



COVID-19: A Positive Tipping Point for Some Brazilian Banks?

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The coronavirus pandemic is hurting Brazilian banks in the near term, but is the outlook entirely grim? Franklin Templeton Emerging Markets Equity's Gustavo Stenzel explains why certain banks could emerge from the outbreak stronger relative to a new pack of financial technology competitors.

Bank stocks globally have been weak as economic activity collapsed amid the COVID-19 pandemic. Expectations of slowing loan growth, falling margins and rising bad debts have hurt near-term earnings forecasts. Many countries have also called upon banks to support borrowers through measures such as loan moratoriums—where repayments are paused—and more. Banks have understandably come under increased scrutiny during this time.

Shares of Brazilian banks have also corrected sharply. Without question, the pandemic will weigh on their businesses in the short term. However, we believe the selloff in bank shares has been excessive, and we see a low probability of a systemic banking crisis in Brazil. We believe select Brazilian banks with strong fundamentals should emerge with the upper hand over untested financial technology (fintech) competitors that could struggle to stay afloat.

Brazilian Banks Were Generally in Good Shape Prior to the Pandemic

Banks in Brazil largely entered this challenging period better capitalized than during the last crisis the country faced. A domestic recession that unfolded five to six years ago had pushed them to de-risk their balance sheets. Companies and consumers also avoided excessive borrowing as the economy stayed tepid. Given these prior adjustments, we believe Brazilian banks are in generally good shape to endure the current uncertainty.

Brazilian Banks Built Up Capital Buffers Before the Pandemic



Total Capital Ratio (%)

2014 - 2020



This chart is for illustrative purposes only.

Source: Central Bank of Brazil, January 2020. Past performance does not guarantee future results.

Before the pandemic, potential disruption from new fintech competitors had undercut investor sentiment toward Brazilian banks. Generous funding from technology investors fostered a fintech boom in Brazil and enabled many start-ups to vie for users with zero- or low-fee business models. Regulators also lowered operating barriers for fintech companies to compete against incumbent banks. Among prominent challengers is digital bank Nubank, which made waves with its app-based credit card with lower interest rates and no annual fees, as well as XP, an online broker. Some niche competition will continue, but we believe there is plenty of room for the whole pie to grow. Key sectors remain extremely underpenetrated, which is the case for mortgages with only 9% of gross domestic product in loans to that segment, compared to over 70% in the United States or United Kingdom. Strong balance sheets that can be leveraged up and access and trust of the client are key advantages for the big banks. Although newcomers are looking forward to the open-banking initiative that will allow access to the client's credit data, trust will continue to be an important advantage. An example of that is the acceleration of XP's growth after Itau became part of the key shareholders.

The Bank Shakeup

However, we see the COVID-19 outbreak shaking out much of the fintech competition. Global funding activity has slowed as investors conserve cash. Many fintech players with high levels of cash burn as they forgo fee income, coupled with weak deposit franchises and low capitalizations, look unsustainable to us in this environment. Niche fintech firms trying to evolve into full-service banks could also find the path challenging—scale matters in Brazil's banking industry, which faces high regulatory and tax burdens.

In contrast, we expect market-leading incumbent banks with robust deposit bases and strong capital positions to weather this challenging period—just as they have navigated previous crises. Established retail banks that receive regular payrolls from their customers are especially likely to benefit from sticky client relationships and deposits.

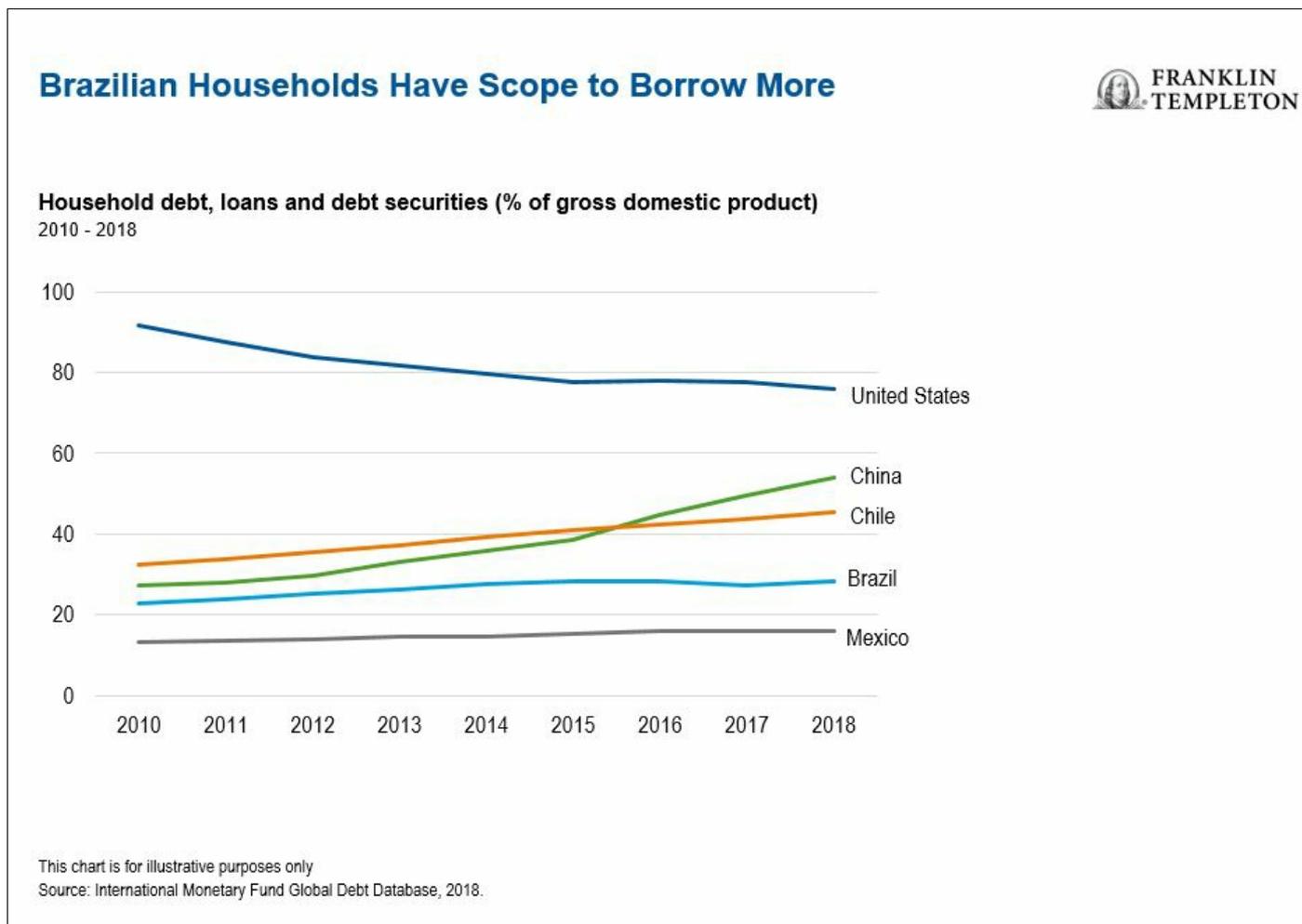
For example, Itaú Unibanco's own investments in digitalization enabled it to adapt well as the pandemic disrupted operations at its physical branches.

Boosting Bank Penetration

The pandemic could also have the unintended effect of boosting bank penetration in Brazil. The government's disbursement of emergency handouts through banks has compelled scores of previously "unbanked" individuals to open

accounts. This group of new customers could drive a fresh wave of demand for financial services in the future.

When the outbreak eventually passes, we expect quality banks to resume secular growth. Credit penetration in Brazil is far below other markets, signaling room to head higher in the coming years. Brazil's central bank has also cut its policy interest rate to a record low, which reduces the cost of renegotiating or restructuring loans, and could be a catalyst for longer-term credit growth.



Our longer-term conviction remains bullish for select Brazilian banks where we see strong fundamentals, improving competitive positions and potential to benefit from structural growth drivers. In this context, we are finding attractive valuations, and will continue to follow developments closely.

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