ECONOMICS

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Brazil – Credit Report

Maurício Molan*
mmolan@santander.com.br
5511-3012-5724

NPLs Improving More Than Meets the Eye

- **Recently released data show that credit is still struggling to grow, while NPLs seems to be improving faster than expected.**
- **The three-month moving average pace of credit expansion remains sluggish, at 0.5% annualized (+1.7% for individuals and -0.9% for corporates).**
- **A simple extrapolation of recent data suggests that private banks' market share could increase from 45.9% at the end of 2017 to 50% by December 2018.**
- **We see strong signs of recovery for unrestricted credit for corporations, after a long and deep process of deleveraging (see Figure 1).**
- **The implied stock of non-performing loans (denominated in BRL) has fallen by 11% (3.5% for individuals and 18.8% for corporates) in the last 12 months. It seems that a still contracting denominator of NPL ratios is hiding some of the considerable improvement of financial conditions, particularly for companies, in recent months (Figure 2).**
- **The favorable performance expected for loans will likely be reinforced during the year by a deeper reduction expected for final rates for consumers and companies, as a result of both lowered funding rates and spreads (due to falling delinquencies).**

Figure 1. Outstanding Credit - Corporates (3-month moving average, annualized)

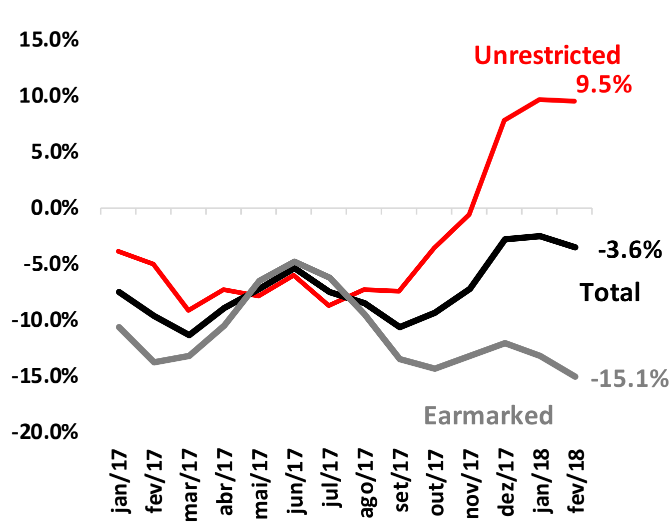
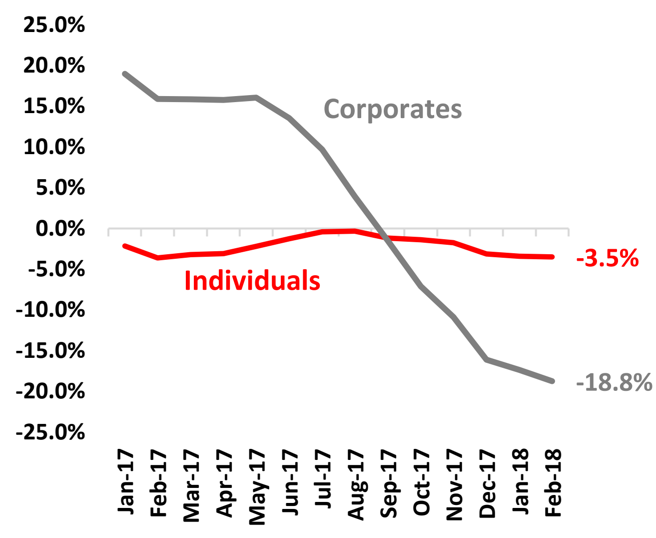


Figure 2. NPL Implied Stocks Variation (% YoY)



Sources: Brazilian Central Bank.

Reality Check

We already know that the magnitude and duration of the Brazilian economic recession in recent years have, to a great extent, been determined by the deleveraging process experienced by consumers and corporations after the exuberance of the previous 10 years. By a similar token, the recovery will be dependent on both the resurgence of the willingness to borrow, as well as the financial sector's desire to lend.

So far, the big picture seems to show consumers already eager to unleash pent-up consumption while companies continued to deleverage (see Figure 3).

On the supply side (Figure 4), BNDES continues working to reduce assets in order to repay the funding obtained from the Brazilian Treasury. At the same time, other public banks are clearly adopting a more conservative approach, in order to clean their balance sheets following an aggressive expansion of credit at the beginning of the negative part of the economic cycle. Meanwhile, private institutions currently appear to have a more focused willingness to grow their loan portfolios and recover the market share lost to state banks last 10 years.

Figure 3. Outstanding Credit by Borrower Type (% YoY)

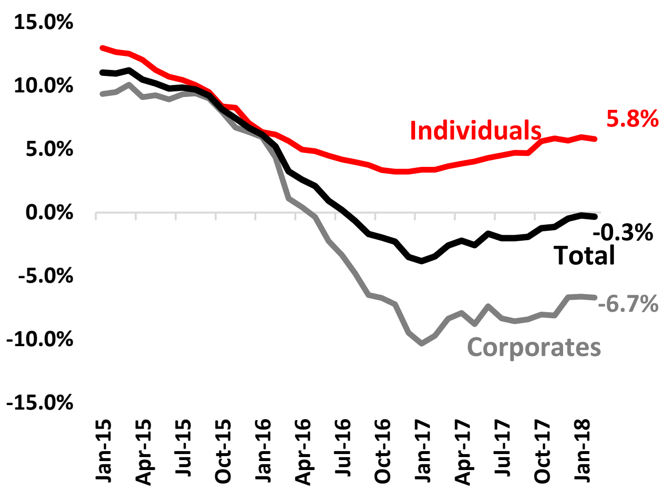
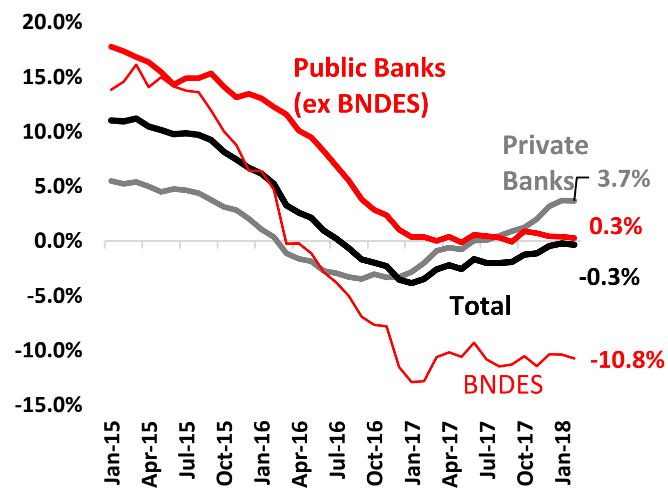


Figure 4. Outstanding Credit by Capital Control (% YoY)



Sources: Brazilian Central Bank.

So what's new? While the above characterization apparently persists on the supply side, it seems that the tide is changing on the demand side. The most important news here, in our view, are the strong signs of recovery posted by **credit to corporations, in particular the so-called free credit**, which is comprised of non-earmarked credit.

The following charts show data on a slightly different perspective than YoY variations. They depict annualized rates of 3-month moving average variations, in order to better assess the underlying trends at the margin. It also breaks down credit to individuals and companies by the abovementioned categories (earmarked and non-earmarked) for each.

Figure 5 suggests a changing in trend for corporations in terms of their credit demand. After a long period of contraction, data for the three most recent months show growth for unrestricted credit currently at an annualized rate of 2.3%. **This contradicts the idea that there should still be an ongoing generalized deleveraging process in the corporate sector leading to still contracting demand**. **A more accurate description of the current situations seems to be that contracting supply from BNDES is driving significant deleveraging by large companies for long-term resources, but medium and small companies have already resumed borrowing, particularly in shorter-term credits.**

With respect to households, the dynamic seems to be more balanced between earmarked and unrestricted credit (Figure 6).

Figure 5. Outstanding Credit - Corporations (3-month moving average annualized)

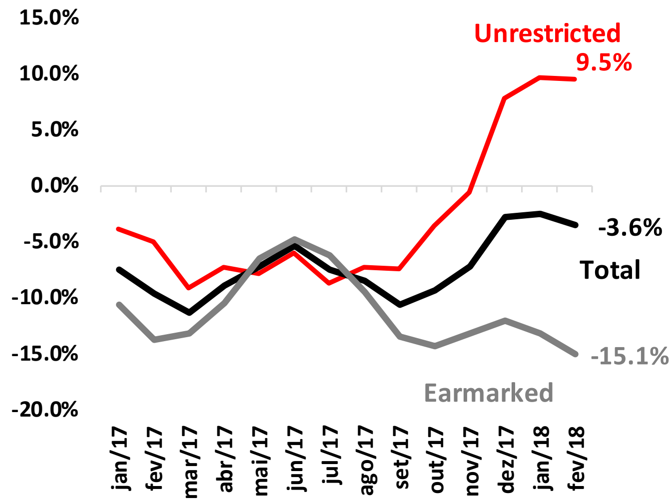
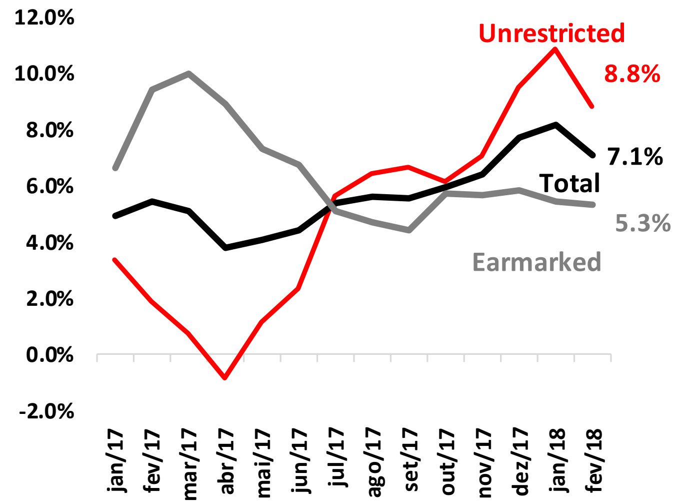


Figure 6. Outstanding Credit - Individuals (3-month moving average, annualized)



Sources: Brazilian Central Bank.

What About NPLs?

In this section we use a slightly modified approach to evaluate the recent trend of non-performing loans. Rather than looking at the NPL / Credit ratio, we analyze the recent performance of implied NPL stocks in order to separate the effect of lower provisions from the influence of the denominator. Our methodology allows us to describe a different scenario than the one illustrated by a simple evaluation of NPL ratios.

Figure 7. NPL Ratio (% of Credit)

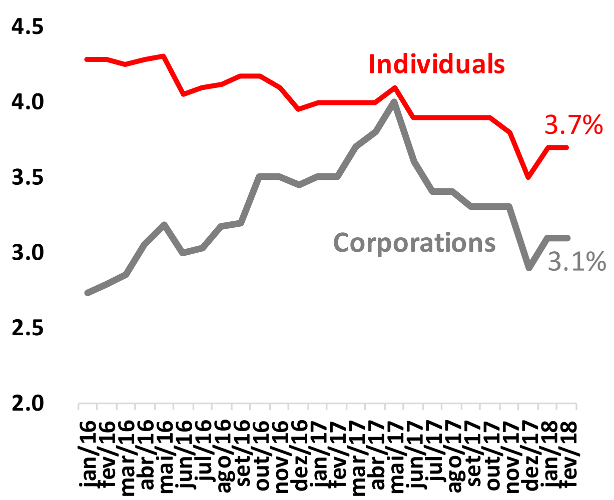
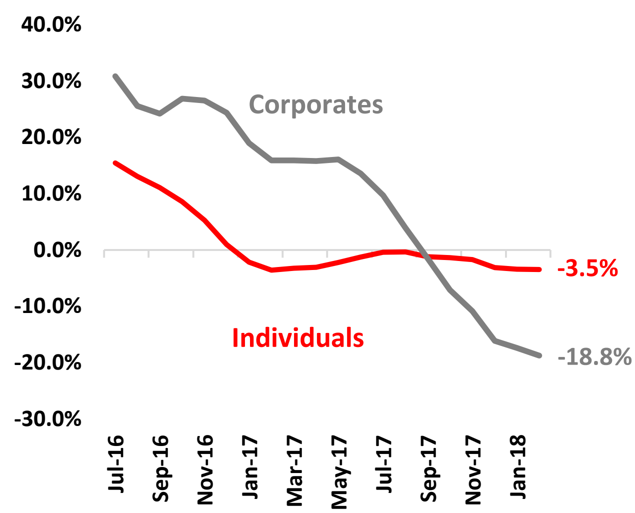


Figure 8. NPL Stocks Variation (% YoY)



Sources: Brazilian Central Bank.

Although NPL ratios appear to be stabilizing at the margin after a clear downward trend (Figure 7), the variation of delinquencies stocks denominated in BRL (Figure 8) shows a much more intense **process of reduction of provisions, particularly for companies. We conclude that a still contracting denominator of NPL ratios is masking some of the considerable improvement in companies' financial conditions in recent months. This should certainly affect spreads, final rates and new loans for corporates in the near term.**

Final Words

As a final note, we highlight that prospects for 2018 should incorporate a non-negligible possibility of an even better evolution than we have seen recently. After all, we know that credit dynamics are usually characterized by virtuous or vicious cycles, and the current one is clearly positive: stronger economic activity and financial conditions leading to lower spreads and final rates for consumers and companies in the near term, which should result in further improvement of overall credit indicators.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Diana Ayala	Economist - Colombia	diana.ayala@santander.us	212-350-0979
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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