Santander Brasil (BSBR) 3Q NIM trends spell trouble for Brazilian banks

Santander Brasil reported 3Q2020 results on October 27. Adjusted net income of R$3.9 billion was up 0.2% qoq and 47% above consensus, as weaker margins were offset by lower provision expenses and a rebound in fee revenues, as well as a sharp decline in operating provisions and expenses. Investor focus will understandably reside in asset quality, given the high provisions of prior quarters – we believe the decline in margins is more important and more lasting. It also provides a read through to what to expect from other banks' earnings in the next days and into 2021.

- **Don't focus on provision expenses.** Recurring provision expenses declined 12.5% qoq, representing a cost of risk of 3.0% (-50 bp qoq). This appears more than adequate, given that 90-day NPL ratios are at all-time lows (2.1%, -30 bp qoq) and NPL coverage is at an all-time high (307%, +2,500 bp qoq) – all driven by significant growth in renegotiations (the renegotiation portfolio is at 5.8% of total loans, up 110 bp yoy). However, even if the 90-day NPL ratio normalizes to 3%, NPL coverage would still be at a healthy 210%. It would take an unlikely large cycle, with the NPL ratio eclipsing 4%, for NPL coverage to be a concern.

- **Margins are be the ongoing problem.** As highlighted in prior reports, margins were expected to decline – and they did: adjusting for 2Q's large trading gain, NIM declined 1.8% qoq, despite a 2.5% qoq increase in average loans, while "client spread" declined 70 bp qoq and 220 bp yoy. It is a difficult combination for all Brazilian banks, led by three factors:
  - *Historically low benchmark interest rates.* The 2% Selic is pressuring lending rates across the board – Central bank data for September showed overall rates on new loans at 18.1% (-600 bp yoy).
  - *A surge in liquidity.* As a result of the government pandemic relief programs, demand deposits for Santander are up 96% yoy and overall deposits are up 48.3% yoy. While more deposits are generally good news for banks, this case is different: reserve requirements limit how much can be lent (especially in demand deposits) and demand for lending remains weak. The excess funding goes into cash and securities, which for Santander was up 24.8% yoy, negatively affecting asset mix.
  - *Mix of loans.* To reduce credit risk at the onset of the pandemic, banks focused origination on more secure loans (payroll, mortgage, corporate). These loans carry lower spreads, putting pressure on margins.

- **It is still early in the process.** In Brazil, bank loan books take between 12 and 18 months to reprice, as new loans (front book) come in to replace older loans (back book) that are paid down. Given that rates on the front book are still declining (as per Central bank data), the pressure on margins is likely to continue for at least 12 months. Unless banks are able to expand their loan books significantly (bringing along with it all the credit risk such a strategy would entail) to offset the weaker pricing, margin pressure should effectively cap bank profitability in the near term.

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