Covid-19: Assessing the Impact on the South American Banking Industry

Overview of the five largest economies

January 2021

EVALUESERVE

Economic outlook: Are banks prepared to cope with the unfolding crisis?

THE CHALLENGE

The banking industry's creditworthiness remains closely tied to the economic performance of sovereign agents during times when the IMF and IDB forecast **GDP losses between 8-10%** for Latin America and the Caribbean in 2020.

While the speed of recovery is a key element to track, in a post-Covid-19 scenario, most banks are still likely to deal with a **thin pool of creditworthy borrowers, high systemic risks, and lower-for-longer interest rates and profit margins.**

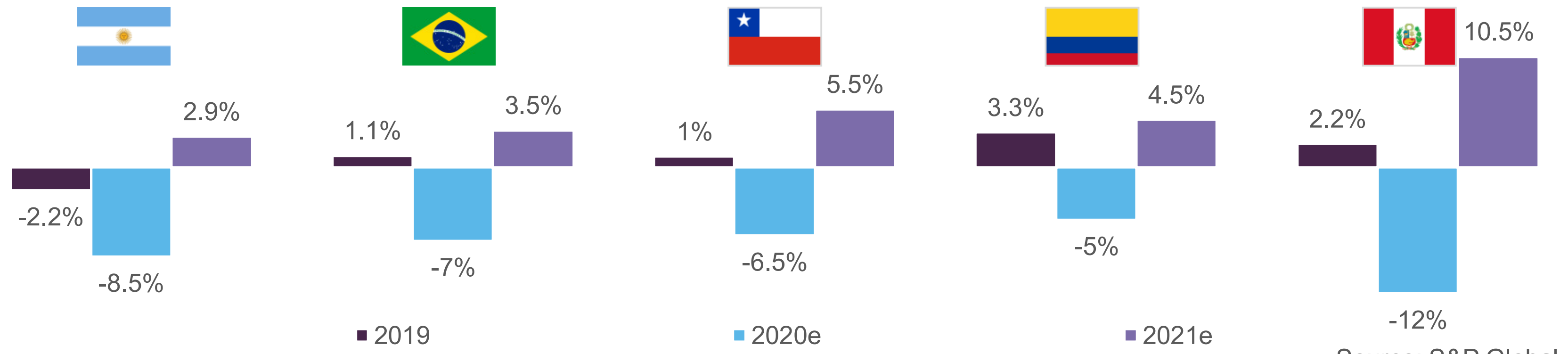
THE STRENGTHS

- Among the largest economies, the **banking industry risk primarily ranges between low to intermediate,** with Argentina being the exception due to concerns about funding, competitiveness, and institutional framework.
- Most countries appear **well prepared to deal with economic imbalances,** with Argentina and Colombia as the outliers.
- **Economic and industry risk trends are deemed stable** with limited instances of negative outlooks.

THE WEAKNESSES

- Economic resilience seems very fragile regionwide, with the biggest **signs of distress coming from Argentina and Brazil.**
- **Credit risk ranks from high to extremely high in almost all the economies** under consideration, with the Chilean banking system being the only exception.
- A potential **increase in nonperforming loans ought to be monitored closely in Argentina and Peru.**

GDP Growth - Selected Countries



Source: S&P Global

Banking Industry Country Risk Assessment

Country	Economic Risk Trend	Industry Risk Trend	Economic Risk			Industry Risk		
			Economic Resilience	Economic Imbalances	Credit Risk in the Economy	Institutional Framework	Competitive Dynamics	Systemwide Funding
Argentina	Stable	Negative	Extremely High	High	Extremely High	High	High	Very High
Brazil	Stable	Stable	Very High	Intermediate	High	Intermediate	High	Intermediate
Chile	Negative	Stable	High	Low	Intermediate	Low	Intermediate	Low
Colombia	Stable	Positive	High	High	High	High	Intermediate	Intermediate
Peru	Stable	Stable	High	Very Low	Very High	Low	Intermediate	Intermediate

Source: S&P Global

EVALUESERVE

Institutional response: How are central banks reacting to the crisis?

	Monetary and Financial Policy Measures				
Country	Reduction in policy interest rate	Intervention in foreign exchange market	Central bank purchase of securities	Reduction in liquidity or reserves requirements	Temporary deferrals on loan payments
Argentina		●		●	●
Brazil	●	●	●	●	●
Chile	●	●	●	●	●
Colombia	●	●	●	●	●
Peru	●	●		●	●

Source: IDB, Central Banks

The Regulator's Goals

- Mitigate the impact of the economic recession on the financial system, thus protecting a main conduit for policy implementation
- Prevent a deeper economic contraction that may result from a credit crunch
- Anchor the risk profile of the domestic banking industry to reduce the prospects of capital flight

Initial Results

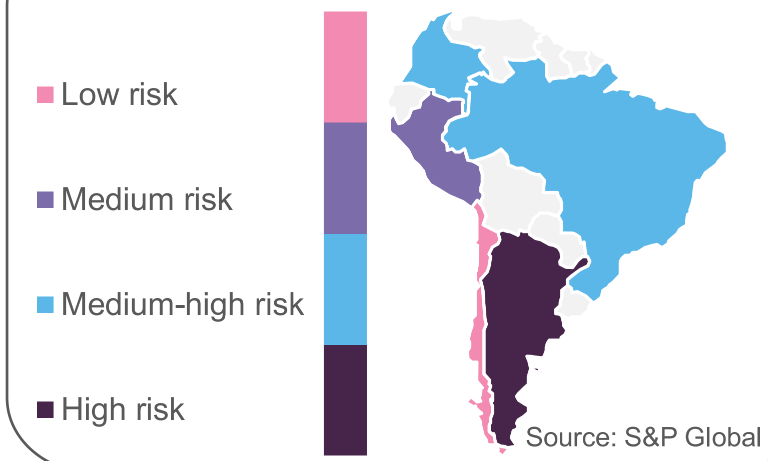
- Credit guarantees and liquidity provisions have resulted in significant increases in credit extensions; the majority of funds have been requested for commercial and consumer purposes
- Loan restructuring and moratoria have become more common in Brazil, Chile, and Colombia
- The banking system in Brazil and Chile have reported an increase in provisions for nonperforming credits despite government guarantees against credit losses

Key Trends to Watch

- Increase in nonperforming loans, particularly in sensitive economic sectors such as commodities, airlines, leisure, and the SME segment
- Emergence of inconsistencies in the way banks report nonperforming credits, which could in turn lead to suboptimal provisions for credit losses
- Announcement of a new batch of credit guarantees by the government, which could signal a persistence of unyielding credit risk in the system

South American banking industry at a glance

Banking Industry Country Risk Assessment



Source: S&P Global

Country	Performance – 2020 v. 2019		
	Credit portfolio growth	**Nonperforming assets**	**Return on active assets**
Argentina	▲	▲	▼
Brazil	▼	▲	▼
Chile	▼	▲	▼
Colombia	▲	▲	▼
Peru	▲	▲	▼

Source: S&P Global

Top South American Banks, by total loans (Credit rating in brackets)

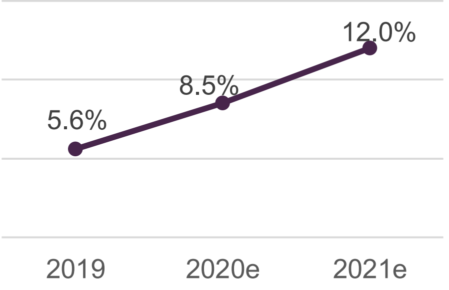
Ranking	Argentina	Brazil	Chile	Colombia	Peru
1st	Banco de Galicia y Buenos Aires (“CCC+”)	Itau Unibanco Holding (“BB-”)	BCI (“A”)	Bancolombia (“BB+”)	Banco de Credito del Peru (“BBB+”)
2nd	Banco Patagonia (“CCC+”)	Banco do Brasil (“BB-”)	Banco del Estado de Chile (“A+”)	Banco de Bogota (“BB+”)	BBVA Peru (“BBB+”)
3rd		Banco Bradesco (“BB-”)	Banco Santander (“A”)	Banco Davivienda (“BBB-”)	Scotiabank (“BBB+”)
4th		Caixa Economica Federal (“BB-”)	Banco de Chile (“A”)	FINDETER (“BBB-”)	Interbank (“BBB”)
5th		Banco Santander (“BB-”)	Scotiabank (“A”)	Financiera de Desarrollo Nacional (“BBB-”)	

Source: S&P Global

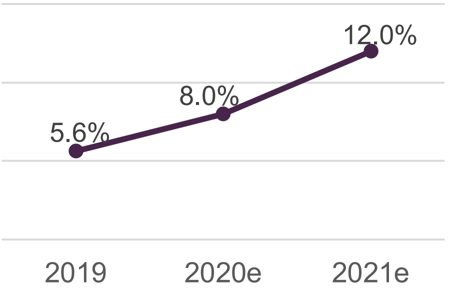
EVALUESERVE

Argentina: Banking industry weighed down by complex macroeconomic environment

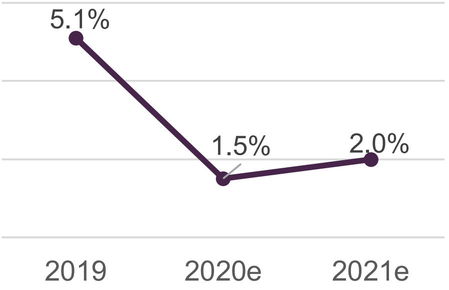
Credit portfolio growth



Nonperforming assets



Return on active assets



Source: S&P Global

Economic Scenario

- Recent restructuring of $100bn foreign currency debt creates a favorable near-term amortization profile for the government; however, a persistent high-debt burden, coupled with weak growth prospects, creates significant uncertainty for economic agents.
- Institutional response to the pandemic has focused on increasing lending facilities, which have been contracting in real terms over the past two years. These efforts are considered quite modest when compared to support packages in other nations.
- Economic imbalances are likely to persist for several quarters, further eroding asset quality and pressuring provisions against credit losses. Additional government intervention may occur in the near term.

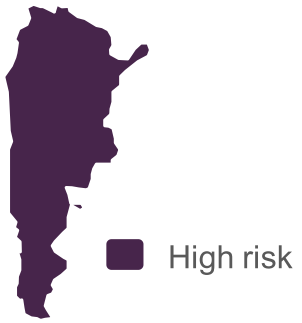
Industry Outlook

- Credit portfolio is forecasted to grow, fueled by government mandate to boost lending to SMEs, self-employed individuals and low-income households; nonetheless, nonperforming assets are expected to mirror the uptick, due to the economic environment and risk profile of the borrowers
- Government has set interest rates on the new credit facilities at 15% for self-employed and 24% for SMEs, well below the 40% inflation rate forecasted for 2020. Directive on interest rates and deterioration of asset quality are likely to take a toll on the profitability of the credit portfolio
- On a positive note, the banking system is considered to remain well capitalized and with high liquidity levels in both cash and short-term investment instruments

S&P rating

- All rated banks have been downgraded from “B-” to “CCC+” due to the likelihood of the government imposing new restrictions on domestic entities to access U.S. dollars.
- Banco Hipotecario SA was already rated at “CCC”.
- Sovereign rating stands at ”SD” (Selective Default).

Banking Industry Country Risk Assessment

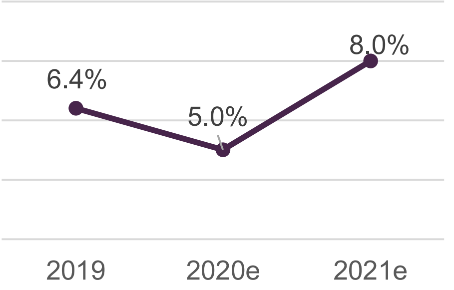


Source: S&P Global

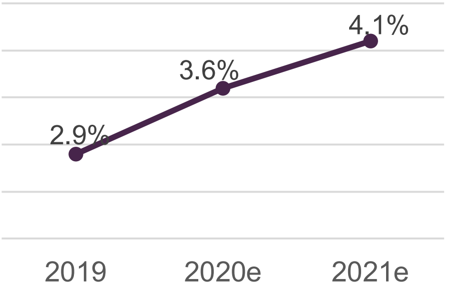
EVALUESERVE

Brazil: Banks likely to wade through the storm, although few players may struggle

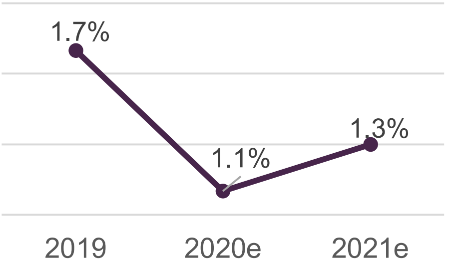
Credit portfolio growth



Nonperforming assets



Return on active assets



Source: S&P Global

Economic Scenario

- Size and complexity of the banking system have impacted efforts to deploy support measures; yet, government response has proven well timed and broadly in line with actions taken by central banks worldwide.
- With liquidity management as the most-used tool during the Covid-19 crisis, the Brazilian central bank is keeping a closer look on baseline inflation projections, while stressing that the room for monetary stimulus is quickly closing.
- 45% of new loans and credit renewals between Mar-Sept 2020 have been processed by private banks, followed by other nonbank financial institutions (28%) and public banks (27%); borrowing is split between the corporate segment (37%), households (36%), and SMEs (27%).

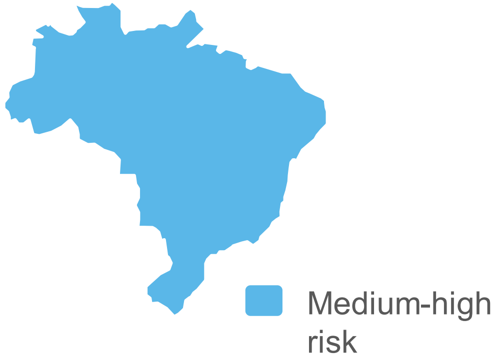
Industry Outlook

- 2020 is anticipated to close with a hiccup on credit portfolio growth, dragged by the sluggishness on credit demand for mortgages, vehicle purchases, and the credit card segment, offset by credit demand from the corporate segment.
- Delinquency rates on loans are expected to remain within a tight range, due to a high level of credit restructuring and flexibilization of rules for nonperforming credit recognition. Further, steadiness of asset quality reflects the systemwide conservative approach to lending.
- It's noteworthy that not all banks entered the pandemic with sound balance sheets; the most fragile institutions may face financial sustainability issues should the economic crisis persist.

S&P rating

- Outlook on 15 financial institutions revised to stable from positive, following the same action on the sovereign rating. Action reflects the view that GDP growth and fiscal performance will continue to suffer in 2020 due to the Covid-19 pandemic.
- Sovereign rating stands at "BB-", a stable outlook.

Banking Industry Country Risk Assessment

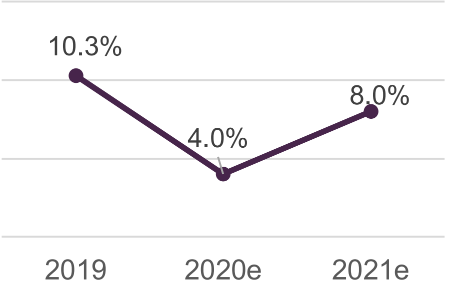


Source: S&P Global

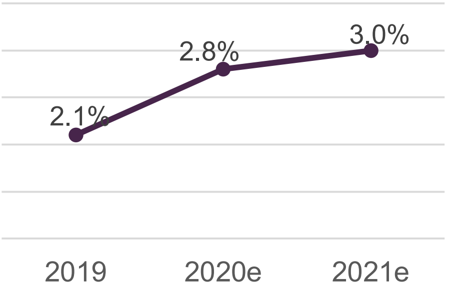
EVALUESERVE

Chile: Credit activity markedly lower, but government intervention softened the blow

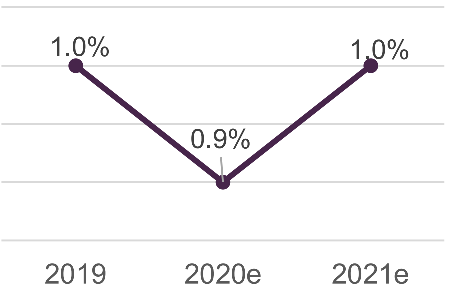
Credit portfolio growth



Nonperforming assets



Return on active assets



Source: S&P Global

Economic Scenario

- Following a convulsive end to 2019, Chile launched the first round of crisis response measures that provided an early counterattack to the effects of the Covid-19 pandemic. Actions combined liquidity support measures and guaranteed to prevent a spike in credit losses.
- Additionally, the regulator focused on channeling lending toward SMEs, thus limiting the possibility of smaller firms getting crowd out of the capital market, although at the risk of fueling a wave of bankruptcies among large companies.
- Whereas the second and third quarters of 2020 registered sharp declines in employment and consumption, the impact of monetary transfers and relaxation of lockdown measures have helped kickstart economic activity in recent months.

Industry Outlook

- Credit portfolio growth is anticipated to shrink to single digits in 2020, as the corporate and consumer segments react to a continuing decline in income generation; both segments are considered to carry a higher-than-average leverage when compared to other countries.
- Credit delinquency is forecasted to remain under control primarily due to wide-ranging loan moratoria rules encompassing mortgages and commercial and consumer credits; however, as the facilities expire, the rate of nonperforming assets could climb to 3% by 2021.
- Interestingly, while some analyst declare capital provisions for Chilean banks to be somewhat low due to a lag in implementing Basel III, the government has chosen to postpone its enactment to support liquidity. Complete rollout of Basel III is now expected by 2025.

S&P rating

- Outlook on 11 financial entities revised to negative from stable, due to impact of social unrest in Q4 2019 and Covid-19 pandemic in 2020
- Rating for banks operating only in Chile stands at “BBB+”.
- Sovereign rating stands at ”A+”, a negative outlook.

Banking Industry Country Risk Assessment

Source: S&P Global

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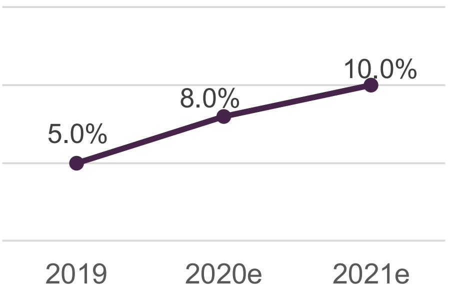
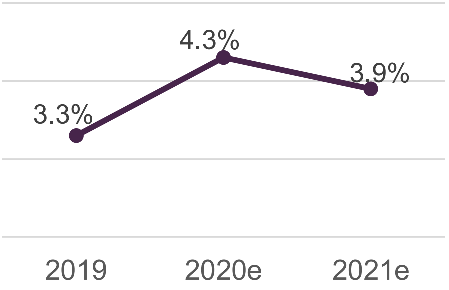
Colombia: A prolonged recession could prove very challenging for banks

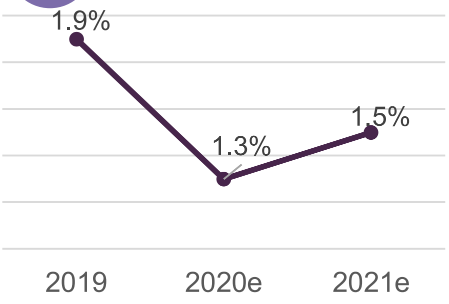
Credit portfolio growth



Nonperforming assets



Return on active assets



Source: S&P Global

Economic Scenario

- Faced with an unprecedented economic contraction of the GDP by ~8.5%, the authorities have started to worry that the near-term recovery could be moderate at best, leading to high unemployment; the immediate result could be a demand shock greater than supply effects, thus generating a negative output gap.
- Gross debt as a percentage of GDP is expected to reach 65.6% in 2020, showcasing the limitations of government intervention within fiscal prudency; failure to jumpstart economic dynamism may translate into a lower-than-expected credit growth.
- A stress test on the credit risk of the financial system, assuming an economic recession in 2021, shows that a significant number of institutions could face solvency problems and an inability to extend credits starting from Q2 2021.

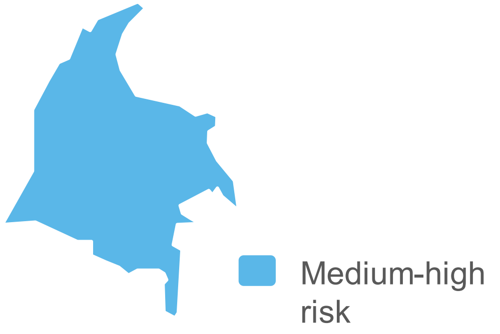
Industry Outlook

- Credit portfolio is anticipated to grow in the near term, driven by transitory provisions to funnel liquidity into lending facilities; however, the take-up rate of payment relief initiatives has been high, reaching 40% of total loans as of Q2 2020.
- Nonperforming loans are forecasted to record a steady increase starting in Q2 2020 and continuing into 2021, driven by the banking system's exposure to segments such as services, transportation, infrastructure, commerce, construction, and consumption; vulnerable economic segments account for 30% of the banks' credit portfolio, same percentage as consumer loans.
- Large exposure to assets in Central America could pose a risk to capitalization levels for Colombia's largest banks; it is estimated that one-third of the assets of Bancolombia, Banco de Bogota, and Banco Davivienda are tied to Central America.

S&P rating

- Outlook revised to negative from stable for three banks due to the sensitive nature of their business to sovereign stress
- Action are not driven by the deterioration of the banking system nor by the entities' stand-alone credit profile.
- Sovereign rating stands at "BBB-", a negative outlook.

Banking Industry Country Risk Assessment



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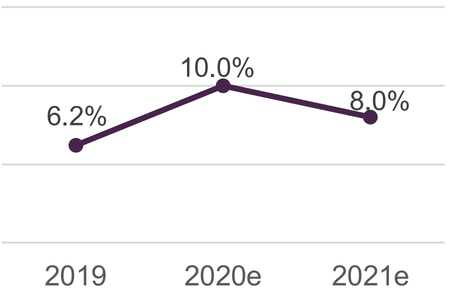
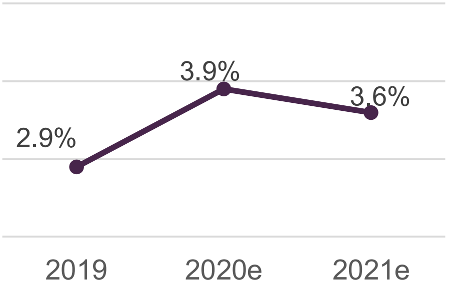
Peru: Systemwide exposure to procyclical segments feeds risk of credit losses

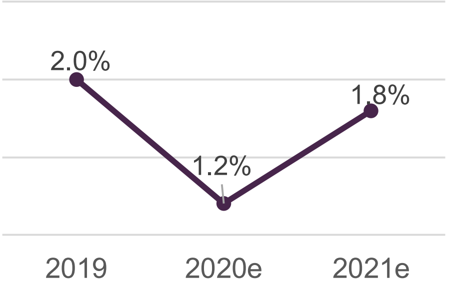
Credit portfolio growth



Nonperforming assets



Return on active assets



Source: S&P Global

Economic Scenario

- Pre-pandemic forecasts considered 2020 to be a year of economic recovery, however, the Covid-19 outbreak disrupted positive estimates and set the stage for a potential liquidity gap and a subsequent solvency crisis similar to that of the late 1990s.
- A broad package of support measures have been made available through the banking system to support SMEs, including loan guarantees for a combined total of up to 8% of GDP.
- Government intervention has led to a marked improvement in the business confidence index, which by September 2020, registered levels close to those recorded in February of the same year. This signals a perception among enterprises of a slow but steady recovery of economic activity.

Industry Outlook

- Lending facilities fostered by government intervention have resulted in an average increase on total credits to businesses of 20.1% as of June 2020; the main recipients of new loans have been the retail (37.1%), services (29.8%), and construction (29.1%) sectors
- As a result of the above, some analysts have expressed concern about the banking system's exposure to procyclical sectors, as well as to the SMEs segment (~27% of total credits); a market uptick in nonperforming loans is expected in 2020, although current capitalization rations ensure that most banks will be able to withstand the shock.
- Contrary to the situation in Argentina, Brazil, Chile, and Colombia, the banking system in Peru has a high exposure to U.S. dollar denominated loans (28-30% of total credits), some of which are nonprovisioned against losses.

S&P rating

- Most rated banks stand at the "BBB" level and should be able to absorb credit losses if the economic situation further deteriorates.
- Intercorp, BBVA Peru, and BCP have a negative outlook due to their risk-adjusted capitalization ratios.
- Sovereign rating stands at "BBB+", a stable outlook.

Banking Industry Country Risk Assessment

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Conclusions

Slow-Moving Recovery

While economic growth may rebound in 2021 for many economies, the improving outlook could take some time to translate into a stronger banking system, as credit risk only gradually declines and bad debts are fully realized. Additional rounds of institutional support could be required in the near term.

Rebuilding Trust Will Entail Reforms

The Covid-19 crisis has exposed the frailty of the institutional framework, competitive dynamics, and credit provisions in various countries; thus, preventing future crisis may require both encouraging adjustments and introducing new regulations. In countries like Peru, the authorities may want to induce a credit portfolio restructuring to reduce exposure to risky assets.

Revamping Regulations May Not Suffice

As creditworthiness of the banking industry closely tracks sovereign credit ratings, nations like Argentina may have to endure significant economic adjustments for banks to regain the rating agencies' favor. Meanwhile, for Chile, the fading of social unrest could be enough to turn the current outlook into positive prospects.

Banks Must Start Casting a Wider Net

The crisis has demonstrated that under certain conditions some economic agents could be crowded out of the capital markets; in a post-crisis scenario the banks should rethink risk assessment for the smaller firms and boost their offers to players other than large and mid caps. Such a move could help in increasing profitability amid a low-interest-rate environment.

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