Q3 2018 Earnings Call

Company Participants

- Candido Botelho Bracher, President & Chief Executive Officer

Other Participants

- Carlos G Macedo, Analyst
- Carlos Gomez-Lopez, Analyst
- Domingos Falavina, Analyst
- Eduardo Rosman, Analyst
- Felipe Gaspar Salomão, Analyst
- Jason Mollin, Analyst
- Jörg Friedemann, Analyst
- Marcelo Telles, Analyst
- Nicolas Riva, Vice President
- Philip Finch, Strategist
- Rafael Frade, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to Itaú Unibanco Holding Conference Call to discuss 2018 Third Quarter Results.

At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time.

As a reminder, this conference is being recorded and broadcasted live on the Investor Relations website at www.itau.com.br/investor-relations. A slide presentation is also available on this site.

Before proceeding, let me mention that forward-looking statements are being made under the Safe Harbor of the Securities Litigation Reform Act of 1996. Actual performance could differ materially from that said anticipated in any forward-looking comment as a result of macroeconomic conditions, market risks and other factors.

With us today in this conference call in São Paulo are Mr. Candido Bracher, President and CEO; Mr. Caio Ibrahim David, Executive Vice President, CFO and CRO; Mr. Alexsandro Broedel, Group Executive Finance Director and Head of Investor Relations; and Mr. Milton

Maluhy Filho, Itaú CorpBanca CEO. Mr. Milton is participating in this conference call as the future CFO and CRO of Itaú Unibanco.

First Mr. Candido Bracher will comment on 2018 third quarter results. Afterwards management will be available for a question-and-answer session. It is now my pleasure to turn the call over to Mr. Candido Bracher.

Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you. Good morning and welcome to our third quarter 2018 earnings conference call. Starting our presentation on slide 2. We had another solid quarter with our recurring net income reaching BRL 6.5 billion and a consolidated ROE of 21.3% and of 22.4% in our Brazilian operation.

You can see that the growth of 1.2% of our financial margin with clients and the reduction of 9.4% of the cost of credit were the main drivers of the third quarter results. This positive performance was partially offset by the 2.1% decrease of our fees and result from insurance and by the 3.1% increase in our non-interest expense.

The higher expenses were mainly influenced by forex valuation (00:02:53) and by the collective agreement with the Bank Employees' Union. Nevertheless, our expenses from Brazilian operations excluding the impact from Citibank retail business grew 0.9% over the past 12 months, well below inflation for the period.

Additionally, the credit portfolio grew 10.6% over the last year, while the non-performing loans over 90 days improved 30 basis points at the same time. It's important to note that the 10 basis point (00:03:28) of the NPL ratio in the quarter was mainly due to a few corporate cases that were already properly positioned. Lastly, our capital ratios continue to improve despite the credit growth in 2018. The Tier-1 capital ratio reached 14.8%, which already considers the fully loaded Basel III capital requirement and also the impact of XP Investimentos minority interest acquisition.

On slide 3, we present our income statement. You can see that our cumulative performance over the first nine months of 2018 generated a 10.1% growth in income before tax and minority interest. This performance was partially offset by a temporary higher effective tax rate in the period. The higher tax burden is caused by the accounting of our tax credits at a 40% rate, while we pay current taxes at a 45% rate in accordance with current regulations, which should expire at the end of the year.

Now on slide 4. The financial performance reported on slide 3 is an essential element of our value creation growth. Here in slide 4, we show that our value creation reached BRL 7.2 billion in 2018, an increase of 36% on the last four years, which confirms our focus on capital discipline. Also, essential to our value creation process is our investment in technology, which as shown on page 5, has increased 67% since 2014. This investment is far most important to generate both cost efficiency and product quality. This investment has promoted the constant evolution of our digital platform including the user experience of our clients. This led to a constant growth in the adoption of our digital channels by our clients as they already amount to (00:05:46) almost 11 million individuals by the end of September.

Through our app, we opened more than 160,000 new current accounts in the third quarter, a 30% growth compared to the previous quarter. Our digital branches represent more than 30% of the operating revenues in the retail business with an efficiency ratio that is more than 4,000 basis points better than a brick-and-mortar branch. These are some of the important KPIs tracked during our digital transformation journey.

Now on slide 6, we see our business model with a breakdown of our income statements between credit, trading, insurance, services and excess capital. We evaluate our business allocating capital to each and every transaction in the bank creating a more critical capital management approach. This process allowed us to enforce our value creation in each area of the bank linking it to the each manager (00:06:49). As previously shown in this presentation, our value creation increased BRL 1 billion during the first nine months of the year as has been the case in recent years. Our insurance and service operations continue to account for the bulk of the value created. But it is important to point out that credit transactions have consistently created value throughout 2018.

Turning to slide 7. Our credit origination remains strong mainly in our individuals and SMEs credit portfolio. As mentioned in the past quarter, this growth is driven by fresh demand from our client and not by the loosening of our risk appetite and credit strength. On the corporate portfolio, the origination remains subdued due to lower demand from our clients and our minimum value creation requirements. However, this does not implicate in a reduced relationship with our large corporate clients, as we continue to advise and help them to access the debt capital markets in which we play a leading role both in the distribution and in the origination of corporate debt.

Now, turning to our credit portfolio on slide 8. You can observe a growth rate of 2.1% in the quarter and of 10.6% over the last 12 months. This performance is concentrated in our individuals and SMEs portfolios, which in aggregate grew 11.9% over the last 12 months. Our portfolio in Latin America continues to be affected by forex variation (00:08:30), especially when compared to last year. If we strip out (00:08:34), the portfolio would have grown by 5.2% in the last 12 months, instead of the 27.4% as the table shows.

That brings us to slide 9, where we show our financial margin with clients growing by 1.2% primarily because of the continuing change in the credit portfolio mix, powered products with higher spreads as shown on the previous slide.

Our risk adjusted NIM increased 10 basis points in the quarter, also in line with the improvement of the credit quality of our portfolio. Also of note, it's a fact that before the easing cycle of the Selic rate, we were constantly questioned about the negative impacts that a lower Selic would have in our financial margin. Now two quarters after the stabilization of the Selic, the figures shown here indicates that our NIM is less sensitive to market volatility than people originally thought (00:09:39).

Slide 10, shows our financial margin with the market. This revenue (00:09:45) as you know, includes not only our trading gains, but also our assets and liability management, and it remained well relatively stable in this quarter, despite the market volatility in the period.

Turning now to slide 11. We will take a look at our credit quality indicators. Our non-performing loans over 90-day improved 30 basis points over the year, consistent with our risk appetite and strategy. In this quarter, the 10 basis points increase is caused by the corporate book, and refers to delinquency of a few companies that were properly provisioned, and did not cause any negative effect in our P&L.

The NPL over 90-days of our SMEs portfolio reached 3.4% this quarter, which represents 150 basis points improvement over the past year. In addition, the delinquency of the individual's portfolio, which remained stable in this quarter, shrunk 60 basis points over the last 12 months. Both portfolios are at the lowest delinquency ratios since the Itaú and Unibanco merger.

Moving on to slide 12, we can see that our cost of credit capital has reached 2.1%, once again the lowest point since the merger between Itaú and Unibanco.

Now on slide 13, we show our coverage ratio which has declined 1,300 basis points over the quarter. As mentioned previously, this indicator was likely to decline either due to the default of exposures for which revisions already existed or due to the upgrade of the credit ratings from clients, whose financial health improved. During this quarter, both factors contributed to the decline.

Slide 14 gives a breakdown of our revenues from services and insurance. And as you can see, these revenues were down by 2.1% in the quarter. Commissions and fees declined 1.1% in the quarter, mainly due to the advisory services and brokerage. This line was naturally impacted by the pre-election instability. Despite the higher competition in our fees and services businesses, its revenues still show a good performance, growing 6.8% in 2018. This is fair to say that without the effects from the Citibank retail business, revenues grew 5.2% in the same period. As for the lower result on our insurance operation in the quarter, it is related to the liability of (00:12:30) revenue recognized in the second quarter. Since this task (00:12:33) is held once every six months, we have no impact this quarter.

Now, turning to our non-interest expenses on slide 15. We had an increase of 3.1% in the quarter. This growth was mainly related to the effect of ForEx evaluation in our expenses in Latin America, as well as the impacts of the collective agreement with the bank employees union. We note that our expenses from the Brazilian operations, excluding the impact of that Citibank retail operation, grew 0.9% over the first 12 months, well below inflation for the period.

On slide 16 now, we show our Basel III Tier 1 capital ratios, which increased 60 basis points in the quarter, reaching 14.8% already accounting to 19 bps impact on the acquisition of XP Investimentos. This evolution was due to our net income in the period as well with the effect of resolution for 680, (00:13:40) which changed the treatment of deferred tax assets originated from hedging strategies of international investments.

Now, on slide 17, we are glad to announce that we have received the final approval from the Brazilian regulators for acquired minority interest of 49.9% in XP Investimentos. The total transaction value was BRL 6.7 billion, and the financial settlement took place at the end of August. This acquisition reflects our strategy to diversify our net income (00:14:18) revenues.

With this, now, we conclude this presentation, and are open for the questions, which you may have. Thank you.

Q&A

Operator

our first question comes from Eduardo Rosman, Banco BTG Pactual.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Hi. Good morning, everyone. I have a couple of questions on the acquiring segment. The first one is regarding the competitive environment in the industry, where we can see that your price has declined a lot in the third quarter when compared to the previous ones. We did some calculation here, and we can see here that (00:15:16) calculated as revenues divided by the card volumes declined 13 basis points "to 1.08%." So, I wanted to understand what drove let's say the lower price, if this was something more proactive from you. Also what do you think we can expect, if these prices should continue moving downward, if you believe that from now on this should be a more stable level? So if you can elaborate a little bit, we would be grateful.

And the second question is also, let's say talking – it's also in the industry, right. We saw (00:15:58) announcing recently, it is leaving the banking lock agreements. So I wanted to know if it makes sense for (00:16:05) to remain in the agreement or not, right, or if it makes sense to have the agreement at all from now on?

I think clearly some of the new ventures they have been able to be very aggressive on prices because they do a lot more prepayment than incumbents. So, I wanted to understand here the view of the bank. For the bank, I understand at the end of this agreement is bad, right, because it increases the risk on the loans that have card receivables as collateral. But on the other hand, this could help (00:16:40) to become more competitive when compared to the other ones. So if you can talk a little bit about these as well I would be thankful as well. Thanks.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Good morning, Eduardo. Thank you for your questions. So, first on the acquiring business and the competitive environment in the acquiring business, I mean I think it's no secret everybody witnessing I mean how competitive this business has become in the past six years and it's becoming recently (00:17:11) more competitive. In this scenario, we have first lost some market share due to the competition. But we have restructured our activity in many ways with this investment. And we have been able now to stop this loss in market share. But as to the prices, I mean we don't make the prices. The competition makes the prices, the market makes the prices, so I can't tell you I mean if they will keep on falling or not.

But I could say that, I see nothing the market that indicates that the competition will ease in the near future. So, I mean, we – as you know, I mean we have created POP Credicard in order to compete in another segment. We have increased significantly our direct sales force. And we will, I mean, keep on competing in this market, expecting to bring always a better service to our clients and to be a strong competitor in the (00:18:23).

About SCG, I mean, the agreement, (00:18:32) has announced that it will lead the SCG. We have announced as well that we are building the SCG. Yet, I expect this should not happen, neither for (00:18:46) nor for us. I believe at the end of this agreement is first and foremost a loss to the system, not to the bank, especially a loss to the client. And the clients today have access to this type of credit that in Portuguese we call [Foreign Language] (00:19:04), smoke, which is the ability to discount revenues, which are still to be made or of sales which are still to be made.

I mean, SCG enables so this credit to be made, it's a safer credit. And thus, it has a lower interest rate which is very beneficial to clients. Without this agreement, without the SCG, such credit performance [Technical Difficulty] (00:19:34). An agreement has already been reached on how this market should function in the future, but it takes some time, takes about two years for all the technical evolution to be made.

And then, when this is done and ready, all the participants will have access to discounting receivables in the market, thus I mean improving the rates for the companies. And what is being worked upon now is a solution for the meanwhile, I mean between now and two years from now. I trust that the efforts of the Central Bank and (00:20:22) banks, we will succeed and we will be able to find some way of functioning that will enable the (00:20:30). And so, we won't have to leave the (00:20:37).

Q - Eduardo Rosman {BIO 16314825 <GO>}

No. Perfect. Very, very clear. Just a small follow-up on the (00:20:44) question, do you expect any increase in provisions, because of the, let's say, deterioration of these collaterals? Or you don't think that this – you don't think this is going to happen?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I don't think nothing significant can happen there, Eduardo.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Okay. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Yes, good morning, (00:21:19) gentlemen. Thanks for taking questions on more of the banking side. First, you mentioned during your presentation that much of the growth that you've been seeing so far, the acceleration at least has been driven by demand and not by appetite. I think I asked this question in the last couple of quarters. Now, that the elections in Brazil are done, we have an outcome. Of course, we still need to see the new President come to power and govern, but what will it take for the risk appetite of a bank to improve? I mean, on the asset quality side, NPLs are at the lowest level, they've been as you said since the merger, and cost of risks hasn't – is being pretty much flat. What does it takes for your risk appetite to increase it and what would that mean for loan growth, if it did?

And I have a second question that's an asset quality specifically on the consumer side. Volatility on the corporate, but the consumer side has been pretty steady. Do you see any room for further improvement there given where you are? The cost of risks there hasn't really declined that much. It's actually been going trending a little bit upwards at least on the retail side. How do we think about that going forward in terms of the cost of risk of that specific segment? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thanks for the question, Carlos Macedo. You said you've been making these questions for the past two quarters, and making the same question, this time I may give you a different answer. So as to risk appetite, so first, just to be precise on what is risk appetite and what is not risk appetite, risk appetite for us means that we don't lend to companies or to individuals with a probability of default above a certain level, which established at different levels for different segments.

So, how have we then been able to increase our portfolio and to increase our credit activity, because companies get better when the economy gets better and their probability of default decreases. So, companies which were out of the risk appetite, they get in the risk appetite as the economy improves and as they improve. So, changing the risk appetite would mean acceptance lending to companies with – companies (00:23:46) with higher probability of default.

We think that the steadiness we have seen in the improvement of company and the perspectives we have ahead may encourage us to review these levels of probability of default, below which we do not lend. I mean, we are studying this as we speak and we may submit to our board some measure in this direction over the cost of this next quarter. So, this is your first question.

On your second question, if I understood well, was – I mean about the perspectives of cost of risk in the consumer side. It has really improved very significantly. It should, at some moment, it should stabilize, we do the – we do not see the signs of this year. It continues to so far (00:24:47-00:25:05)

Q - Carlos G Macedo {BIO 15158925 <GO>}

...guidance for next year, but a stronger risk appetite. I mean, you're already growing at 13% per year. Would that mean loan growth potentially staying in the mid-teens next year, the risk appetite doesn't need to go up or is that a little bit too aggressive for the size of the market, as it is now in the prospects that we have for the GDP growth?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I cannot right now estimate, I mean, what your loan growth look like for next year. But what seems safe to say is that, the growth for next year will lean more upon credit than it has leaned to this year.

Q - Carlos G Macedo {BIO 15158925 <GO>}

Okay. Perfect. Thank you, Candido.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

The next question comes from Jason Mollin, Scotiabank.

Q - Jason Mollin {BIO 1888181 <GO>}

Hello. Thank you for the opportunity to ask questions. My first question is again on loan loss provisions and the declines we've seen, and I would call normalization I guess of the cost of credit, as well as loan loss provisions to loans. We've seen in the chart you show for all the history there where we are at the lowest levels. Should we expect levels to increase as loan growth accelerates or can they continue to decline would be my first question.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Jason. I mean, as long as growth accelerates, you have a natural tendency for these levels to increase, because you have to make provisions for the new loans. However, given the very high level of the...

A - Operator

Coverage ratio.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

... the very high level of the coverage ratio that we present, as I have been saying over the past quarter, I mean these levels tends to decrease over time. It will decrease because some companies will default and they will add to the denominator or it will increase because some companies will improve and the provisions will be reversed. I think this is still a trend that was normalization as you named it.

this is still a trend that was normalization as you named it, I mean which we should see still for one or two years ahead. And so, this trend of course tends to reduce the cost of credits. I mean what will be the balance between both trends, I mean one of increase because of the total portfolio and one of decrease because of decrease in our coverage ratio, I don't know.

Q - Jason Mollin {BIO 1888181 <GO>}

Well, thank you for that. Let me ask a second question on the credit card business. So, cards now represent about 35% of the loan book at close to BRL 69 billion – around BRL 69 billion, only less than 9% of revolving credit. We know we have, I think you recorded about 83% our transactional charges, including installments without interest. So, I just wanted to understand how you see these potential changes in this market, specifically the use of interest free installments. And if – I mean we've seen some push to reduce the use of interest installments and move to installment payments and charging interest rates, how do you think about this issue and what are the implications for Itaú and the credit card market in general?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay, Jason. Well, as you know, I mean interest-free installments is embedded in the culture of Brazil. I mean it's something, I mean every retailer sells on interest-free installments. Just recently, one year ago, the retailers have been allowed to have a discount when the sale is not made in interest-free installments. As this habit becomes more widespread, then there tends to be a tendency to increase the interest bearing strategy, (00:29:42) which is where we place our effort.

Our main efforts in the credit card area is to increase the interest bearing portfolio. I think we are being (00:29:53). I think, this is a trend, which should increase as we go forward. But it's a long – I don't think interest free installments will ever be excluded or will ever be finished. I mean, they are too much of a traditional lending in the market, and a lot of the retail market depends upon it. But as we create alternatives for it and the alternatives, I mean, with a discounted value, and then their interest in the financing. I think, we'll be able to grow our credit card portfolio that bears interest.

Q - Jason Mollin {BIO 1888181 <GO>}

Can you share a little bit of this 83% that you call – I would call, transactional charges? What portion of that is the interest-free installment versus just the usage that the – when the card payment is due by the client, paying it off and so what percentage of that is actually due to this interest-free installment product?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Jason, I don't have this figure right now with me. I'll have to ask Gustavo to call you back with it.

Q - Jason Mollin {BIO 1888181 <GO>}

Great. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You are welcome.

Operator

The next question comes from Jörg Friedemann, Citibank.

Q - Jörg Friedemann

Thank you very much for the opportunity. I have also two questions. The first is related to your fee income business. I was particularly intrigued by the performance of the asset management fees. So just wondering, if you could describe a bit what drove the performance in this quarter, if you could attribute that only to competition or it could also be the initial signs of the effect of Itaú opening its platform and migrating a bit I know from the pure asset management fees to distribution fees, something that we will be accommodated over time.

And my second question is related to costs. Of course, it became very clear to us in your presentation that the bulk of the increase has been related to the LatAm unit, given the depreciation of the real during the quarter as well. But you also had this impact of the labor agreement. So, just wondering, if you strip it out the FX impact, what we could think about is structural growth. The question is more related, if the LatAm units will continue pushing costs above inflation for the foreseeable future. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Jörg. First your question on the asset management, it has the decrease in season asset management is not related to our change in terms of distributing more third-party products or so. It's very statistical in this project. It's due to smaller performance fees. I mean we have most of our funds this year in the first quarter after yield in the industry, and so performance fees were very strong in the first semester. And it was a bit less so in the third quarter. So, this was the reason for the impact in the asset management fees.

As to costs, I mean, cost related – Latin American costs, I mean, if they will be above or below our inflation in Brazil, is related substantially to the exchange rate variation. We cannot forecast that. Locally, their costs tend to increase below inflation as is the case in Brazil, and as we intend to continue to do so.

Q - Jörg Friedemann

Yeah. Perfect. Just a brief follow-up on debt (00:34:49) part of Latin America, some of the units, particularly Chile and hopefully Colombia soon are recovering. And the question is more related to, if this growth observed (00:35:06) continue pressuring expenses in the quarters ahead, or if you believe that at some point, we will converge to the guidance this year and lower levels for next year? That was a bit more of my point. Sorry, if I was not clear.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I think that the improvement in performance, especially in Chile and Argentina, they have more to do with the way management is evolving and there is no way a new managing guidelines are being implemented in these banks, then with investments in itself. So I think – I mean – you'll be able to keep on improving the performance there, keeping expenses below inflation in this country.

Q - Jörg Friedemann

That's prefect. Very clear. Thank you very much.

Operator

The next question comes from Rafael Frade, Bradesco.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi. Good morning, all. My question is really to the guidance you – in your press release, you reaffirmed the guidance, but you don't mention anything on the – during our initial presentation. I would like to just get a sense of how are you seeing the guidance for the year, a few lines now seems to be looking for credit. It seems that probably you will be above your guidance in fees and maybe we can be more in the low end of the guidance. So I would like to hear your talking about it?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay. Thanks for the question, Rafael. As you know, I mean we provide guidance for these various lines and we know that you make your calculations and you end up with our guidance for final results. We do the same thing here. And when we look at this calculation, we think that we will be well within the guidance, the result that you have talked (00:37:09) for our final results. Yesterday, in the (00:37:12) lines, you are right, I mean there are some cases, where we will be around the extremes of the guidance either positive or negative.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay. Thank you.

Operator

The next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you, Candido and team, for taking the question as well. Two quick questions, one is on head count. We noticed about 1,000 employee increased in this Q-on-Q. And I believe in addition to the FX and also the salaries, one of the reasons for the OpEx increase according to the release was the efforts or the focus on the commercial efforts on the Acquirer as well as on insurance. So, if you could provide a little bit of detail of this head count increase, what percentage you point through Acquirer or how many people actually did increase our Acquirer sales effort by, and as well as your insurance? And then I go for the second question.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you for your question, Domingos. Yes, I mean you are right. I mean there has been a head count increase, and they will continue to be investment in people in these two areas, I mean insurance and acquiring business. I think that this third quarter rough figures, they were around 300 for the acquiring business and 400 for the insurance. We expect to have of course efficiency gains in many other areas of the bank, which will offset the impact on costs created by this investment in this area.

Q - Domingos Falavina {BIO 16313407 <GO>}

No. Super clear. Thank you. And one additional one on the Acquirer, it seems that the (00:39:10) rental is sort of the most commonly used negotiation tool to retain clients. And it seems Itaú is really focusing on keeping these client relationships as seen by the number of clients, as well as by the volume growth. My question is when you look these POS rental revenue stream, do you see that decreasing or becoming irrelevant and how long? Is that something that you believe will continue to be a relevant stream or will cease (00:39:39) to be important in the short-term?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

No, you are right. (00:39:42) we are trying to adapt our product and our offer to consumer needs, to client needs. And one of the main victims of it is the POS rental. And apparently, it will continue to be so – POS rental tends to continue to decrease.

Q - Domingos Falavina {BIO 16313407 <GO>}

Okay. Very clear. Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

The next question comes from Marcelo Telles, Credit Suisse.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hi. Good morning, Candido. Good morning, everyone. Thanks for your time. I have two questions. The first one, and it's more of a broad question regarding fintechs. How do you see the threat of fintechs to your business, particularly considering your expectation of problem like – accelerating your loan portfolio down the road. So, where we see the biggest threats from fintechs for you, that's something that could perhaps change the dynamics a little bit in terms of this loan growth acceleration into the future?

And my second question is regarding costs kind of a follow-up on Falavina's question considering that you expect to accelerate your loan growth going forward and how should we think about your operating cost base down the road? Can we still continue to deliver the strong cost control you've delivered in recent years or you think because of higher lending growth, we might start to see an acceleration on your operating expense base? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Marcelo. So, first your question on fintechs. I must tell you that I think the fintechs activity much more challenging for us in the service side than on the credit side, at least for the near future. Most of the activity we're seeing in fintech and the new competition they come on the investments, they come on the acquiring business, mainly they come on services.

In credit, we do not see yet such an intense activity by fintechs, and we see the quality of our credit operation improving very consistently with the use of artificial intelligence, with the use of technology the way our credit models are improving, so here we have the impression that we can compete on a more even basis using technology to compete against fintech. So, my expectation is that the credit portfolio will experience a good growth ahead of us.

And going to your second question, I don't see a huge impact in cost in the growth of the portfolio. I think we have established structure and within this structure, we will be able to grow the portfolio without adding much (00:43:19) are part of the scale gains. It's a completely different scenario than in the acquiring business, or in the insurance business, but we need more people to increase sales. We don't need more people to increase our credit activity.

Q - Marcelo Telles {BIO 3560829 <GO>}

Thank you, Candido, very clear. Just one additional question if I may. Regarding (00:43:40) where do you think you are from a technology standpoints, and from a service standpoint compared today to newcomers in that business, do you think you still have to deal with a lot of like legacy issues that have been potentially (00:44:02) your business. If you could just elaborate a little bit on the service and on the technological strategy of hedge that will be great?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay, Marcelo. I think we have few quite a way to go in our acquiring business. I think we can improve much more there. It's not the case of POP Credicard, POP Credicard is already born and with a new platform. But in the traditional hedge I see a lot of room for improvement in our – in the quality of our, offer to our clients. And I mean, we are following up in all the aspects of this offer, and we are (00:44:53) improvement in each of them and we think we will be able to improve much more and offer much more competition to the market.

Q - Marcelo Telles {BIO 3560829 <GO>}

Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

Our next question comes from Philip Finch, UBS.

Q - Philip Finch {BIO 3252809 <GO>}

Thank you, Mr. Bracher for the presentation. Couple of questions also from me. First, a follow-up to Marcelo's question on disruption risk. We've seen a few new digital players coming to the market and last year also offering free banking, free checking accounts and transfers. Is that putting pressure on you? Are you seeing any customers switching to these new start-ups or additional players? And are you planning to also reduce your fees as well related to this? So, I guess ultimately you're benefiting from cost reduction as a result of technology, digital banking. Is there a risk that these cost benefits are going to be passed through to your customers, partially or fully via lower fees?

And the second question is regarding your dividend payment or payout outlook. So, in previous calls, you've mentioned the potential for a higher dividend payments given that, well, at not least you've issued some additional Tier 1 capital. Now, loan growth clearly has picked up much faster than anticipated. Does this in anyway reduce the potential for dividend payment going forward? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Philip, thank you for your questions, both very good. First question deserves a little longer answer maybe. Of course, this fintechs and all this new competition is a threat to the business. I have no illusion that this will not somehow affect our margins. I think that margins will suffer. As they always suffer when there is (00:47:15) and there is increased competition. As to the way we compete, I have seen this phrase within (00:47:26) somewhere, which made sense for me, which is that incumbents must find innovation before innovators finds distribution. I think this is more or less the race that is established. So, we as an incumbents must find innovation, must be able to compete with the products offered by this new competition. And this is what we are doing and this is why I have shown here our investments in technology. We could go on much longer about investments in technology. (00:48:00) that we have traveled the number of scientists in the data sciences (00:48:13) in the bank and many other progresses which we are seeing, in order to have keep improving our efforts as new competitors appear in the market.

So, I think that in this game, we can compete very well, but margins will be compressed. I think it will be more so in services than in credit. I think in credit, there is – our condition to compete and our gains of scale, and really I mean the accumulated knowledge on credit evaluation that we have and (00:48:51) enables us to compete even more strongly in credit than in tenants in (00:49:01) services. But I think this is the name of the game going forward, things to (00:49:06) face this competition in every market (00:49:10), the insurance business, we have the cash management business. There are many businesses like this. We have, I believe, we offer the benefit of a complex offer of structured financial products stability of being (00:49:28) a one-stop shop and so on, and we think that if we are able to constantly improve the quality of our products to constantly improve the user experience of our products, which is our main focus now, I mean we will succeed in this competition and we will keep the high levels of returns that we have in offering to our investors.

Second question on dividend payout. Yes, (00:50:08) that we should have by the beginning of the year 13.5% Basel III, Tier 1 ratio. And what's above it and will not be consumed by acquisitions or by expected changes in regulation will be distributed as dividend. So, as I look to next year, I think that we'll have a very fair level of (00:50:35) distribution. If portfolio grows much faster than we expect, then (00:50:47) because more capital will be required to keep the 13.5% less (00:50:55).

Q - Marcelo Telles {BIO 3560829 <GO>}

Okay. Perfect. Thank you very much, Mr. Bracher.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome.

Operator

The next question comes from Felipe Salomão, Citibank.

Q - Felipe Gaspar Salomão

Hi. Candido and team, good morning. Thanks for the question. I have a few questions about Credicard POP. Is it possible to share more details about the recent performance of this business? For instance, what is the current POS days of Credicard POP? How many clients Credicard POP has been able to add to its portfolio on a monthly basis? And if you could also, if possible, of course, share some numbers about estimated market share in the micro-merchant segment both the current market share and the market share of net additions that would be great.

And the last question that I have is why Itaú decided to use the systems of First Data to do the processing of Credicard POP transactions instead of using Rede? These are my questions? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thanks (00:52:13) questions. Concerning Credicard POP, we are not disclosing many informations on this. But I think the information I can give you is that we are on track to reaching our goal of 120,000 clients by the end of the year. Why did we decide to use First Data and not Rede as the platform supplier for Credicard POP because we are experimenting with different alternatives. We think this is part of our striving to offer our customers a better user experience, and we are challenging our own internal platforms like these and we expect to have POS improving like this.

There is also another – I could have answered this another way too, and it would also be through, Felipe, this question about First Data. You know that in every company and in every bank there is a competition for IT resources. We have a high competition for IT resources in the bank. We have a very clear and established method of measuring the net present value of (00:53:36) investment that we propose to technology. So, when a new product comes, which has a longer (00:53:48), it's easier for them and it's easier to calculate the results and the prospects of this investment, if you do not rely on our internal IT, but if you can hire it externally.

Q - Felipe Gaspar Salomão

Okay, Candido. Thank you very much for the answers.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Felipe.

Operator

The next question comes from Nicolas Riva, Bank of America.

Q - Nicolas Riva {BIO 20589225 <GO>}

Yeah. Thanks very much Candido, for letting me ask questions. I have two questions. The first one on the level of NPL creation. So, we did see an increase in this level in the quarter, about BRL 5 billion. You do mention the rollover of some overdue loans, which were 15 to 90 days overdue, and now they are more than 90 days overdue, but if you can comment on this increase (00:54:47). Is it something that concerns you for coming quarters?

And then, my second question on your guidance for loan growth. (00:54:56), going forward. But if I look at the guidance for loan growth, you didn't change it for this year, the 4% to 7%. And if I look at what it implies for the fourth quarter, it seems to imply basically zero growth quarter-on-quarter for the fourth quarter. So, my question there is if the acceleration that you're seeing in loan growth will be more of a 2019 story rather than fourth quarter story? Thanks.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Hi, Nicolas. Thank you for your questions. Concerning the NPL creation, this companies that went in arrears over 90 days in this quarter. These are cases dated back to 2015, 2016.

In 2015 and 2016 we identified companies which were much weaker due to the huge prices that we went through. We have made precautionary provisions for this clients, and we follow-up these clients very closely in a different area of the bank that we created especially to follow-up clients like these since. So that, when these clients they eventually default us (00:56:16) was the case with this companies. Now, the level of provisioning is very high. In this case it was above 80% in the case (00:56:27). And we expect we will not lose 80% of this credits eventually going forward. So, this does not represent any special concern to me going forward.

And as I look into our book of similar situations, we see some companies improving, others still deserving a closer attention, expected if the economy as a whole improves, we may have more positive than negative surprises in this portfolio going forward. And we have not seen new companies being added to this portfolio. So, we are not – during this year, it has not been significant, the number of new cases added to these cases that's our bigger concern. And guidance for loan growth, we reaffirmed the guidance is in general with this caveat, this disclaimer (00:57:44) that I mentioned in the previous question. In some lines, we may be around the top or bottom of the guidance.

Q - Nicolas Riva {BIO 20589225 <GO>}

Okay. Thanks very much, Candido.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

You're welcome, Nicolas.

Operator

The next question comes from Carlos Gomez, HSBC.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

Good morning, and thank you for taking the call. I have a question about two products. If I look at page 69 (00:58:14) of your presentation, (00:58:17) and mortgages. In auto, because obviously, you're much smaller than you were before, but you're regaining ground. What will be your (00:58:29) portfolio as large as you had in the past? Do you think it will be a particular percentage of your total – your individual loan portfolios or do you have a market share target as an institution?

And on mortgages, which are now 21% of your individual loans. At what point is funding going to become an issue, and would you make (00:58:52)? Thank you.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Okay. So, about – thank you Carlos for your question. About vehicles, this is a market, which we think we'll grow and where our presence will grow. As you know, we have been – we have restructured completely our activity in this market. We were once market leaders and now we are a much smaller participant in the market, and we want to regain the range here. And we have invested a lot in the quality of our product in the processing, in technology, in order to give better user experience, to have a (00:59:44) quicker turn time to customers. And we think we will be growing this portfolio consistently above inflation going forward.

And sorry, your second question, Carlos?

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

About the funding for the mortgage portfolio?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Funding for the mortgage portfolio does not present a special concern right now. As you know the mortgage portfolio is funded fundamentally by what we call (01:00:18) of the bank, and we have a very comfortable margin to fund the expected growth of this mortgage portfolio.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

So, you don't expect any problem in the next, let's say two or three years, as (01:00:37) for that?

A - Candido Botelho Bracher {BIO 3158644 <GO>}

I expect the portfolio to grow, but I don't expect problems in funding.

Q - Carlos Gomez-Lopez {BIO 18107094 <GO>}

Thank you very much.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Thank you, Carlos.

Operator

This concludes today's question-and-answer session. Mr. Candido Bracher, at this time you may proceed with your closing statement.

A - Candido Botelho Bracher {BIO 3158644 <GO>}

Just to thank you very much for the interest in our results, for the excellent questions you made. And we're confident that we will continue to show strong results going forward. Thank you very much.

Operator

That does conclude our Itaú Unibanco Holding earnings conference for today. Thank you very much for your participation. You may now disconnect.