Q2 2017 Earnings Call

Company Participants

- Candido Botelho Bracher, Executive President and Chief Executive Officer
- Marcelo Kopel, Investor Relations Officer
- Unverified Participant

Other Participants

- Carlos G Macedo, Analyst
- Domingos Falavina, Analyst
- Eduardo Nishio, Analyst
- Eduardo Rosman, Analyst
- Jörg Friedemann, Analyst
- Mario Pierry, Analyst
- Natalia D. Corfield, Analyst
- Olavo Arthuzo, Analyst
- Philip J. Finch, Analyst
- Rafael Frade, Analyst
- Tito LaBarta, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding Conference Call, to discuss 2017 second quarter results. At this time, all participants are in a listen-only mode. Later, we will 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. The audio webcast works with Internet Explorer 9 or above and Chrome, Firefox and mobile devices, iOS 8 or above and Android 3.0 or above. A slide presentation is also available on this site. The replay of this conference call will be available until August 7 by phone on 5511-3193-1012 or 2820-4012, access code 3987548#.

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 anticipated in any forward-looking comments 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, Executive President and CEO; Mr. Caio Ibrahim David, Executive Vice President, CFO and CRO; and Mr. Marcelo Kopel, Investor Relations Officer.

First, Mr. Candido Bracher will comment on 2017 second 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>}

Good morning. It's a pleasure to talk to you about our second quarter 2017 results. Starting first on slide 3, which venture the main themes of our challenges looking ahead. There are six topics, which I will briefly describe. In this quarter, we will explore the main evolution points in the digital front, first focus on clients. First and foremost, we will strive to offer our clients a significant enhancement of products and services. We want to reach a new level of customer satisfaction. We know this is not done overnight, but it should be a permanent objective of the bank.

In order to improve client satisfaction, we must keep in touch with each for transformation. Financial systems worldwide earned by growing deep pieces of change, and we strive to be at the forefront of this book. We seek to implement the best practice available not limited to the ones available to the financial system, in order to continue improving clients' experience and our efficiency. This digital transformation and client centricity require an adjustment of our HR practice, in order to foster even more the cooperative working communities and the trial fails, while promoting a fair (00:03:51). And we already talked at length here about risk management in previous presentations, but we shall keep perfecting our risk management tools.

And we continue to move forward with our internationalization process. At the moment, we strive to reach the countries where we already have presence, the same management quality, which we accomplished in Brazil, rather than expanding our business abroad. This all should allow us to keep a consistent level of profitability and value creation to our shareholders.

On slide 4, we go into more detail about our investments in the digitalization of our sales. This is in progress and also present the innovations that we had recently implemented. Today, internet and mobile transactions already represent 77% of our clients' transactions. Digital clients amount to BRL 13.6 million and mobile users amounted BRL 10 million, an increase of 15% over the last six months.

The speed at which the world is becoming increasingly digital is unprecedented, and financial services are no exception. In particular, mobile services have enjoyed exponential growth. Our mobile apps already represent the number one channel to reach our clients at Central Bank. Innovation in this environment requires a very strong customer focus, a deep understanding of customer experience, multifunctional teams working in agile methods, and comparative investment in data and analysis.

Our initiatives in digital platforms, digital branches, mobile and internet channels have seen relevant development. The highlight here, the launch of our Itaú Light app, targeted at less digitally literate clients. It offers a simple interface and runs on entry-level smartphones, and has been a new force in digitizing previously non-digital clients. A second development to point out is a new Internet banking channel for our SME's clients and credit card holders, with a new and improved customer interface. Finally, this quarter, we'll reach the milestone of 100,000 bank accounts opened through our mobile app in a fully digital process.

Turning now to page 5 and our results, but still, before talking about our financial results, I'd like to make a few general comments about this quarter. This quarter, as you all know, was impacted by a significant change in mood, which was triggered by events and starts great instability. Because of those events, the likelihood of having reforms approved reduced, negatively affecting confidence levels in Brazil. These events postponed the recovery of client demand, which was beginning to happen and will probably resume in a more modest base in the second half of the year.

It's important to note that we observed a relatively calm period in the market following a short high volatility spend. This can probably be attributed to the good perception the market has from the economic team and the expectation that this team will remain in its functions. As a result of that, demand for private and financial services was affected, but not as seriously as one would have feared, given the intensity of the events.

Now, on slide 5, we highlight the key performance figures from our second quarter results. Bank posted a BRL 6.2 billion of recurring net income in the quarter and BRL 12.3 billion in the first half of 2017. This ladder represents a 15% increase when compared to the same period in 2016. The recurring ROE in the first half of 2017 was 21.8%.

Focusing on the first half of the year figures, compared to the same period of last year, the highlight was the decline of our cost of credit. We will comment on the operational trends of our result in the following slides.

On slide 6, we show a brief history of quarterly recurring ROE, which highlights the stability of our performance even in an adverse environment. In the second quarter of 2017, the recurring consolidated return on equity was 21.5% and the consolidated recurring return on assets was 1.7%. When we segregate the Brazilian operations, the ROE was 22.7%.

On slide 7 now, if we look on the right side, with the first half of the year figures, we can notice a small contraction in operating revenues of -0.2%. This was due mainly to a decrease on the credit portfolio in the period, which affected our financial margins slightly. But business sector is more than compensated by a substantial decline in cost of credit and increase in commission and fees and strict constant growth. The combination of these results led to a recurring net income increase of 15% in the period, when compared to the same period of the previous year.

On slide 8, we disclose the breakdown of our profit and losses in Brazilian and Latin American operations. We note that Latin American operations are in the building process, notably Itaú CorpBanca, which was merged one year ago and still has significant room for growth.

Slide 9 is where we present our business model chart. In this chart, we break down the income statement between credit operations, trading, insurance and services, and excess capital. Throughout the first five years, we placed special purpose on our services business, and the results presented in this chart, I think they are a reflection of this stretch. You can see that insurance and services business accounts to pay for more than 50% of our recurring net income, which is one of the reasons why we've been able to keep our profitability at current levels in such an adverse scenario for credit operations. But an important point to mention here, is that we see now in this quarter that the credit business is recovering and showing returns in line with our cost of equity. As a matter of fact, you see 14.9% recurring ROE on our credit operations, which is above our cost of credit spread of 14.5%.

So, on slide 10, talking about credit portfolio, what we observed here is the impact of low credit demand environment, which translate into originations, yet enable to outpace amortizations even if they are growing. Nevertheless, the reduction pace of our loan book has been slowing down as the year-over-year contraction in this quarter is 30 bps lower than what was presented last quarter. Here, our expectation is for the loan book, for it to stabilize in the second semester, and we are prepared to resume credit growth whenever credit demand are lost.

Slide 11, financial margin with clients, we see that despite this more difficult economic scenario and the Selic rate reduction, our net interest margin remains stable at 10.3% in the quarter. But we suggest that net interest margin improve significantly due to better cost of risk in the quarter. The lower part of the chart represent the evolution of our financial margin with clients. Despite the effect of the new credit card regulation and the lower Selic rates, which affects our liabilities margin, there were some compensating factors in the quarter that allowed our financial margin with clients to increase, like higher number of calendar days, some structural operations of the wholesale segment, and higher gains in commercial derivatives in our Latin American operations. Going forward, one could expect that the drop in the Selic rate will cause pressure over our liabilities margin.

Slide 12, financial margin with the market, we had another positive quarter here, which given the unexpected events of May 17, we consider to be especially good results. Looking ahead now, we believe that for the full year of 2017, the financial margin of the market will reach a level around BRL 6 billion. Because the financial margin with the market has some correlation with the Selic rate, therefore, the macroeconomic scenario, where average Selic rate will be single digit from 2018, proves to be correct, it is very likely that this margin trend is to reduce in the Q3.

Which slide is now?

Unverified Participant

13.

Candido Botelho Bracher {BIO 3158644 <GO>}

Slide 13 now, comment on our credit quality, here, there are good news, as you can see, there was a 20 bps improvement in our total 90-day NPL ratio in the quarter. There were improvements in individuals and SMEs and corporate. So, there's movement across the board here.

Regarding the 15- to 90-day NPL ratio, there were also improvements in all segments in Brazil. For the corporate segment, we've mentioned in the last conference call that the 130 bps increase observed in the first quarter was related to the construction company's exposures. This quarter, there was 100 bps improvement as these exposures were re-negotiated, and therefore, included in our re-negotiated portfolio.

Slide 14, it's the NPL creation, so there was an improvement in the overall level of the NPL creation in the quarter, mainly led by a significant improvement in the wholesale segment. The small increase in retail segment here is due to (00:15:10). It's not a threat.

Page 15 now, provision for loan losses and cost of credit, let me see, there were improvements in the overall provision expenses due mainly to the wholesale segment. Detailed provision expenses increased a little bit in the period, but as I said, this is a normal behavior for second quarter, as you can see in the historical data here. There was also a small increase in Latin America provision. The same trend we can see for cost of credit, but we delivered these improvements in cost of sales since there were less impairment expenses in this quarter.

Page 16 represent our total allowance by type of risk. The bank's overall level of allowance reduced marginally in the quarter from BRL 37.6 billion to BRL 37.4 billion. Considering the stem of allowances were aggravated and overdue loans, there was a reduction from BRL 20.5 billion to BRL 20.2 billion in the quarter, which is in line with the improvement observed in the 90-day NPL ratios. Therefore, there was a slight increase in the potential provisions from BRL 17.1 billion to BRL 17.2 billion.

Now, page 17 represent our coverage ratio, and here you see that the coverage ratio reached 243%, increasing from 231% last quarter. First, high coverage level is not only due to the NPL improvement, but also due to some credit exposures from the wholesale segment, for which we have made anticipatory provisions that are neither defaulting nor improving sufficiently for the provisions to be reversed. This effect can be seen as the wholesale segment coverage ratio reached 715% this quarter.

Page 18, commissions and fees and result from insurance, here, we see that current commissions have increased 4.9% when compared with first half of 2017 with the same period in the previous year. We can highlight here the good performance of our asset management piece, in line with the solid growth of our assets under management in the period. We see also decline in result from insurance, and this is explained mainly by the sale of our group life insurance to Prudential, that became effective in April this year, the discontinuing of our extended guarantee activity, and to the fact that lower inflation and lower Selic rates negatively affected the remuneration of insurance assets. That all said, the same performance in the segment is still below optimal, and we are working on improvements, which should bear results going forward.

Page 19, non-interest expenses, expense evolution is in line with our plan. Comparing the first half of 2017 to the first half of 2016, non-interest expenses growth was only 1%.

Now, on page 20, moving to our core capital ratio, as of June 30, our common equity Tier 1, considering the full application of Basel III rules, the impact of Citibank with their business acquisition and the investments in XP, well, this capital ratio reached 13.5%. As you may notice, we continue to observe organic capital generation, even continuing with our buyback program during this year, where we bought back 37.9 million shares until July 2017. We are still accumulating cash.

Slide 21, here, there are two important observations to me, the first one is purely technical and relates to the fact that we are re-classifying this cost trend from margins to cost of credit line. This amount should be added to the results of loan losses plus internal line, that should now remain cost of risk. Then in this quarter, the guidance damage was 14.5 to 17, compared to 15.5 to 18, increasing this in the 4Q of 2017.

And now, talking about our forecast, we reiterate here all our ranges for the year. Having said that, the event of last May led us to believe that we will deliver a credit portfolio growth around the bottom of the forecast range.

Regarding financial margin with clients, we believe that we will end the year between the bottom and mid point of the range. For cost of credit, we believe we will end the year around the top point of the range. For commission and fees and results from insurance operations, we now estimate that we will end the year around the middle of the range. And to finalize, non-interest expenses, we believe we will end the year between the middle and the best point of the range.

Just to finish on slide 22, you may see the invitation details of our annual APIMEC meeting, which will be held on September 26. We would like to bring forth the invitation for you all, and remember that the event will also be webcasted with simultaneous English translation.

That finishes our presentation, and now I'd like to poll in for questions and answers.

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session. Our first question comes from Mario Pierry, Bank of America Merrill Lynch.

Q - Mario Pierry {BIO 1505554 <GO>}

Hi. Good morning, everybody. Congratulations on the quarter. Let me ask you two questions, please. The first one is related to your ROE of your credit operations, that you showed on page 9. You're showing the ROE at 14.5%, significant improvements from a year ago. Your ROE now is in line with your cost of capital. I was wondering, as far as I remember, the target has always been to reach the cost of capital, but also wondering if you do think you could go above your cost of capital at least this year, given the expected improvements in provisions? So, that's question number one.

Question number two has to do with the big spike up in your wholesale coverage ratio to 715%, as you mentioned. It seems like you made some provisions in anticipation, but if you could give us a little bit more color, what sectors are of concern that led you to boost such coverage ratio? Thank you.

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

Thank you, Mario, for your questions. The first question you asked, whether the ROE on current operations could go above costs of capital, 14.5%, as a result of the expected improvement in credit quality, and my answer is yes, it could. I think modestly, because we expect this improvement in credit quality to be slow over time and not to be in a jump. And also, cost of credit could see some reduction maybe further due to the lower yields of the loans, in which we paid our evaluation of cost of credit. So, yeah, yes. I think it's possible that ROE and credit will be above cost of credit.

Now, as to our coverage ratio, maybe it's good here that I am at the risk of going a bit so much into the tale that explains the dynamics of this provision with this complementary allowance, which we make and which we have made. As the client sees the companies, we looked at many companies, and here, especially companies, in some way, related to the Lavashat (00:24:54) scandal, but not exclusively. So, many companies, I mean, that would face difficulties. I mean, EBITDAs were dropping, at the same time, interest rates are going up, exchange rate was devaluing. So, the relation net debt to EBITDA was increasing much more than what have been forecasted when we extended this credit.

As a result of that, we make anticipatory provisions for potential allowances for these companies, based on the expected loss method, which we use. And these provisions, they cancel to accumulate, how is the way that this coverage levels decreased? I even said in the last conference they are expected to decrease, and I was wrong there. The more the provisions decrease, they decrease in one or two ways. These are these companies, for which we made anticipatory provisions. The effect will be default, and when they do default, the provision is transferred from the potential provision to the regulatory provision or they improve to a point where the expected loss is reduced. They can be upgraded and the provisions can be reversed.

What happened in this quarter is that neither of these two things happened with both of the companies. They have neither defaulted nor improved to a point where the provisions could be reversed. And I think given our scenario now of a slow improvement in the economy in Brazil, that these trends may still continue for some time, that the companies are in this twilight zone. That's it. So, it's not impossible that the coverage ratio could even increase from the point where it is, because NPL may reduce. So, it's not because the provisions will increase, but because NPL nicely may reduce and so the coverage ratio could be decreased. I hope this answers your question.

Q - Mario Pierry {BIO 1505554 <GO>}

Yes. So, just to be clear, though, so this increase is primarily because you had more companies having problems or you see more companies having problems than before, and that led for you to reduce the risk rating on some of these companies, or the expected losses are now higher than you expected?

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

No. The main reason for the coverage ratio increase is the decrease in NPL, 90.

Q - Mario Pierry {BIO 1505554 <GO>}

So, it's just primarily that the NPL has come down, not necessarily the provisions went up. Okay. Very clear. Thank you very much.

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

The provisions, as they should, they went from 17.1% to 17.2%. The potential provision.

Q - Mario Pierry {BIO 1505554 <GO>}

Thank you.

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

Although this is not (00:28:07). Okay.

Operator

The next question comes from Eduardo Rosman, Banco BTG Pactual.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Hi. Good morning, everyone. I have two questions. The first one is kind of a follow up on Mario's question, it's on your cost of equity. I remember the last year, when Mr. Setubal presented the fourth quarter 2016 results, he mentioned that cost of equity above 18% for Itaú, which is very high, right? Of course that, given all the improvements since then, cost of equity has been improving the last quarter, if I'm not wrong. You mentioned cost of equity of 14.5%, I think, but this was before May, right? So, I wanted to know if cost of equity increased since then or not, and what are the drivers that could bring this cost of equity down the next 12 months, right? So, this would be question number one.

Question number two, would be on trying to understand a little bit how do you see in all your results next year, right? Because we still have very weak lending activity. It seems that given all the political uncertainty, we're not going to see any big acceleration until presidential elections, and the fact that the Selic rate will also be a lot lower next year. It seems the NII will barely grow, as it grows at its own rate, and when we look to your other P&L lines, you are already delivering very good figures in most of them, right? Expenses are growing only 1% in nominal terms, cost of credit coming down, that's why your pre tax is going to go up probably more than 20% this year, right? So, of course, this is very good, but it also creates a tough base of comparison for next year. So, my question is what to expect for next year, and if you guys think that it's possible to grow above inflation or any fluctuate? That's it. Thank you.

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

Thank you, Rosman, for your questions. The first one, concerning cost of equity, yes, our cost of equity was 14.5% and it remains in this level in the event that we have not outages. There was a brief spike in the formulas, which we follow, which are basically based on risk premium, but they already improved back and we did our track into cost of equity, not to escape the range, in which we positioned it, and we don't like to change the cost of equity very often. So, we expect for it to get out of the band, it is not, and the band has reduced again, so it remains at 14.5%.

As to 2018 results, we are not making any forecast or any guidance on the 2018 results. What can be said is that, I mean, we will keep our focus on cost control, on improving efficiency, and of course, we are ready to grow assets as soon as demand picks up. I think it's a fair assumption that if the assets do not increase, if loans do not increase, it will be difficult to grow results next year. But let's see how the demand for loans behaves going forward this year and the beginning of the next.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Perfect. Just a follow up on the cost of equity question, do you think it's possible to forecast that to come down before presidential elections next year or no? Until then, given all the uncertainty, probably they're not going to see any changes.

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

I don't see cost of equity coming down very significantly in Brazil. When we compare the cost of equity we use in Brazil with the cost of equity that European and American banks use for them, around 9% or 10%, it appears to us that there's difference of 4 to 5 points, at least fairly represents weaknesses of risk in the different markets. Having said that, I mean it could go down marginally, yes. I think it could go down marginally the next quarters.

Q - Eduardo Rosman {BIO 16314825 <GO>}

Okay. Thank you very much.

Operator

The next question comes from Jörg Friedemann, Citi.

Q - Jörg Friedemann

Thank you very much for taking my questions. So, I'm also having two questions today. Just the first point on the NPL progression, I'd like to understand how do you see the growth for anything else going forward? I am particularly referring here to the NPL creation in the retail book that iterated a bit and also the increase in re-negotiation. So, just wondering if putting all together these trends together with what you just commented on the corporate's book, you believe that really the worst is already behind of us?

And my second question is related to the process for NII, net interest margin. You mentioned during your presentation that you had at least three potential impacts that are affecting NII. Of course, the most important one, credit growth, but also you referred to a structured operations that helped the NII this quarter plus the mix, the shift.

So, I'm wondering if you could comment on your prospects for NII with the normalization of those conditions and your guidance implies as like the cut-off in credits volumes. So, if you also believe that the worst is behind in terms of NII, or if this pressure of lower rates will not be cutting credit volumes? Thank you very much.

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

Thank you, Jörg. First, on NPL, harder to report, the NPL creation in the retail book in this quarter, we attribute it to seasonality. It was second quarter seasonality. Here, we think that the trend is not stable to a small reduction in the NPL line in this book. The question you asked me, whether, for corporate credit, if I think that the worst is already behind us, yes. I mean, this is my impression.

And as to the re-negotiations you mentioned, I think they are a natural consequence of debt dynamics I have explained before. So, I mean, when this company have had their debt augmented today, it averages and one day have difficulties in meeting their commitments in the agreed dates. And it's natural that we give them some room for breathing and to recuperate, and this is done through re-negotiation of credits. Following the re-negotiation, as I said before, one of two things may happen. Either they default because they cannot recuperate or they improve their conditions, and then we are able to reverse the credits. In both cases, the provision flows out of the component carrier allowance, of the potential allowance.

Concerning NII, I think this year is very much, what I said on the slide, going forward, I think that one could expect here that a drop in the Selic rate will cause some pressure on our liability side, which are important part of NII. Of course, I mean if you manage to have a steady growth, we can compensate for this. So, I think this is all reflected in the guidance I have just given you, concerning NII.

Q - Jörg Friedemann

Okay. That's perfect. Thank you.

Operator

The next question comes from Philip Finch, UBS.

Q - Philip J. Finch {BIO 3252809 <GO>}

Good morning, Mr. Bracher. Thank you for your presentation. A couple of questions from my side, please. First of all, regarding loan growth, really, can you shed some color in terms of what you're seeing in terms of loan origination, and which segments do you think will most likely rebound? So, we saw in the 2Q numbers, I think on slide 10, that sequentially credit card growth was slightly positive, all the other segments are negative. Going forward, which segments should we assume to recover first and maybe an explanation why?

And linked to this first question, do you have any visibility in terms of the sensitivity to the economic recovery in terms of product demands of GDP growth? Would it recover sharply next year to 2% or more? What does that mean for credit demand? Is there a lag? Does it come back quicker? So, any color on that front would be very helpful.

Second question is regarding asset quality, and specifically slide 15 in your presentation, so whether it's the top chart or the bottom chart, you're seeing the levels of provision to loans or cost of credit in Q2 approaching or at historical low levels or trough levels. So, the question is going forward, , how much more to go for it to come down, given that you could argue that the loan composition of your book is so much more defensive than it had been previously? Thank you.

(00:39:38 – 00:39:49)

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

Well, Philip, thanks for your question. I will give you a very generic answer on your first question, because it's not very clear, the item in which segments could first respond to an economic recovery and increase demand in loans. But what we see is that working capital needs would come before investment needs. So, generally, this could mean the reaction coming first in individuals than in corporate, more strategically for working capital. Although, if we really experience a more robust recovery in the economy, I think corporate loans have more potential to grow going forward, not in the first moment, but going forward.

Then your question on asset quality on slide 15, how much more room for improvement there is. I think there is still room for improvement. We have relatively small loan book now, which was built conservatively, and which has a high level of provisions. So, when we look forward in the corporate segment, we have listed what or not basis, name by name basis, not only statistical. We have the impression that there is still some room for improvement, not too much, but still some room for improvement.

Q - Philip J. Finch {BIO 3252809 <GO>}

Great. Thank you very much.

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

You're welcome.

Operator

The next question comes from Tito LaBarta, Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi. Good morning, Candido. Thanks for the call. A couple of questions also. I guess, first on your financial margin with clients, looking at slide 11, you can say it's probably held up pretty well, given the reduction in interest rates, the lower rates on credit cards. I know the lack of competition has kept spreads somewhat high. But if we think, once the rate has finished coming down maybe by year end and maybe as growth starts to come back, how much do you think this financial margin with clients can come down from this 10.3%? I know you don't have a long history given the incorporation of CorpBanca, but just want to get maybe a little sensitivity of that line to the lower Selic, in a more normalized environment with better growth. Do you see it falling below 10%? Just any color you can give on that would be very helpful.

And my second question, you started the call talking a lot about your digital strategy. A lot of Internet and mobile transactions have picked up quite a bit. What does that mean for expense growth over the next few years? Do you think it will continue to grow in line with inflation, maybe some additional investments that could push it above that, or maybe some benefits and improvements in efficiencies because of that? If you could maybe give some color on how you see that's going to impact expense growth for the next couple of years will be helpful. Thank you.

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

Thank you, Tito. So, on your first question, the trend in financial margin is, as I mentioned, Selic rates will put some pressure, the reduction in the credit rate will put some pressure on this margin, and for it to grow, we will need a growth in the loan portfolio. Having said that, we look more here is the financial margin with client adjusted by risk, which has been growing. And here, that we'll be able to keep this margin stable over time.

Your second question, how much our investment in technology development may affect our total level of cost investment in the bank. And here, I don't have a precise answer for you. But we must remember that technology has double effect when it relates to cost. It increases cost because it requires a lot of investment and we make investments, we want to increase the rate that which we are able to produce our apps, and as we fact these, we're investing a lot in adapting our way of production here in having the community sales, the agile sales working. So, this all represents investment.

On the other hand, technology presents great possibilities of cost reduction, like cloud and computing, for instance, is a great example of that. So, it seems that all things added, one should at least compensate the other and we shall be able to keep a very strong hand on cost growth.

Q - Tito LaBarta {BIO 20837559 <GO>}

Thanks, Candido. Sorry, go ahead.

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

No. I was just going to compliment that the low inflation environment of cost also helps.

Q - Tito LaBarta {BIO 20837559 <GO>}

Right. Makes sense. Thanks, Candido. That's helpful. Maybe just a one follow up on the first answer. You mentioned looking at financial margin adjusted for risk, which is 7.3%, has come up from 5.4% in the first quarter of 2016. When you say that it can remain stable, you mean around this 7.3% more or less? Is that what you're thinking in terms of the stability?

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

I see, that's on average.

Q - Tito LaBarta {BIO 20837559 <GO>}

Right.

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

We can have this margin around, but on average. I mean, of course, it will float around.

Q - Tito LaBarta {BIO 20837559 <GO>}

Sure. Okay. No, but thanks. That's very helpful.

Operator

Our next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Thank you. Hi, Candido, Caio, Kopel and team. Thank you very much for taking the call. Actually, I have two questions. My first one is regarding the asset quality trend, which at least last year was a bit surprisingly good on the early delinquencies, specifically on the 15 to 90 on the SMEs, which is supposed to be a bit less volatile, I guess, than the large corporates and still it came down substantially. So, my question, I guess, on this part of asset quality, like if you could explain a little bit more what happened on the SMEs, if it is just you being more cautious, is the market getting better? And what kind of coverage ratio do you feel comfortable working, because I understand that you explained that your coverage went up because new NPL formation came down, but you could have provision less too and kept the coverage flat. So, I guess my question is like what's kind of reasonable for the year end coverage ratio?

And my second question has to do a little bit with the NII. And we've been a bit more concerned of the NII. We're looking at the loan book shrinking 3% this year. If we use your guidance, it basically implies in 2018 starting with loan book at the same level we started 2017, and then we have all the additional headwinds, right? Selic coming down, spreads coming down, and so on. So, just on the top line and then we look at rumored estimates and it bakes in, like the market is baking in either flat or slightly growing NII. My question is more directionally, if you believe it's reasonable to assume top line growing in 2018? And that's it. Thank you.

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

Domingos, thanks for your questions. So, first, asset quality trends concerning 15 to 90 days SMEs. Here, all I can tell you is that in our experience is that the most recent waves of credit we have made, the vintages, the most recent vintages of credits are showing better results. So, I think that we still can enjoy this trend for some time in the SME.

Then you asked me about what my guidance would be for the year end coverage ratio, and I don't know. Here, really, it depends on so many invariables. I thought last quarter that the general trend was going to decrease, because of course, 231% was already a very high level and you think that intent to robust and this coverage ratio should reduce. But since there is a possibility, given the very slow growth of the economy here, that these credits for which we have the complementary allowance, that they neither default nor improve to a point of being able to reverse, and that at the same time, NPL may reduce. So, really, it could go up or down here in this short period of time.

If you ask me about what would my forecast be to the end of 2018, then I would say that surely, it should be lower, significantly lower than it is today. But for the end of this year, I'm not comfortable in making any forecast right now.

Your question about NII, I think you're right. There are some headwinds on NII. The Selic rate, especially the main headwind. We also had the credit card, the change in credit card rules and things like this. My impression here is that in order for NII to grow next year, it will be necessary growth in assets, which right now, is higher than we can foresee.

Q - Domingos Falavina {BIO 16313407 <GO>}

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. Just going back to NII, you have, I think, in your release that there were structural operation with a corporate client. I would like to have an idea of how relevant it was for the NII, given that you highlighted this?

And second, despite the lower interest rate, in fact the results of working capital grew Q-on-Q, mostly because of a larger base. I would like to understand a little bit this base. I saw that there were some change for example in the capital that are located in the insurance company. It seems that it maybe some of it goes to the line, because the result of all of these is that when you restate your guidance for the NII for the year, we are getting a little hard to reach it because, basically the NII needs to be almost flat for the second half, and given the lower interest rate, it seems a little hard. So, we would like to understand this a little better.

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

Okay. Thanks, Rafael. I'm not quite sure I got your second question exactly, but I will try to answer it. Concerning the NII, there's a structure operation with corporate clients. It was around BRL 100 million, the result. That's the impact on NII. And yes, you're right. We expect our NII to be relatively stable throughout the year now. It's been balancing positive and negative effects, which we see ahead. It seems that the most probable scenario for us is for it to remain on this level.

Q - Rafael Frade {BIO 16621076 <GO>}

Right. Thanks, Candido. Just a follow up on this is, just that I'm seeing more negative than the positives that are basically the lower interest rate and the impact on credit card. Which ones would be the deposit that you think that could compensate for that?

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

It's important that we also know that and I think in credit cards, the main impact was already in this quarter. We expect the situation now to stabilize. It could even improve a bit as the installment credits and installment portfolio should grow a bit more of that.

Q - Rafael Frade {BIO 16621076 <GO>}

All right. That's perfect. Thank you.

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

You're welcome.

Operator

Our next question comes from Carlos Macedo, Goldman Sachs.

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

Thanks. Good morning, gentlemen. Thanks for taking questions. I actually have a couple of questions. First question is related to loan growth, because you said you're going to lend when the demand comes looking to the second half of the year. Your guidance implies an annualized growth rate of between 5% and 12%, which is something that the market hasn't done for a while, and then you haven't done for a while. Where do you think the growth will come in the second half of the year to get to the bottom end of your guidance, which would imply 5% annualized?

Second question, going back to capital, 14.5%, that doesn't even consider the eight bidding regs you have in excess of reserves that essentially is capital on the other side of the book. Obviously, what you've been doing, even with XP, you haven't really made a dent into that capital, and it's going to continue to build as long as risk-weighted assets don't grow, buybacks aren't making a dent. Is there a time where you were considered to make a payment of complementary dividends, something large in order to get capital back to more manageable or lower position?

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

Thanks, Carlos, for your questions. Concerning loan growth, we are already seeing originations growing. Not yet. Even in this quarter, we're already enough to offset the amortizations. We expect this trend to continue and to allow us to reach the bottom part of our guidance. We see this, I mean, in all sectors, more or less widespread, and I think we have a good chance of getting there.

Concerning our capital, you're right. We keep on accumulating capital. Of course, our preferred way to deploy this capital would be through our growth (55:34). It's not coming significantly, possibly not coming in the near future. And then we will have to consider alternatives, as the one you mentioned, also with dividend increase.

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

But is this, I'm sorry, just a follow up. You already raised the payout. That helps, but that just basically stems the flow. It doesn't lower it from the current level. Is there a deadline or a timetable for you to think about that, given where risk-weighted assets or the way that risk-weighted assets are growing, or is it something that will be decided when the conditions present themselves?

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

Well, we are permanently thinking about this effort, and we are evaluating this cautiously. And I think if it becomes the conclusion, that it's a structural situation that we cannot alter with the natural evolution of our business, even with acquisitions, we will have to decide something based on dividends. Performance, we should take it just on from truth, though.

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

Okay. Thanks. Thanks for the answers.

Operator

The next question comes from Eduardo Nishio, Banco Plural.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Hi. Good morning. Thank you for taking my question. I have two questions. Well, first one is regarding requiring units, ones have been running below market average. I was wondering, what's the full acquiring time, what strategy rating, if you plan to grow a bit more faster than what you have done so far?

And my second question is a bit more in the long term. Looking to your forecast, in your macro forecast here, you're seeing interest rates going to 7%, GDP is roughly 3% in a normalized environment. How do you see that environment, your normalized growth in loans and how you see that recovering over time if you see a spike before, and then have come down later or will be a gradual growth in loan growth over time? Thank you.

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

Thank you, Eduardo.

Q - Eduardo Nishio {BIO 15333200 <GO>}

I'm sorry. Yeah. Sorry. And perhaps, if you can also elaborate a little bit on cost and how the bank's moving toward that direction, cost of technology and perhaps cost of risk, and how you see this play around in a more normalized environment? Thank you.

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

Well, thanks, Eduardo, for your questions. They basically cover everything, but let me start by hedge. The situation here in hedge is not yet what, where we can speak about going the number hedge. We are still facing an adverse competitive scenario. We started a couple of years ago with the opening of the market, and since then, what we have seen is newcomers, also with new technologies gaining market share in this market, and we consequently are losing some market share.

Our present intensity reviewing our commercial structure and our commercial practices, engaging in this acquiring business aiming at first stabilizing this negative trend. And I think this is what our goal is right now and where most of our efforts are placed.

The second question concerning our economic forecast, we see really some improvement in economic growth for next year, which economists put is at 2.8, when we project our business, we do not use such a large figure. But I think the economic growth would be gradual, and if this is just a guessing exercise, it could be gradual until the result of the elections. And then, when we have the result of the elections, depending on how the market sees the new president, we could have a spike in growth.

Finally, you asked about costs, technology and cost of risk. Cost of risk, as I mentioned, we see improving in the second half of this year and next year, as credit quality has basically improved and the economy is recovering. It is to be expected that this positive trend we are seeing in credit will endure.

On technology, I believe I already answered it. Here, we are investing sizeably on technology, aiming at giving our clients a much better digital customer experience, and these are our big investments. We must also say that we have a very high regulatory demand for our technology services, as every bank in this market has.

In terms of cost, there's nothing much new. We keep a tight grip on cost in the bank and expect to administer them close or below inflation rates.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Okay. Thank you so much.

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

Thank you.

Operator

The next question comes from Natalia Corfield, JPMorgan.

Q - Natalia D. Corfield {BIO 6421991 <GO>}

Good morning, everybody. So, my question is a little bit going back to your regulatory taxes and also involving your subordinated debt. As was mentioned, you're building capital right now, and your subordinated debt is losing capital treatment due to Basel III rules. Specifically, the Itaú 20s, I believe, probably it's counting very little now for capital. So, my question is do you have any strategy with regards to the subordinated debt? I know all of them are trading above par right now. Wouldn't it make sense to replace some of this debt? That's basically my question.

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

Thanks, Natalia, for your question. I think that if we had a lower level of capitalization, then we could consider replacing and issuing some new subordinated debt. At 13.5 of Forex to Tier 1, it really makes no sense for us right now to consider this high cost of risk.

Q - Natalia D. Corfield {BIO 6421991 <GO>}

No. For sure. That's clear. But for instance, you have, a portion of your subordinated debt is losing capital treatment right now. So, would it make sense for you to keep this, to have this debt still even like they have higher coupons, and they are not helping you in terms of capital as much as they used to do like few years ago?

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

Yes. You're right in mentioning that this subordinated debt is entering in the phase when it loses its capital effect. But so far, it still has some capital effect. So, we are not (01:04:50).

Q - Natalia D. Corfield {BIO 6421991 <GO>}

Okay. Thank you.

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

Well.

Operator

The next question comes from Olavo Arthuzo, Santander.

Q - Olavo Arthuzo {BIO 19964942 <GO>}

Hi, everyone. Thank you for taking my question. I just wanted to go back and clarify some points related to the excess of capital the bank has in this quarter, it increases once again. And talking about expansion in Latin America, we used to hear from you that the focus was the integration of the operations Itaú CorpBanca, but today, you're looking to all the adjustments that were made throughout 2016, and the expectations that those operations were higher and more normal returns going forward. So, do you see some room for more M&As or investments, but outside of Brazil?

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

Thanks, Olavo, for your question. So, concerning Itaú CorpBanca, we have merged a year ago, a bit more than a year and two months ago. We still see a lot of work ahead of us in the integration of this operation, especially if we move to Colombia now. So, we are not, in this moment, contemplating the possibility of breaking other acquisitions any more. Of course, , there's always something very interesting up here in the market, which gives us a significant market share and so on. We will consider (01:06:40), so far.

Q - Olavo Arthuzo {BIO 19964942 <GO>}

Okay.

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

Okay.

Operator

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

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

Thanks very much. Thank you all for participating in the call. Thanks for your very good questions, and I hope my answers are adequate. I would like now to pass the floor to Marcelo Kopel to make some remarks.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. Just to say a few words. We have Marcelo Barreto here with us today, and he's transitioning from the IR role into Treasury, a very important function at Treasury. It's part of his career development. And I would like to take the opportunity to thank him for all the work he's been doing for IR. It's been a pleasure to work with him, and I'm sure you guys share the same view. So, thanks for him being here. And he would be making some changes and announcing them shortly in the IR team.

So, thanks, everyone, and look forward to seeing you.

Operator

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