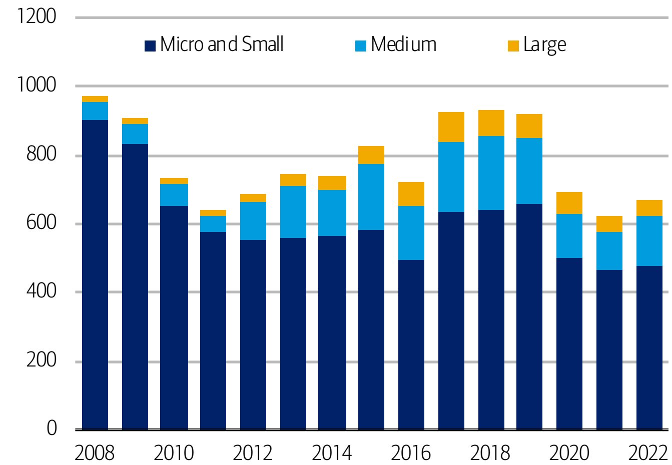
Exhibit 7: Government support avoided insolvencies in 2020
Total bankruptcies per company size



Source: BofA Global Research, Serasa Experian.

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Total credit to companies reached R$5.1tn in 2022 (52.4% of GDP), a 10% nominal increase in 2022, from 11% in 2021. The virtual unchanged pace of growth was possible, despite the deceleration in credit granting, due to strong acceleration in private bonds issuance.

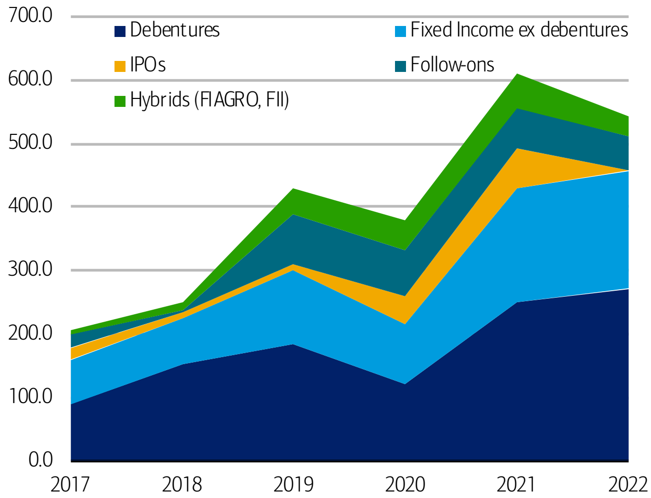
According to the Brazilian Financial and Capital Markets Association (Anbima), issuance in capital markets last year totaled R$544bn, a 10.9% drop from 2021 (Exhibit 8). The deceleration was driven by the lower volume of issuance in the equities market, which totaled R$55bn. That was 57% less than the previous year. After a record number of IPOs in 2021, there was only one public offering in 2022, amid the low attractiveness of equities in comparison to fixed-income assets and election uncertainty. Most stock offerings were follow-ons, totaling R$54.6bn.

On the other hand, fixed-income issuances rose. Total issuance was R271bn and of that 41.5% was earmarked to increase capital. Of the total, almost 83% of private bonds issued indexed to the DI (Interbank rate).

The risk aversion in the secondary market is spilling over to the primary market. As investors seek higher premiums and shorter maturities, the distribution of new debt becomes more expensive. Therefore, total issuance in capital markets should keep declining as fewer companies seek to delay or cancel primary offers. Corporates may wait for a less uncertain scenario to resume operations. In February, the total volume issued of private bonds (debentures) was 73.2% lower compared to February 2022 (Exhibit 9). So far this year there have been no offerings in the equities and external market.

Exhibit 8: New corporate issuances in the equities capital market were practically null in 2022…

… as high rates benefit fixed income assets, such as debentures. Total issuances (R$ bn).



Source: BofA Global Research, Anbima.

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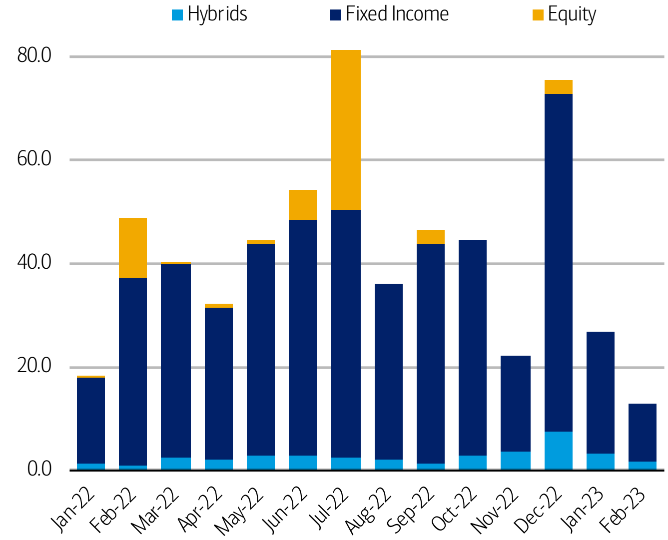
Exhibit 9: Issuances are being cancelled or postponed in 2023…

… as corporates wait for a better economic scenario. Total issuances (R$bn).



Source: BofA Global Research, Anbima.

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Given the current scenario, the slowdown in corporate credit will likely hamper productivity. Without credit concessions, the productivity capacity gains would be limited by the firms' readiness to self-finance operations.

3. What is happening to NPLs?

Another element holding back credit concessions is the sharp increase in Non-Performing Loans (NPLs). Loan conditions have worsened and spreads have surged as inflation accelerated. In fact, households' delinquency rate on non-earmarked loans rose to to 6.1% in January, a level not seen since June 2016. Though companies' delinquency rate on non-earmarked credit remains at a reasonable level (at 2.3%, yet in an upward trend), loans represent about 40% of total corporate funding. Debt securities' share on funding has been increasing since 2016 and reached a peak of 25% in January 2023.

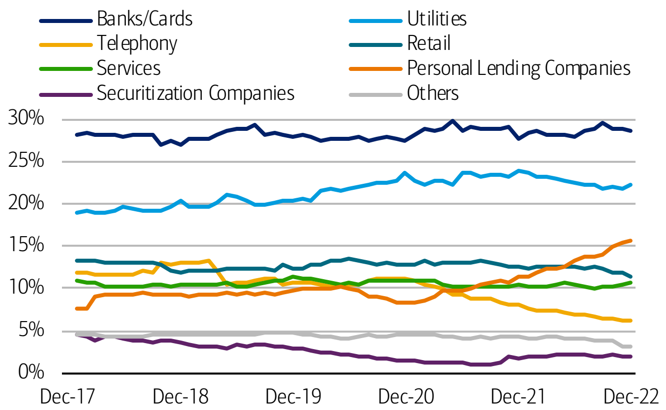
Understanding the household credit default rate

To future gauge household default conditions we looked at the monthly Serasa Experian Consumer Delinquency Indicator. (The index considers an indebted consumer anyone with at least one unpaid loan in a month.)

Looking at the breakdown of household defaults, roughly 30% are in bank loans and credit card debt (See Exhibits 10 & 11 for the breakdown.), Utility bills account for around 22% of NPLs while debt with personal lending institutions totals 16% of NPLs. While bank and credit card consumer debt participation have been relatively stable since the end of 2020, loans from personal lending institutions increased meaningfully in the same period. Also NPLs on the loans from personal lending institutions increased the most in the same period.

Exhibit 10: Financing companies gaining relevance...

Sectors participation on total consumer default (%)



Source: BofA Global Research, Serasa

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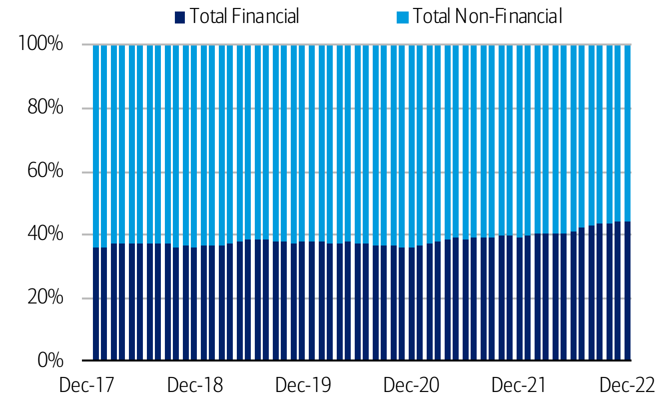
Exhibit 11: ...and impacting total NPL on financial loans

Sectors participation on total consumer default (%)



Source: BofA Global Research, Serasa

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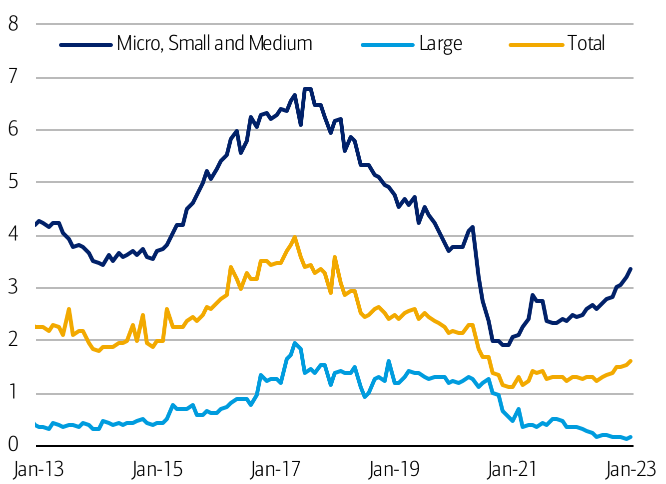
Corporate loan delinquency rates are on the rise

The surge in household debt has begun to impact companies' financial results in recent months. A look at consumers' capacity to pay credits shows that, as of December 2022, there were 6.4 million companies with at least one commitment due and not paid, according to Serasa Experian data. Of that total, about 89% corresponded to micro and small enterprises. This category also represented 71% of total bankruptcies through last year.

Exhibit 12: Corporate NPLs accelerating, pushed by SMEs

Non-performing loans by company size (%)



Source: BofA Global Research, BCB .

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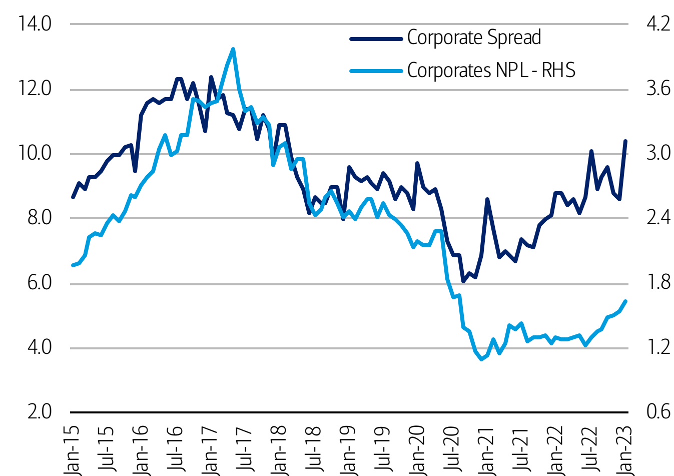
Exhibit 13: Increased risks and rates pushing spreads and NPLs

Corporate spreads (%) and NPL (%)



Source: BofA Global Research, BCB.

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In January 2023, in seasonally adjusted terms, there was a 9 bp increase in corporates' NPL and the level reached 1.63%, mainly driven by Micro, Small and Medium enterprises (MSME's), in an upward trend since October 21 (Exhibit 12). Outstanding loans to corporates dropped 1.1% mom in January, with large companies' loans declining 1.5% mom and MSMEs by 0.7%. New loans for corporates went down by 26.2% mom. Spreads have also increased since the beginning of monetary tightening and have accelerated from 8.6pp in December 2022 to 10.4pp in January of 2023 (Exhibit 13).

A credit shortage was already expected given a muddle-through scenario for activity this year. Nevertheless, a surprise announcement from one of the biggest Brazilian retailers changed the dynamics of the private credit market.

4. Did the Americanas episode affect credit markets?

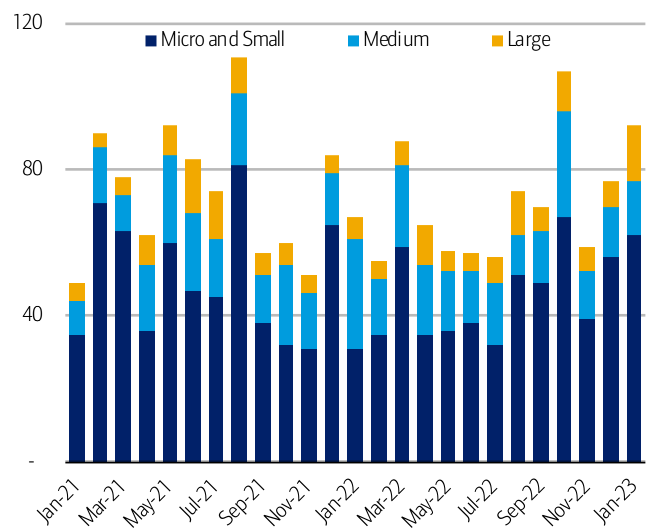
The credit market suffered a shock in the beginning of this year when retailer Americanas released a Material Fact on Jan. 11 2023, announcing inconsistencies in accounting entries impacting accounts payable in multiple years, including 2022. The company published a list of all creditors several weeks later and disclosed debt totaling R$41.2bn.

Shortly after, the Anbima (Brazilian Association of Financial and Capital Market Institutions) IDA Index – which represents market prices of corporate bond portfolios with the most liquid debentures -- fell by 1.28%. Excluding Americanas' debentures, the index would have risen by 0.13%, a sign that investors thought that the companies woes didn't affect other bonds. However, as days passed, the market's perception of risk became more negative.

Following Americanas' announcement, several negative headlines regarding other large enterprises hit the news. According to data from Serasa Experian, 92 companies filed for judicial reorganization in January 2023, increasing 19.5% mom and 37.3% yoy. The data showed that large companies represented a bigger share of total reorganizations filed. In 2022, they comprised an average of 10.9% of the total, while in January 2023 this share rose to 16.3% (Exhibit 14).

Exhibit 14: Companies are signaling major difficulties in 2023

Total number of files for judicial reorganization per month



Source: BofA Global Research, Serasa Experian.

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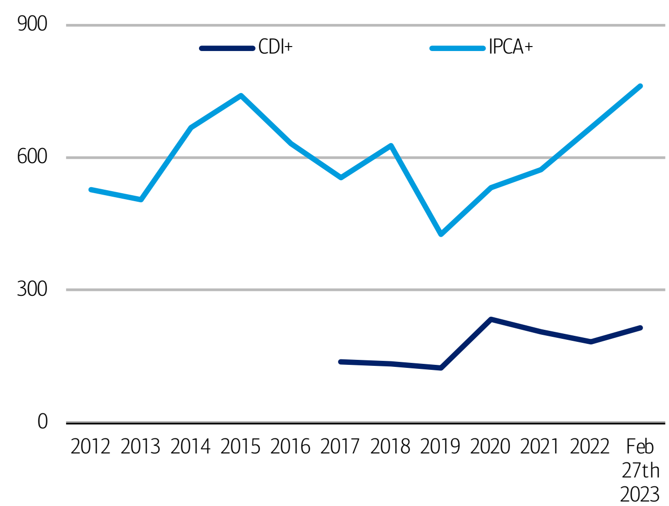
Exhibit 15: Increasing spreads in Brazilian debentures… (in bps)

…reflect the risk aversion sentiment in the domestic market



Source: BofA Global Research, Anbima.

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The increased risk of default has led to a sell-off and drove spreads wider. A new Anbima rule, which went into effect on January 2, also increased the visibility of private credit spreads by mandating that brokerage firms reveal the market price of each asset class in their portfolios.

An analysis of the IDA Index shows the spread increase in Brazilian debentures. Current market spreads for debentures linked to the CDI plus spread (CDI+) are above 200bp over the reference rate. Current market spreads for inflation-linked debentures are above 750bp over IPCA (Exhibit 15). It is worth noting that this measure does not include distressed debentures, such as the ones of Americanas (AMERBZ) and Light

(LIGHTBZ), for example.

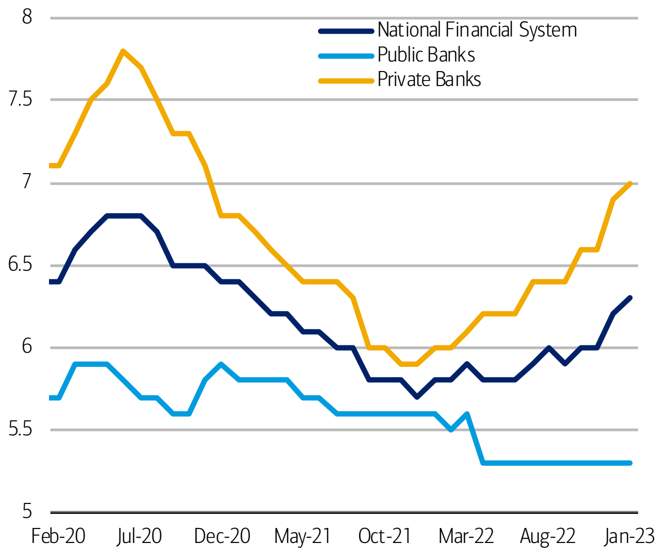
Private Banks: Skating on thin ice

In response to current market conditions and, more specifically, as another consequence of the Americanas news, major Brazilian banks provisioned 100% of their loan exposure in the last quarter (while bankruptcy protection requires banks to provision at least 30%)[2]. Most Americanas loans were short-term and the total provisioning related to the retailer amounted to at least R$9.5bn. Provisioning in relation to the total portfolio of the National Financial System had already been happenuing since December 2021, as seen in Exhibit 16, but the increase curve steepened in recent months. As default rates continue to rise, banks could maintain (or further increase) provisions in future quarters.

Another sign that banks are becoming more conservative is the composition of loans. Within the activity slowdown seen in the 2H22, concessions of non-earmarked credit to households increased for secured loans, such as payroll deducted personal credit and financing of goods in general (collateralized loans). On the other hand, unsecured loans, as personal credit without payroll deduction, are declining (Exhibit 17).

Exhibit 16: Banks provisioning more amid high default rates

Provisions over portfolio (%)



Source: BofA Global Research, BCB.

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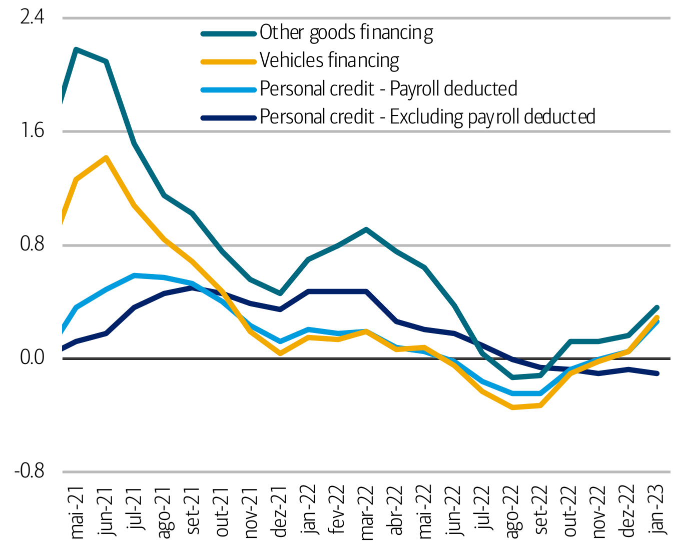
Exhibit 17: Unsecured loans drop as lending risks increase

Non-earmarked new operations to households (3mma yoy%)



Source: BofA Global Research, BCB.

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As banks become more conservative in lending and as debt spreads increase, credit conditions will become tighter and tighter. All signs point to increasing indebtedness, especially among micro and small companies, and more restrictive conditions for large companies' funding.

Public Banks: New behavior expected

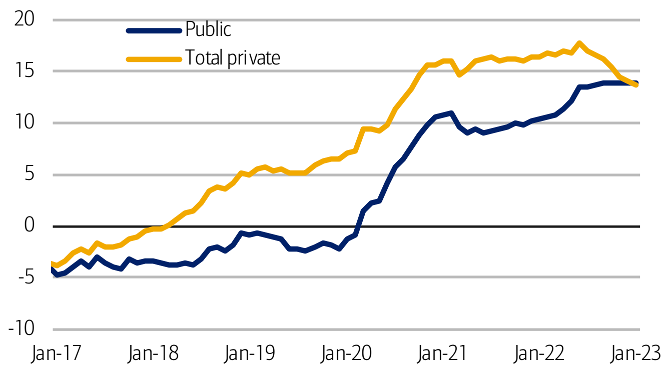
Public banks scaled back and registered a decline in their lending share from 2017 until just before the pandemic. Recent data suggests that loan growth from public and private banks have gotten closer (Exhibit 18).

That is considerably different when we compare public and private banks regarding NPL rates. Amid the increasing default context, mainly due to higher household NPL and indebtedness, private banks were the most affected (Exhibit 19), with a consistent increase in NPLs since the last quarter of 2021. Meanwhile, public banks faced some

[2] The provisioning timetable must follow BCB guidelines, which determines that a loan 180 days overdue should be 100% provisioned.

volatility, but only around the same NPL level of 2.1%, with a more negative trend materializing on the second half of the year. This reinforces the retraction in public bank behavior in the last 8 years, with lower exposure to higher risk credit.

Exhibit 18: Public banks should increase participation ahead
% yoy growth



Source: BofA Global Research estimates, BCB.

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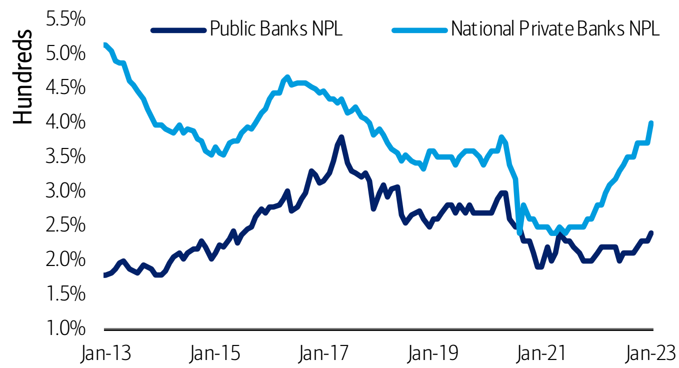
Exhibit 19: NPLs going back up, but mainly in private banks
Public and Private banks' NPLs (%)



Source: BofA Global Research, BCB.

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The dynamic is expected to change in the next four years as the new administration has said that it intends to use public banks and SOEs (State-owned enterprises) more actively in its intent to support stronger GDP growth numbers in the country. As a result, credit concessions from public banks should increase meaningfully, with this lower NPL rate in public banks supporting such a dynamic. Among the public banks (Caixa, Banco do Brasil and BNDES), the BNDES should be the biggest highlight in terms of more lending ahead.

5. So, how tight are financial conditions?

Financial conditions in Brazil remain tight. Despite the reduction in the 1-year ex-ante real rate, which occurred at the beginning of March and has been beneficial to financial conditions, tightness continues at record high levels – and close to levels not seen since the 2015-16 recession. This time, however, higher global rates are supporting the restricted environment.

More recently, external financial stability concerns, derived from the risk of contagion in the US financial system, have led to lower expectations of rate increases by the Fed going forward and lower commodity prices. This is supportive to financial conditions domestically.

Regarding exposure to the events in the US banking system, Brazilian banks rely on strong balance sheets and comfortable liquidity position. For more on domestic banking sector, see Banks - Brazil: Unrealized losses on HTM portfolios seem manageable 14 March 2023.

Under these circumstances, we forecast a slowdown in the credit market ahead. The pace of the slowdown, however, is still unclear. Debt renegotiation programs promoted by the government, as well as the role of public banks in the current administration, are key points.

BCB to cut rates sooner

We are revising our Selic forecast for 2023YE to 11.0%, from 11.75%. We believe the Central Bank will frontload the easing cycle and start cutting rates in May (instead of August) with a 25bp move. This would be followed by consecutive cuts of 50bp, reaching the same budget as we had before of 425bps. We continue to expect the terminal Selic at 9.5% in 2024 year-end.

Even though the new fiscal rule has not yet been approved in Congress, there has been a reduction of uncertainty regarding the fiscal accounts, which should change the board´s assessment on balance of risks. Indeed, we expect the March statement to present risks for inflation forecasts tilted to the downside, on the back of continuously deteriorating activity, the downturn in the labor market, decelerating, concerns regarding the domestic credit conditions and the deterioration in the external banking sector.

Lower inflation and a deceleration in underlying measures should help the BCB to start cutting, even though certain price increases (such as the return of federal taxes on gasoline and ethanol) should keep headline inflation above target levels this year.

In our view, inflation expectations are the biggest obstacle to an earlier cutting cycle. Longer horizon inflation expectations have been increasing, mainly driven by the potential change in the inflation target. We expect the 2024 target to be increased from 3% to 4%, following a declining path in subsequent years. Under that assumption, 2024 year-end inflation should reach target-levels, opening room for further cuts this year. Although expectations may suffer in the short-term, the announcement of the new fiscal framework should reduce uncertainty and risk perception.

Appendix 1: Structural advancements in the banking sector

Brazil has one of the most sophisticated banking systems among emerging market economies, following changes and advancements seen in more developed economies. Moreover, domestic financial inclusion is way above peers, with 79% of the population (15 years old or older) currently having active bank accounts, versus 49% in Argentina and 37% in Mexico.

However, the credit market has been historically incipient in the country, with a low credit to private sector/GDP ratio. When compared to developed economies (e.g., Euro Area and OECD), Brazil is way behind concerning the ratio: while the Euro Zone and OECD countries had 93.7% and 160.7% (in 2020 numbers), respectively, Brazil was still at 70% in 2020, as reported by the World Bank. The country has space to expand concessions even when considered among some of its peers, as China (182.9%), Chile (124.6%) and South Africa (111.2%). Institutional changes, through regulatory advancements, are key in such process.

The Open Finance system (deemed to foster competition and lower interest rates) has been put forward since 2020 but is only expected to fully materialize in the coming years, supporting further optimism. The concept proposes the creation of a banking environment where more data is shared between institutions, with the prospect of improvements in services and products for the customer, especially through the reduction of information asymmetries and the resulting increase in competition – intensifying the scenario observed with the rise of fintechs.

A market that is expected to be most benefited by such changes is the credit one. That is because changes should improve the capabilities of banks to offer more precise credit offers, using data from all the credit history of the clients, from different banks – if they allow for the sharing of this data. Amid this expected higher competition for clients, lower spreads and ampler credit access should be positive consequences.

Special Disclosures

Some of the securities discussed herein should only be considered for inclusion in accounts qualified for high risk investment.

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