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Banks - Argentina

FAQ: The impact of ongoing financial turmoil on Argentine banks

Despite the peso's dramatic depreciation, Argentines remain confident in the banking system and have not significantly withdrawn deposits like they have in previous crises. For now, at least, liquid assets at banks remain ample in both US dollars and pesos, which limits funding and foreign currency risks. Even so, funding costs have risen sharply, in line with benchmark interest rates. This will reduce spreads, especially at banks that rely more on wholesale funding, until lenders can reprice their loan books.

We expect loan growth to slow continuously through 2019 while inflation rates remain high, leading loan books to contract sharply in real terms. We also expect delinquencies and credit costs to rise. Initially, profit will decline mildly on inflation-adjusted basis, but we expect it to recover by the second half of 2019 as inflation eases and the economy begins to recover. In this report we will answer some of the questions that investors most frequently ask about market volatility will affect Argentina's banking system.

Q: Economic growth forecasts have been slashed while inflation expectations have surged. How will this affect loan growth at banks?

Rising inflation, extraordinarily high interest rates, and the ensuing decline in economic activity are significantly reducing loan growth and we expect this to continue in the coming months as the recession deepens and the monetary policy becomes much more restrictive. The peso started to plummet in early May, when it was valued at 21 to the dollar, and had fallen to 37.6 to the dollar by October 3, a week after the head of Argentina's central bank resigned, making him the second central bank governor to quit in less than four months.

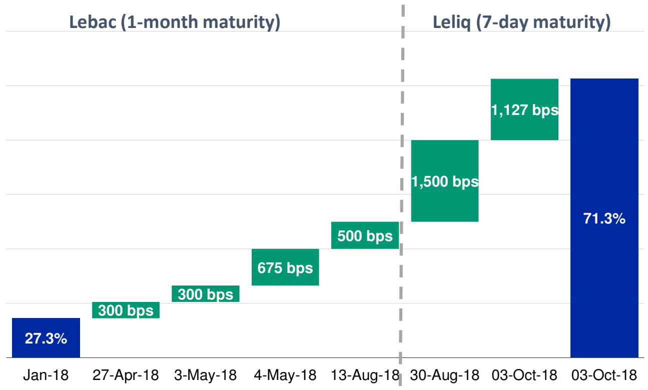
To contain the peso's rapid depreciation, the central bank has raised interest rates by nearly 40 percentage points to 71% annually (103% effective rate), as of October 3, from an already very high 27.25% in April (Exhibit 1)[1]. This has led to a doubling of interest payments on variable-rate and new short term loans, which together represent a significant part of the banks' loan book.

In addition to raising interest rates, the central bank has also significantly increased average deposit reserve requirements to 41% in mid-September from 28% in late July, to absorb excess liquidity. Despite the remarkable rise in interest rates and reserve requirements, annual inflation surged to 34% in August from 25% in April (Exhibit 2) and we expect it to surpass 40% this year. Rising inflation and interest rates led the economy to shrink 4% in the second quarter QoQ adjusted for seasonality. We expect real GDP to contract 2.5% this year and 1.5% in 2019.

Consequently, the central bank recently announced a new, more restrictive monetary policy based on limiting the growth of monetary aggregates. The monetary base had been growing at a rate of 40% annually as of September, but the bank has committed to limiting growth to zero between now and June 2019. This extreme monetary tightening will likely lead to even higher interest rates, higher minimum reserve requirements, or both.

Exhibit 1

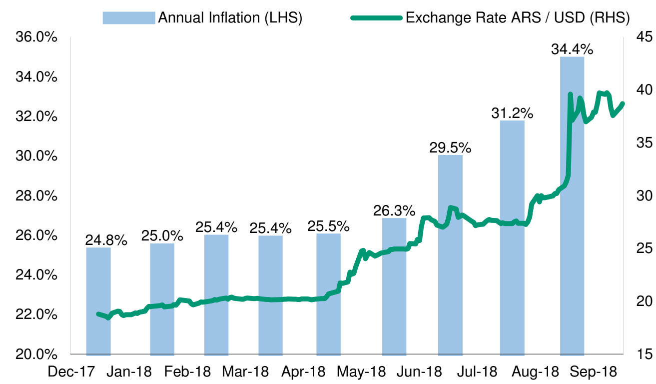
Argentina's central bank has dramatically raised interest rates to curb the peso's slide



Sources: Moody's Investors Service, Central Bank of Argentina

Exhibit 2

Inflation has surged since the peso began to collapse

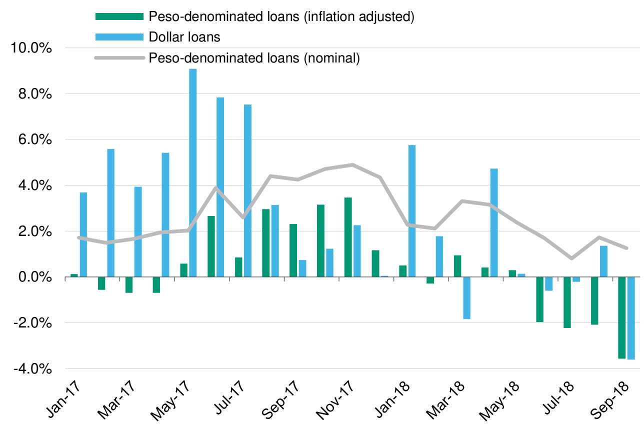


Source: Moody's Investors Service, Central Bank of Argentina, INDEC

The mix of rising inflation, higher rates and recession has weakened the demand for consumer and corporate loans since mid-May. Meanwhile, banks have lowered their risk appetite as delinquencies have already begun to rise, a trend that will likely worsen in the months ahead as people find it harder to pay off their loans. The systemwide, peso-denominated loan book has already shrunk about 10% adjusting for inflation (in nominal terms, it has grown by 7%) from May to September, a sharp contrast with the 2% real growth (11% nominal) posted in the first four months of the year (Exhibit 3). Dollar lending has also contracted since May, albeit by a much lower pace of 3%, after rising by 11% between January and April.

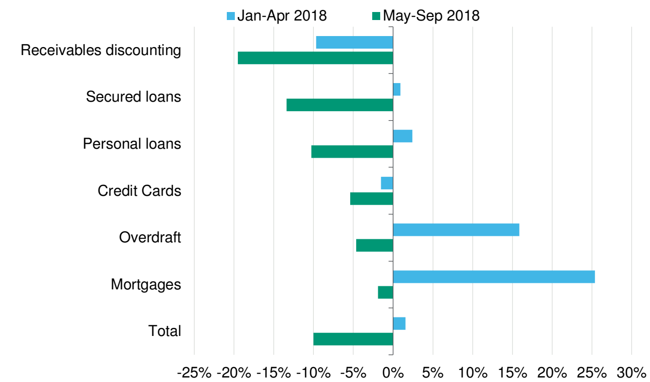
While almost all types of loans have taken a hit, the biggest blow has been to receivables discounting (mostly comprised of deferred payment cheques, a type of financing favored by smaller companies), secured loans and personal loans (Exhibit 4). The mortgage loan book, which surged 70% last year and another 25% in the first four months of 2018 in real terms, has also been impacted, with monthly nominal origination having fallen by 50% since May.

Exhibit 3
The loan book has contracted sharply in real terms since the turmoil began
Monthly loan growth



Source: Moody's Investors Service, Central Bank of Argentina

Exhibit 4
Peso lending has declined across the board in real terms
Peso-denominated loan book inflation-adjusted growth



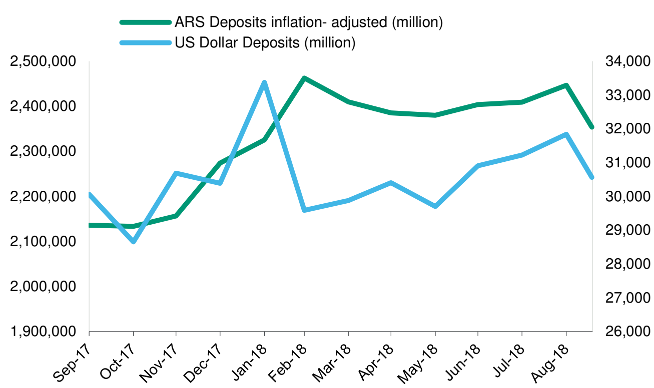
Sources: Moody's Investors Service, Central Bank of Argentina

Q: How has the crisis affected funding?

Between the beginning of the turmoil in late April and late August, peso deposits rose a mild 2.6% in inflation-adjusted terms (16% in nominal terms), indicating that depositors remained relatively confident in the banking system. Since the beginning of September, though, nominal growth of peso deposits has slowed sharply to just 0.6% and, in real terms, we estimate they fell by almost 4%. US dollar -denominated deposits also slid 3.5% in September, after rising 4.7% between April and August.

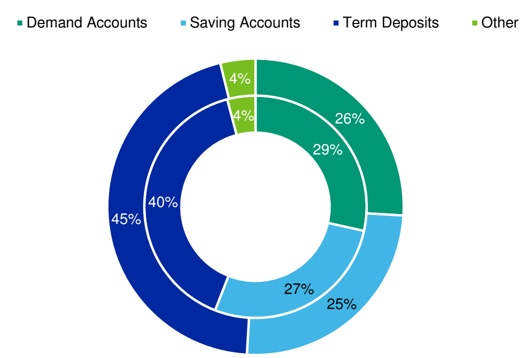
There was an exceptional inflow of deposits in late August following the move by the central bank to reduce the stock of Lebacs, which drove investors, who lacked more attractive options, to banks to park their money. Without this inflow of fresh cash, deposits would have declined even farther. The deposits declines, however, are still relatively minimal and do not indicate a significant deterioration of confidence in the banking system. Nor do we expect confidence to erode sharply or for deposits to decline substantially in the months ahead given the recent announcement of the government´s revised accord with the IMF.

Exhibit 5
Both peso and dollar-denominated deposits have recently begun started to decline



Source: Moody's Investors Service, Central Bank of Argentina

Exhibit 6
Reliance on term deposits has increased in 2018
Breakdown of deposits by type, September 2018 (outer circle) versus December 2017 (inner circle)



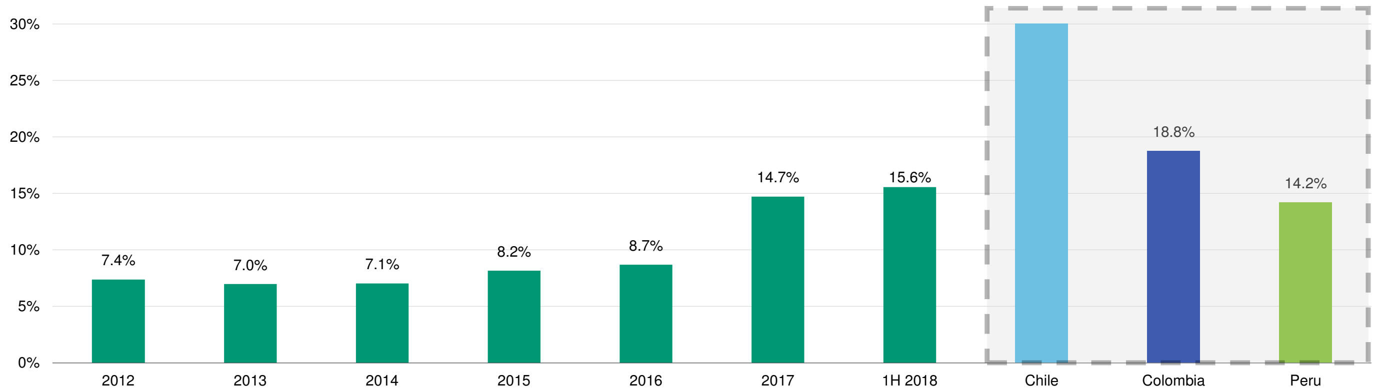
Source: Moody's Investors Service, Central Bank of Argentina

While overall deposit levels have held steady, however, the composition of them has begun to shift as retail depositors have been replaced by corporates and institutional investors, which has driven a shift to term deposits from savings and demand deposits - term deposits rose to 47% of total deposits as of September from 40% at the end of 2017. This has increased banks' funding costs, as term deposits currently pay rates averaging more than 40% annually, while average savings accounts rate was 6.7% annually. Moreover, term deposits rates have increased more than savings accounts rates, rising nearly 20% from late April versus 6%. (While precise information is not available for demand deposits, anecdotally average rates are reported to have risen considerably).

Assuming interest rates remain high, we expect this shift to accelerate. In addition to being more costly than demand deposits, fixed-term deposits are more rate driven, and hence less reliable, than savings deposits, which are more relationship driven. Consequently, the shift to term deposits could increase funding risks if conditions deteriorate at individual banks.

Finally, although banks' reliance on market funds has risen over the past two years, it remains modest at just 15.6% of tangible banking assets as of June. This remains below that of most regional peers. We do not foresee market funds rising until loan demand recovers.

Exhibit 7
Banks reliance on market funds is modest



Source: Central Bank of Argentina

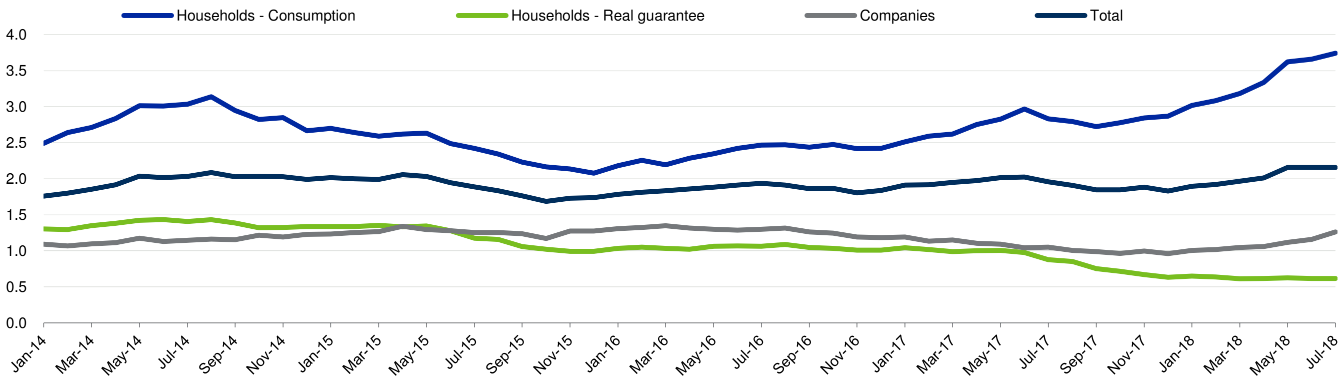
Q: How will the recession, higher interest rates, and the expected decline in real wages affect asset quality?
Together with higher inflation and slower economic growth, the spike in interest rates will increase delinquencies and credit costs. The systemwide nonperforming loans (NPLs) ratio was a low 1.8% of gross loans at the end of 2017, but had already risen to 2.3% in July and we expect it to deteriorate as the recession worsens, hitting 4.5% by the end of 2019.

As shown in Exhibit 8, delinquencies have risen the most on consumer loans (3.7% in July versus 2.9% in December) and corporate loans, although the ratio for the latter is still very low (1.3% in July versus 1% in December). Mortgages are still performing well, which is helping to prevent overall delinquencies from rising even further as these now represent 9% of the total loan book. Given that mortgages are indexed to inflation, however, and that they are a new product that has yet to be tested in this inflationary environment, we believe its delinquencies will likely rise, although they will remain manageable unless there's unemployment increases significantly. In addition, as house prices are quoted in dollars (if sales are transacted in pesos) and have remained resilient thus far, the depreciation of the currency, which has significantly exceeded inflation, has caused loan to values to decline sharply, strongly increasing the incentive for borrowers to remain current.

Exhibit 8

Delinquencies have hit consumer loans harder than other loans

NPLs ratio by type of loan



Source: Moody's Investors Service, Central Bank of Argentina

While salaries in Argentina are typically adjusted in line with inflation, we nevertheless expect real wages to decline this year as the recession will limit employees´ bargaining power. Coupled with rising unemployment, which has already increased to 9.6% in June from 8.7% a year earlier, that will make it harder for many borrowers to pay down their loans.

Moreover, Argentina's still very low level of credit intermediation, as well as the short duration of bank portfolios, will help contain the overall deterioration of asset quality. Credit was just 16% of GDP as of June 2018, well below the regional median of close to 50%, and the average tenor of granted loans, excluding mortgages, is about 180 days. Therefore, we expect asset quality deterioration to be concentrated over the next two to three quarters as outstanding loans mature in a much less favorable environment compared with what banks anticipated when they originated the loans in 2017 and early 2018. Thereafter the deterioration should be more moderate, reflecting more conservative underwriting standards. We also note that high inflation in the past has in fact supported asset quality, at least for secured loans, as the value of collateral increases in line with inflation while the amount of most loans is constant, providing a strong incentive for borrowers to pay. About 20% of banks' overall loan book is collateralized.

Rising delinquencies will lead to higher loan loss provisioning. We expect credit costs to increase to around 3% of gross loans by 2019 year-end, from 2.2%, as of March 2018, although this will still compare favorably with Brasil, Mexico and Colombia.

Q: How has volatility affected liquidity?

Liquidity remains ample in both pesos and US dollars, with total liquid assets equal to nearly 46% of deposits as of June, compared with 42% in December 2017. As a percent of tangible banking assets, liquidity remained relatively stable at 35% during the same period. This reflects subdued loan demand, attractive yields on central bank notes and the substantial rise in reserve requirements.

Banks loan-to-deposit (LTD) ratios are modest in both dollars and peso, which underscores banks' strong liquidity position. Overall, the ratio had declined to 61%, as of September, the lowest in the region, from 67% in December 2017, and in pesos, it had declined to 65% from 73%. While the dollar LTD ratio rose slightly to 53% from 48% during the same period, it remained very low.

Liquid assets in pesos are largely invested in government securities, while the majority of liquid US dollars assets consist of deposits at the central bank and other financial institutions. We expect liquidity to rise further as nominal loan growth continues to lag growth in deposits. While the increase in reserve requirements limits the availability of these resources to fund loan growth, they will remain available in the event of a sudden withdrawal of deposits, helping to reduce the risk of a deposit run should one occur.

Q: How will the rise in inflation, interest rates and credit costs, and the deceleration in loan growth affect profitability?

While profitability will likely maintain relatively stable in nominal terms with net income equal to about 2.2% of tangible assets, it will decline after adjusting for inflation as income from lending declines in line with slowing loan growth and rising funding costs, while provisioning costs rise. Rising securities Income will only partially offset this. Consequently, we expect real return on equity will be negative; although the annualized return on equity in the first half of 2018 was a seemingly robust 15.4%, it was already a negative 1.3% when adjusted for inflation.

The surge in the benchmark interest rate will temporarily squeeze bank margins as bank liabilities reprice faster than their assets. Half of the system's total funding continues to comes from cheap demand deposits and saving accounts, which will not be significantly affected by higher rates. But rates on term deposits, remunerated corporate deposits and interbank lending, which are market driven, have risen sharply, and the share of total funding represented by term deposits has increased as well. The BADLAR rate, which is the benchmark rate for term deposits of ARS1 to ARS20 million, jumped to 42.7% as of September 27 from 22.8% in late April. (The relatively limited rise in the rate compared to the increase in yields on Central Bank notes is due to the increase in reserve requirements.) At the same time, the benchmark rate for wholesale time deposits above ARS20 million, dubbed the TM20, rose to 43.25% from 23.06%.

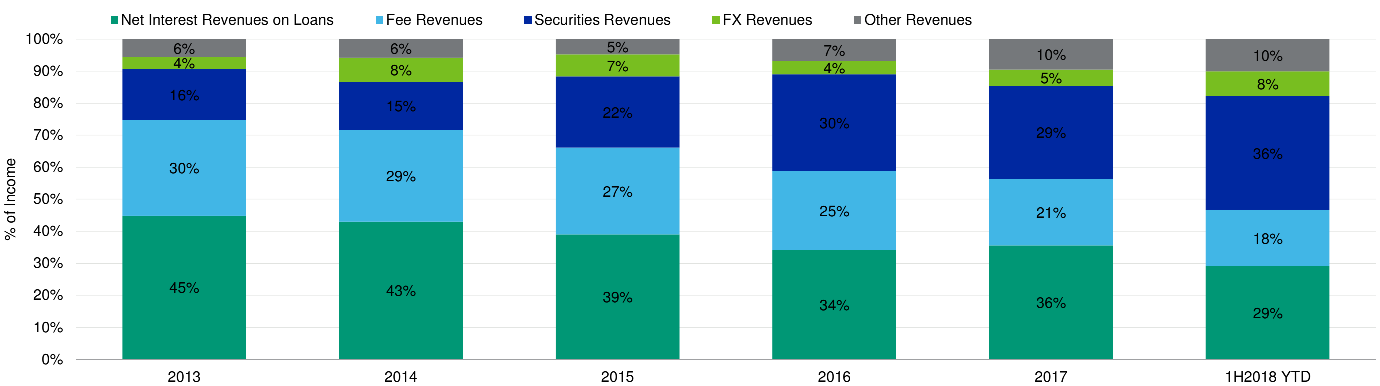
As loans gradually reprice, however, the strain on earnings should diminish and margins should actually increase. However, the effect will vary by bank. Small consumer banks, which rely more heavily on market funds and have more fixed-rate loans, will see margins narrow more.

Banks will continue investing their excess liquidity in Leliqs, helping to bolster profit even as lending contracts in real terms. Consequently, bank earnings will become increasingly reliant on interest from their holdings of central bank notes, which already accounted for 36% of total revenue in the first half of 2018, up sharply from 15% in 2014.

To help compensate for narrower margins, banks will try to raise fees on everything from cash management to foreign currency operations. However, we expect these increase may be below inflation to limit the impact on demand for these services. As a result, fees and commissions may continue to fall as a share of income, having already fallen significantly this year to just 11% of total revenue as of June 2018, down from 21% in 2017. The lower fee income is largely explained by a regulatory driven reduction in fees on credit and debit cards.

Exhibit 9

Banks´ reliance on securities revenue will continue to rise as loan growth slows



Source: Central Bank of Argentina

Finally, rising inflation will cause personnel expenses to rise as banks increase salaries again in the second half of the year - wage hikes are obligatory because inflation will exceed a 15% trigger included in recent collective bargaining agreement with unions. However, we expect overall operating expenses will grow below inflation.

Q: How exposed are banks to the foreign exchange risk?

Due to a recent a central bank rule aiming to increase the inflow of dollars and reduce pressure on the currency, banks are only allowed to hold a long position in foreign currency of up to 5% of regulatory capital, though that can be increased to 30% of regulatory capital if the excess is invested in foreign-currency denominated Argentine Treasury notes known as Letes. Consequently, most banks have small open foreign currency positions and are net long on average. Therefore, the peso's depreciation will have a relatively limited impact on their profits.

Regarding funding, banks exposure to US dollar denominated deposit is contained. Foreign-currency deposits had risen to almost 33% of total deposits by September, up from about 24% last year, but this was driven mostly by the peso's depreciation. Additionally, while

31% of market funds is comprised of cross border debt, much of this is peso-linked and hence does not generate foreign exchange risk. Moreover, most of that was issued over the past 18 months with maturities of three to five years, which together with slow loan growth will limit banks financing requirements and hence exposure to refinancing risk.

The peso's weakening should not significantly effect asset risk in and of itself. Although foreign currency loans represent around 30% of all loans, up from 19% as of April due to the depreciation of the peso, banks are only permitted to lend in foreign currencies to exporters and suppliers to exporters. Most of these borrowers are paid in foreign currency, or its equivalent in pesos, giving them a natural hedge against the peso's depreciation.

Q: How will the new macroeconomic variables affect bank capital?

We expect the change in the macroeconomic conditions to lead to a decline in banks' adjusted capital metrics, though the impact should be relatively limited. We forecast banks' average tangible common equity to risk-weighted assets ratio will fall to 11.3% as of 2018 year-end and 11.1% in 2019 from 11.8% in 2017 as subdued loan growth will limit banks' capital consumption, helping to offset the increase in risk-weighted assets derived from the revaluation of foreign currency loans at the new weaker exchange rate. At the same time, still strong nominal pre-prevision income will help to absorb increased credit costs.

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Endnotes

1 The current rate reflects 7-day central bank notes known as Leliqs while it previously reflected 1-month notes dubbed Lebacs. The Central Bank is in the process of replacing Lebacs with Leliqs as the primary instrument of monetary policy, because it hopes the shorter tenor of Leliqs will increase the effectiveness of transmission mechanism to the real economy. In addition, Leliqs are available only to the country´s banks, whereas Lebacs were a popular investment alternative for a wide range of investors.

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