S&P Global
Ratings

Credit Stress Looms In Latin America As Financing Costs Surge

March 22, 2023

This report does not constitute a rating action

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Key Takeaways

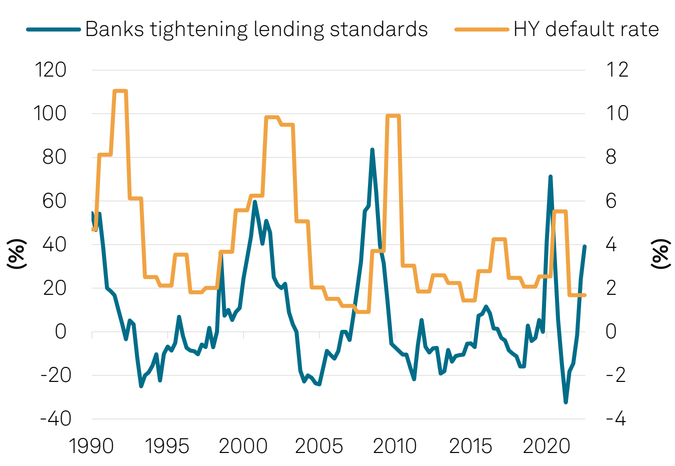
- **Latin American corporates could see significant credit stress by the end of 2024.** Our analysis shows that nonfinancial entities in Latin American countries are enduring the most severe tightening of financial conditions seen in recent history, raising concerns about default rates and banks' asset quality.
- **We expect credit stress could surface quicker in Brazil.** Corporate defaults may pick up in Brazil before other countries because of the significant share of floating -interest rate debt on corporate balance sheets and the rapidly rising interest burden stemming from it.
- **Businesses, households, and governments are all facing the effects of unusually severe tightening in financing conditions.** This is expected to result in a particularly strong credit deterioration in countries like Chile and Colombia that have previously enjoyed prolonged interest-rate stability.

Banks tightening lending standards is an indicator of potential credit stress. The Senior Loan Officer Opinion Survey on Bank Lending Practices, which has been conducted in the U.S. since 1990, provides a valuable overview of the financing conditions for corporate issuers. The insights provided by this survey have proven to be able to anticipate future defaults in this high-yield space. Unfortunately, this data is not available in other countries. However, it is possible to approximate the survey's findings by comparing the current borrowing rate for high-yield issuers to the average rate over the past five years (referred to as "tightening proxy"). This approach allows us to estimate changes in lending standards and credit risk in other countries.

Chart 1a

Tightening lending standards historically precede defaults

U.S.

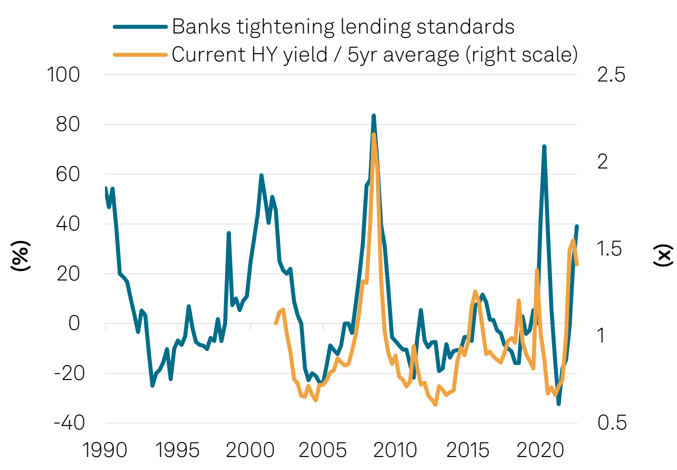


Sources: FRED, S&P Global Ratings.

Chart 1b

Lending standards can be approximated using HY yields

U.S.



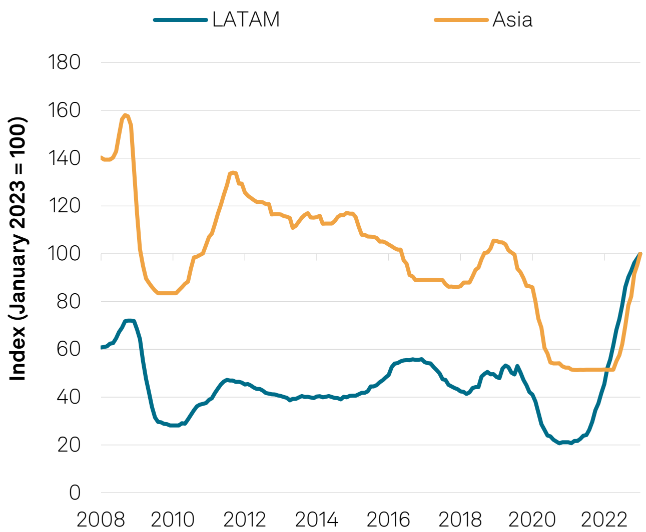
Source: S&P Global Ratings.

Financial stringency is significantly increasing Latin America, and is not affecting all emerging markets equally. Although policy rates have reverted to their pre-pandemic levels in Asia, they are notably higher in Latin America (see chart 2a). In fact, the degree of policy rate tightening, as measured by the current rate compared to its five-year average, is far beyond anything seen in recent history, about twice as severe as during the great financial crisis. While policy or interbank rates serve as a benchmark for other interest rates in the economy, other factors come into play when determining borrowing rates for companies. Thus, while the tightening of policy rates provides a reliable indication of financing conditions, it is necessary to examine interest rates on business loans to gain insight into how corporate credit stress is likely to evolve.

Chart 2a

Divergence within emerging markets

Policy rates, indexed (January 2023 = 100)

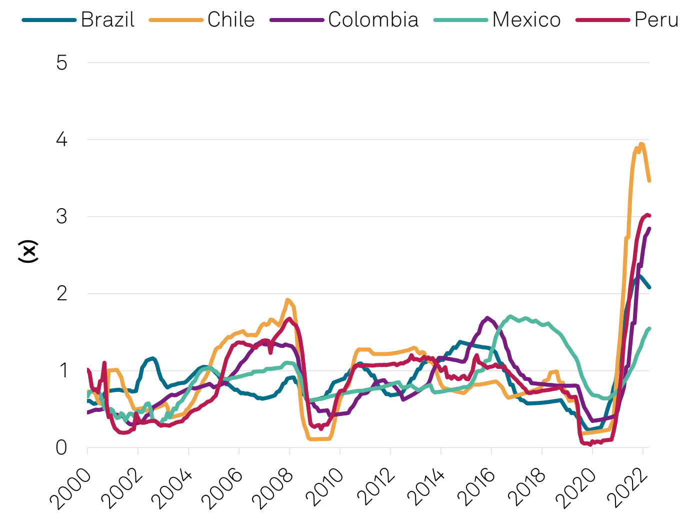


Sources: Connect by S&P Global, Banco Central De Reserva Del Perú, Banco de México, Federal Reserve Economic Data (FRED).

Chart 2b

LATAM lives an unprecedented tightening

Policy (or Interbank) rate / 5Y average



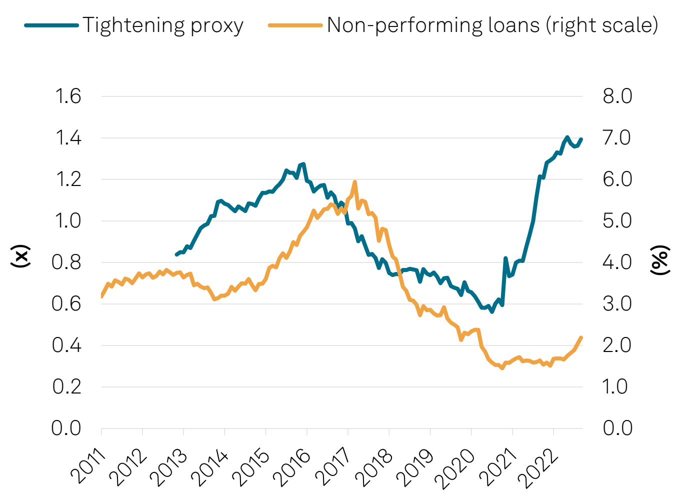
Sources: Connect by S&P Global, Banco Central De Reserva Del Perú, Banco de México, Federal Reserve Economic Data (FRED).

Latin American businesses are starting to feel the heat. Country-level testing confirms that the change in interest rates is a good predictor of future credit stress, with a variable lag ranging from 15-25 months, despite variations in definitions across countries. The data indicates that a substantial rise in credit risk is likely to occur in Brazil, Chile, and Colombia, even though only faint signs of stress have surfaced in Brazil up until now. The timing and severity of the credit stress will be influenced by a range of factors such as the length of outstanding maturity and the proportion of variable interest rate debt.

Chart 3a

Brazil (since 2013)

Tightening proxy and non-performing loans

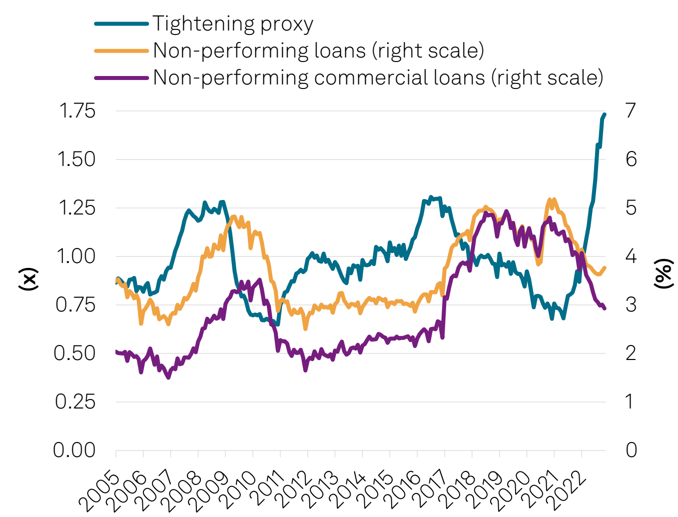


Sources: Banco Central Do Brasil, S&P Global Ratings.

Chart 3b

Colombia (since 2005)

Tightening proxy and non-performing loans

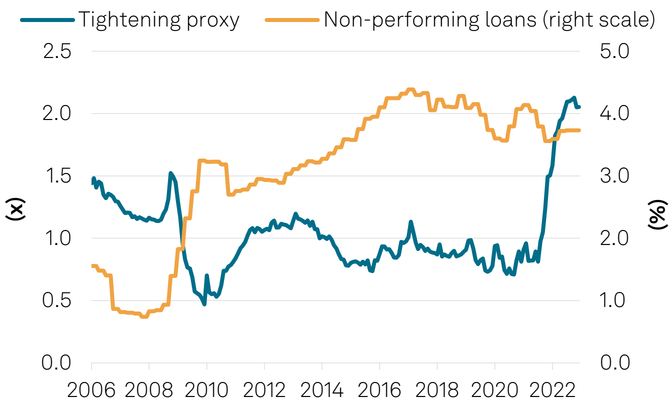


Sources: Banco de la República | Colombia, Superintendencia Financiera de Colombia, S&P Global Ratings.

Chart 3c

Chile (since 2007)

Tightening proxy and non-performing loans

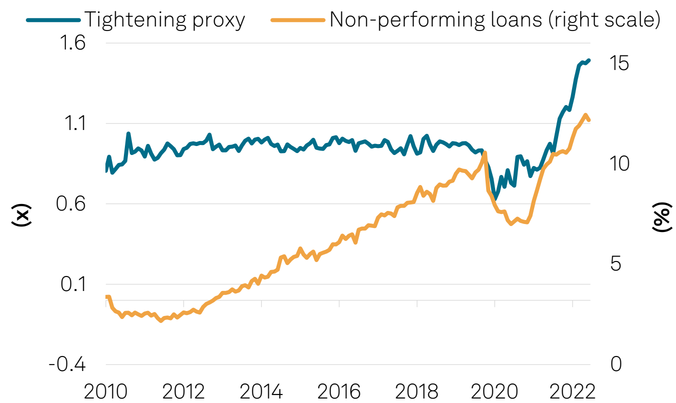


Sources: Banco Central de Chile, S&P Global Ratings.

Chart 3d

Peru (since 2011) - SME

Tightening proxy and non-performing loans



Sources: Superintendencia de Banca, Seguros y AFP, S&P Global Ratings.

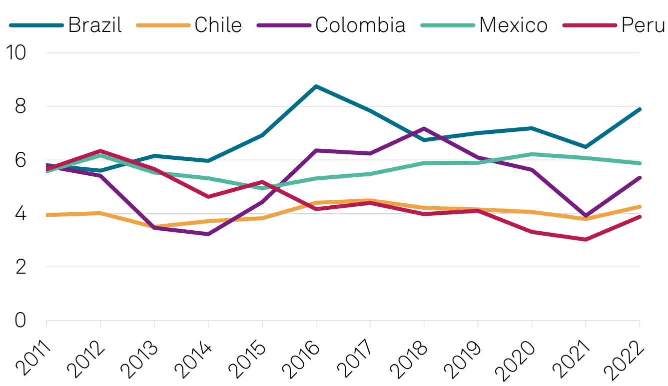
Credit stress is likely to materialize quicker in Brazil; Chile faces the sharpest tightening. Among the four countries that we are reviewing, Chilean companies have experienced the sharpest tightening of financing conditions, which raises concerns given its historical stability. Its tightening proxy value reads 2, indicating that today's interest rate is twice as high as it was on average over the past five years. This value has not been reached since 2005; even during the 2008 global financial crisis Chile's tightening metric only reached 1.5. This suggests that Chilean corporate credit quality could deteriorate significantly in the coming quarters.

Conversely, in Brazil, the significant share of floating-rate debt on corporate balance sheets poses the biggest threat. Brazilian corporations have historically relied on variable-rate loans and this reliance has increased since Inflation picked up in 2021. As a result, the effective interest burden for these companies has risen sharply to 7.9% in 2022 from 6.5% in 2021. This translated into a meaningful deterioration of Brazilian corporates' credit metrics, with the median EBITDA interest coverage ratio dropping to 3.9x from 4.5x, widening the gap with other countries in the region. One mitigating factor for Brazilian issuers is that they are familiar with the current interest rates on commercial loans. Even though they have risen quickly over the past years, interest rates remain in line with the levels seen in Brazil between 2011 and 2018, and remain far below their peak in 2016.

Chart 4a

Interest burden bounced back in 2022

Average effective interest rate (%)

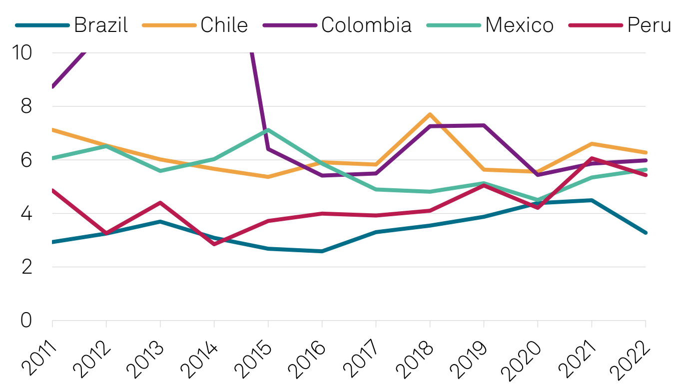


Non-financial corporates. Sources: S&P Capital IQ, S&P Global Ratings.

Chart 4b

Credit metrics deteriorated faster in Brazil

Median EBITDA interest coverage (x)



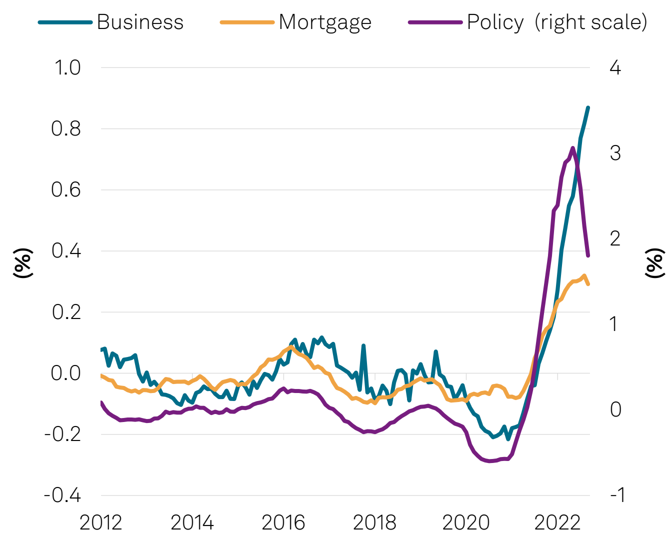
Colombia--2012: 10.9x, 2013: 20.4x, 2014: 18.3x. Non-financial corporates. Source: S&P Global Ratings.

The economy is experiencing a pervasive impact from the tightening shock. While corporate issuers are feeling it acutely, the unusually rapid and robust rise in interest rates is also hitting governments and households. Consequently, new mortgage rates have risen significantly, reaching their highest levels in more than a decade in Colombia, Chile, Peru, and Mexico (though the increase has been more subdued in the latter).

Chart 5a

Tightening is felt throughout the economy

Year-on-year change in interest rates, by category

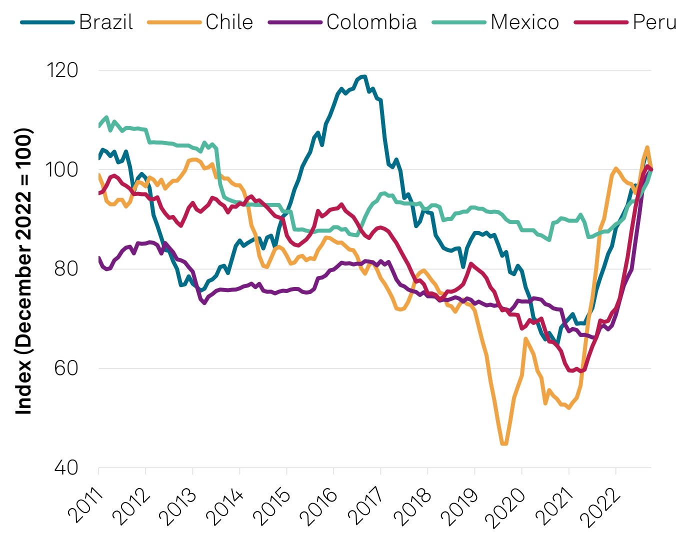


Note: Average of indexed interest rates (Nov 2022 = 100). Includes Brazil, Chile, Colombia, Mexico and Peru. Sources: Banco Central Do Brasil, Banco Central de Chile, Banco de la República | Colombia, Banco de México, Superintendencia de Banca, Seguros y AFP, S&P Global Ratings.

Chart 5b

Households face higher rates in almost a decade

Interest rate on new mortgages or household debt



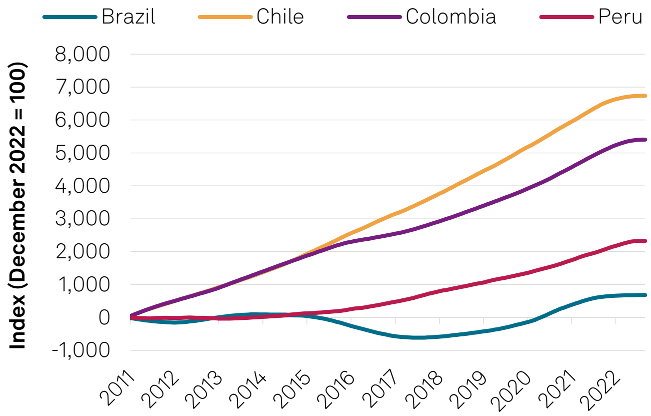
Sources: Banco Central Do Brasil, Banco Central de Chile, Banco de la República | Colombia, Banco de México, Superintendencia de Banca, Seguros y AFP, S&P Global Ratings.

Chilean companies and Colombian households are on the front line. Beyond the pace at which interest rates are climbing, the real concern is that credit stress could emerge if issuers are unable to roll over their debt because interest rates are substantially higher than the historical rates at which the original debt was financed. In such cases, defaults become inevitable as capital structures adjust to the new elevated financing costs. Given that the interest burden increases proportionally with interest rates, the lower historical interest rates were previously, the faster the deterioration of credits metrics for a given increase in interest rates. The corollary is that the longer a country has enjoyed favorable financing conditions, the greater the potential stress that may have built up in the system, as balance sheets gradually adjusted to the easy financing conditions. Therefore, countries like Chile and Colombia, which have traditionally experienced stable and relatively low interest-rate environments compared with other countries in the region, are likely to see the sharpest deterioration in credit quality because of the departure from their usual conditions. Based on anecdotal evidence, we observe a strong correlation between the cumulative tightening in household interest rates and the movement of real estate prices. Specifically, we notice that the more mortgage rates diverge from their previous levels, the faster home prices tend to decline (Chart 6c).

Chart 6a

Businesses: Chile is in uncharted territories

Cumulative sum of distances from current rates (indexed)

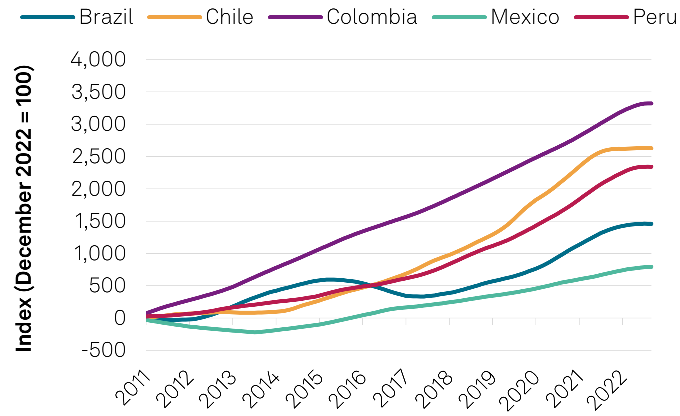


Note: see methodology in Appendix. Sources: Banco Central Do Brasil, Banco Central de Chile, Banco de la República | Colombia, Superintendencia de Banca, Seguros y AFP, S&P Global Ratings.

Chart 6b

Households: Colombian real estate under pressure...

Cumulative sum of distances from current rates (indexed)

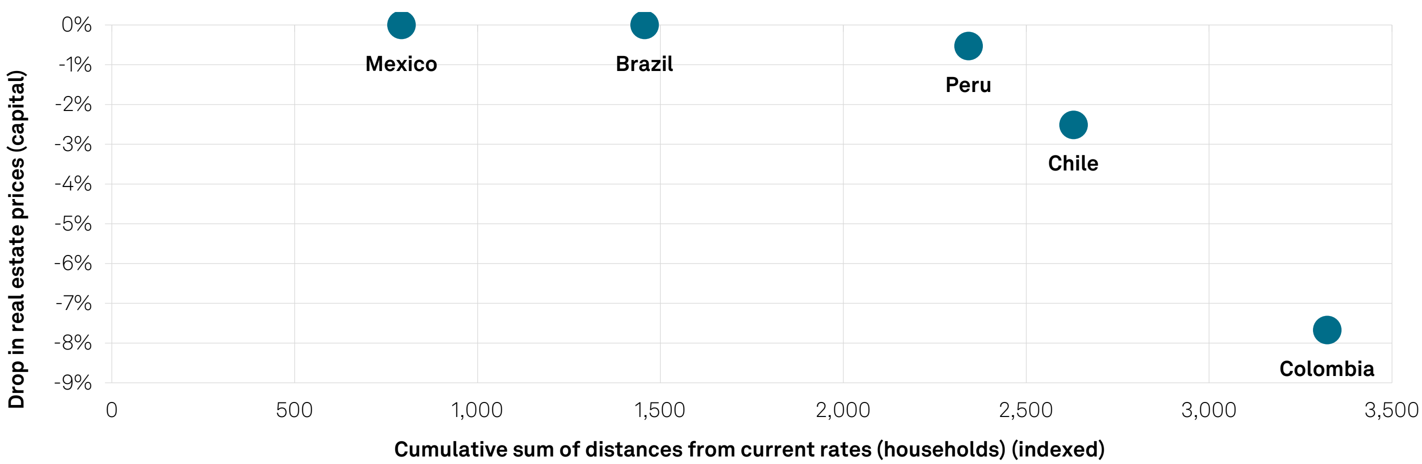


Note: see methodology in Appendix. Sources: Banco Central Do Brasil, Banco Central de Chile, Banco de la República | Colombia, Banco de México, Superintendencia de Banca, Seguros y AF, S&P Global Ratings.

Chart 6c

...As reflected by house prices

Change in house prices relative to credit stress build-up

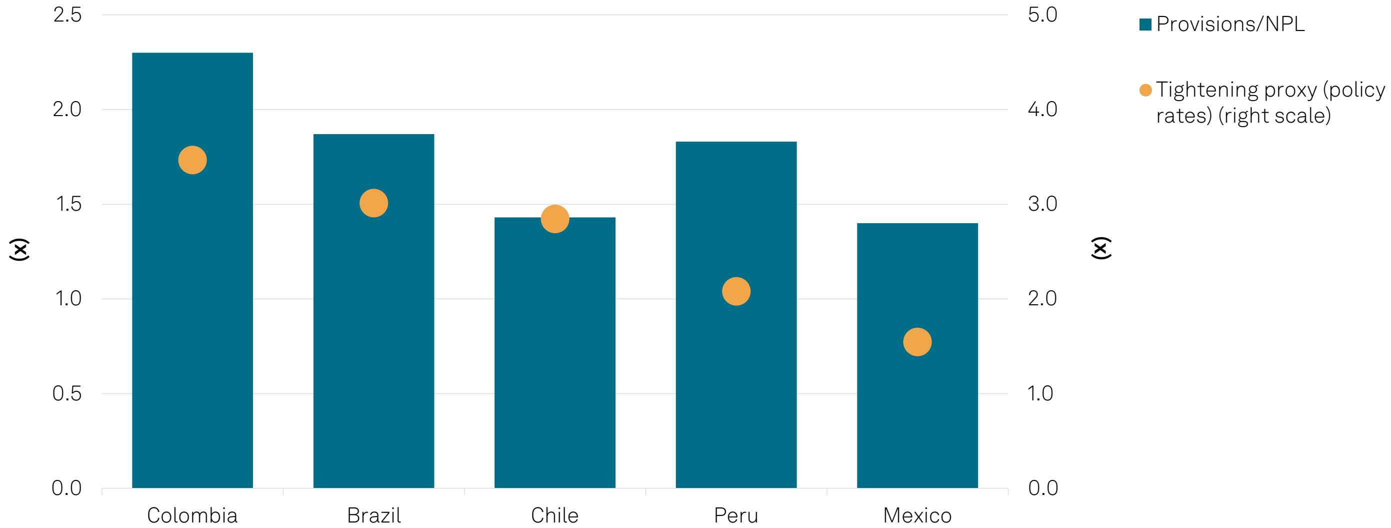


Sources: tradingeconomics.com, Cámara Chilena de le Construcción, Banco de la República | Colombia, Banco de México, Banco Central De Reserva Del Perú, S&P Global Ratings.

Banks' provisions are higher in the countries where conditions tightened the most and will provide a buffer in the short term. Provisions even appear to be sufficient in Peru and Mexico, where interest have risen proportionately slower. Chile stands out as having a wider divergence between its stock of provisions and the tightening of its financing conditions, suggesting potential vulnerabilities in its banking system if defaults were to rise significantly.

Chart 7

Provisions Suggest Banks Are Bracing For More Difficult Times

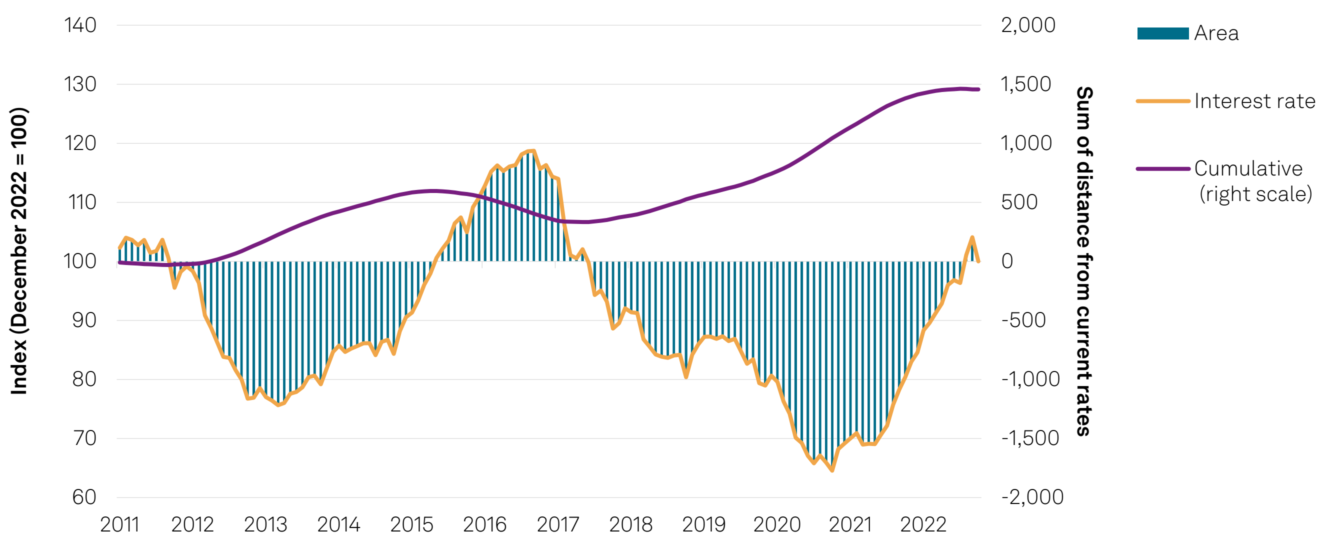


Sources: Connect by S&P Global, Banco Central De Reserva Del Perú, Banco de México, Federal Reserve Economic Data (FRED), S&P Global Ratings.

Appendix

The "cumulative sum of distance from current rates" metric measures the cumulative amount of tightening over a given period by calculating the area under the indexed curve. The index is set such that the last available data, which is December 2022, is equal to 100. The metric increases when the interest rate is lower than the current rate at each point in time, and decreases when the interest rate is higher.

Example: Brazil:



Source: Banco Central Do Brasil.

Related Research

- Credit Trends: Risk Reshuffle: Loans Could Become Riskier While Bond Investors May Be Too Optimistic, May 9, 2023
- Default, Transition, and Recovery: Corporate Defaults Reach Their Highest Year-To-Date Total Since 2009, March 13, 2023