Q3 2016 Earnings Call

Company Participants

- Eduardo Mazzilli de Vassimon, Executive Vice President, Chief Financial Officer and Chief Risk Officer
- Marcelo Kopel, Investor Relations Officer

Other Participants

- Carlos G. Macedo, Analyst
- Carlos Gomez-Lopez, Analyst
- Domingos Falavina, Analyst
- Jorge Kuri, Analyst
- Marcelo Telles, Analyst
- Mario Pierry, Analyst
- Nicolas Riva, Analyst
- Tito LaBarta, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding Conference Call to discuss 2016 Third Quarter Result. 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 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 November 7th by phone on (55 11) 3193-1012 or 2820-4012, access code 5591183#.

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. Eduardo Vassimon, Executive Vice President, CFO, Chief Financial Officer and CRO, Chief Risk Officer; and Mr. Marcelo Kopel, IRO, Investor Relations Officer. First, Mr. Eduardo Vassimon will comment on 2016 third quarter results. Afterwards, management will be available for a question-and-answer session.

It's now my pleasure to turn the call over to Mr. Eduardo Vassimon.

Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning. Good afternoon. We will start our presentation at page three with the highlights of the period. We had R$5.6 billion recurring net income. We consider these results to be robust particularly taking into consideration the still challenging economic environment.

We are seeing more positive perspectives for NPLs. Talking about the credit quality, we had 3.9% NPL 90-day. This is higher than what we presented in the previous quarter, but it was affected by one specific economic group that is already for sometime 100% provisioned for and it's a private company of the oil sector.

If we discounted this specific effect (03:10), we would have had a stable NPL 90 day at 3.6%. In Brazil NPL 90-day was 4.8% and here again excluding this specific economic group, we would have had 4.4%, slightly lower than the number we had in the second quarter.

Moving to page 4, we have given a recurring return on equity/recurring return on assets. Return on equity close to 20%, recurring return on assets at 1.6% the same level of the previous quarter.

Moving to page 5, we have the P&L. Here I'd like to highlight some specific points. We had a positive growth of financial margin with clients, 6.9%. This is positively impacted by the fact that in the previous quarter, we had an impairment of around R$540 million, which we disclosed extensively in the previous quarter. But even discounting these would have had a low 2% growth in this line.

Financial margin with the market, we had a strong R$1.7 billion, this quarter 15% higher than what we had in the second quarter. Commissions and fees for the 12 months 7.3% and I'd like to call your attention to the result from loan losses, a reduction of 2.5% in this quarter, although in 12 months, we had over 20% growth, 24.5%.

Non-interest expenses showed a substantial increase at 8.4% but here we had some extraordinary events. When we exclude those events, we would have had the basically a flat number in terms of expenses, when compared to the previous quarter.

Those extraordinary events are basically two elements. The first is methodology enhancements for calculating labor claims, this amounts to R$687 million. And the other element is our lump-sum bonus we paid to employees totaling R$275 million. This is part of the agreement reached with the Union.

So, part of the agreement was an increase of 8%, and this lump-sum of the R$3,500 per employee. So, both these lump-sum bonus and this adjustment in the labor claim are events that although accounted as recurrent results are extraordinary in the sense that we do not expect them to be repeated in the next quarter. So, for projecting next quarters, in our view, you should exclude those two elements.

Moving to page 7, we have the breakdown of our P&L between credit and trading on one side and insurance and services on the other side. We had results in the third quarter that are quite similar to the ones we've had in the second quarter. And insurance and services, that's the more stable part of our P&L, accounts for approximately 60% of our bottom-line.

Moving to page 8, where we have the credit portfolio,. I'd like to call your attention to the growth of two lines. First one is credit card loans. We had a 2.4% growth in this quarter, recovering partially the contraction that we saw in the cost in this particular segment.

And the other one is mortgage loans, keeping basically the same behavior of previous quarter in line with our strategy of moving to less risky experiments (08:10) with a strong 2.9% growth in this quarter. Altogether, given the economic environment, we had a small reduction, nominal reduction of 0.6% in this quarter compared to the second quarter.

In the lower part of page 8, we have more information here no our Latin America portfolio. On the left side we see a growth of 2.8% for individuals and 0.6% for companies. And on the right side, we see the breakdown by country where you can verify a clear concentration of our LatAm portfolio in Chile and Colombia together represents approximately 85% of our LatAm portfolio.

Moving to page 9, we have the loan portfolio mix. When we see here Brazil-only, we continue to see a contraction in the vehicle finance portfolio, given among other things a reduction in the market itself of car sales.

Credit cards, as I mentioned, showing some recovery. And both mortgage loan and payroll loans keeping the same trend of previous quarter in line again with our strategy of moving to less risky portfolios.

In the upper part of this page 9. We see the consolidated loan portfolio including Latin America, which represents already close to 27% of our loan portfolio, but considering that we have in the biggest part of the portfolio, that's Chile only 33% economic interest, this figure would be 12.5% as indicated here in yellow.

Moving to page 10, I'm going to talk about financial margin, we see a good evolution in financial margin in both the regular, let's say, the financial margin and also the risk adjusted financial margin both presenting a good evolution.

Moving to page 11, we had a strong market result, financial margin market at R$1.7 billion, basically flat in Latin America and improvements in Brazil and when we look ahead I think it's reasonable to expect for the next quarter an amount that is compatible with the average of the previous 12 months, of course considering that this is naturally aligned that has more volatility.

Moving to page 12 and starting to talk about credit quality and we have here the 90-day NPL ratio, when we exclude in this particular case, as I mentioned in the beginning of the presentation, of this economic group that's provided 100% reduction (11:47) would have had a flat number at 3.6% for the total. In Brazil, a small reduction (11:58) the reduction of this particular group from 4.5% to 4.4% and a slight increase in Latin America to 1.2% from 1.1%.

In the lower part of this page 12, we have Brazil with a breakdown by the main segments. And here, I think we have a quite positive information with the reduction of NPL for individuals. So for the second quarter in our group (12:37) we had a reduction now at 5.7%. So, we believe that this shows that this segment is performing quite well, and most probably we had seen the peak of NPL for individuals in the first quarter of this year.

For large companies, for corporate, when we exclude this oil company, we would have had a reduction from 1.6% to 1.4%. And as to SMEs, we still have a more challenging environment, still going up, the NPL, although at lower rating.

Let me move to page 13 to see the short-term 15-day to 90-day NPL ratio. We see good behavior of SMEs. So, going down 50 basis points from 4.3% to 3.8%. What encourages us to say that we believe that this segment should also show more concrete signs of stabilization in the next few quarters.

Individuals flat at 4.2%, Latin America also flat at 2.1%. For corporate Brazil, this reduction reflects the fact that this particular oil company moved from 15-day to 90-day to over 90-day NPL, so, it's more reasonable to see in our opinion this is flat around 1.5% in the three last quarters.

Moving to page 14 and showing the NPL ratio, excluding fully provisioned credits. We have in Brazil, individuals with a stable (14:55). We had a small reduction from 2.3% to 2.2%, and also a reduction in companies, again, excluding the fully provisioned credits from 1.1% to 0.9%, so more compatible with the recent standard.

In the lower part of this page 14, we see the NPL creation and we have here, when we deduct this particular oil company case, a reduction both in companies in wholesale and retail, retail for the third consecutive quarter we have a nominal reduction of NPL creation. So again compatible scenario of improvement for this particular line of business.

And for wholesale, we also see a reduction when we exclude this oil company. When you see the ratio with the NPL creation and loan portfolio for wholesale, only 0.5% a year reduction from previous quarter, always considering the exclusion of the oil companies. And a stable ratio for NPL creation to a loan portfolio for repay you (16:35) at 1.9%, very stable with several previous quarters.

Moving to page 15 and talking about renegotiated loan portfolio. We had some increase from R$24.1 billion to R$25.3 billion, this increase is compatible to the economic environment where we see still challenging credit conditions.

But most of the increase is related to operations, transactions that are not (17:19) So, it's in the bottom of this figure, from R$5.6 billion to R$6.2 billion in September. So showing what we believe to be a more pre-emptive approach to renegotiation.

In the lower part of this page 15, we see the 90-day NPL coverage, here excluding this oil company case would be at 188%, so a solid figure compared to both historical standard for 90-day NPL in the range – in the previous three quarters in the range of between 20% and 22%.

Again here excluding this oil company, when we see the nominal figures we had in June, R$5 billion, we have a huge increase of R$1.7 billion, and this is almost 100% related to this oil company. If you exclude this oil company, this figure, as indicated during the period, would have been at R$5.1 billion, so a small increase.

Moving to page 16, we have a provision for loan losses by segment. We had a good reduction in retail banking segment. Here by the way, we believe that in this cycle, the peak of retail (19:03) in terms of provisions was in the last quarter of last year at R$4.6 billion. And for the bank as a whole, we are confident that in this cycle the peak was in the first quarter at R$7.8 billion.

Moving to page 17. We have here the coverage ratio for our 90-day NPLs. In this total, the yellow figure, we have 204% that's a very robust number in our view. And we have also recalculated this deal excluding this particular oil company case, this is the dotted orange line, we would beat them at 214%, the highest figure in two years. So we consider that we have a quite comfortable level of coverage for NPLs.

Moving to page 18, we have the breakdown of our allowance for loan losses by type of risk. In the bottom, what we call overdue is the minimum required by Brazilian Central Bank. The intermediate block, that you call aggravated is related to transactions that are overdue where we have more provisions than the minimal required by Central Bank and also provisions related to renegotiation.

And finally the upper part is what we call potential where we do not have anything overdue or renegotiated, but according to our modules and our judgment, we have provisions related to expected losses. So, all together, we had a small increase from R$38.5 billion to R$39.1 billion of allowance for loan losses.

Moving to page 19, we have here condition (21:40) for provisions and NPL creation by segment. Therefore part for retail, we continue to be around 100%. So in some quarters, it was slightly above in some quarters as is the case for the third is slightly below. But in storage perspective, around 100%.

For wholesale banking in Brazil, we are at 79% including everything. If we exclude this particular oil case, that again 100% provision would have been at 256%. And excluding this very same case, the total would be at 120%.

Moving to page 20 and talking about commissions and fees and insurance results. We had a flat figure for this quarter, when compared to the second one at R$7.8 billion and a 7.3% growth in 12 months. This figure is negatively affected by the credit operations and guarantees provided line, that of course is pretty much related to the economic environment and our credit policy. And in this particular line, we show the nominal reduction of 0.7% in 12 months.

Moving to page 21 and talking about the non-interest expenses. Again here, we show huge increase of 8.4%. But excluding extraordinary events, that again is not expected to be repeated, we'd have had a flat figure. So nominal expenses in the third quarter, very similar to the second quarter. We have again excluded this, because we believe that to forecast, to project expenses in the next quarter, this is something that we would not see in the future.

In the lower part of this page 21 on the right side. Just to highlight the fact in line with our strategy of getting more and more digital, we're expanding our digital branch network.

Moving to page 22. Here very quickly, just to highlight the fact that efficiency ratio without considering extraordinary items, that I referred to would have been 44.9%, so below this 46.7%, that we observed in the previous quarter.

Moving to page 23. Talking about capital. We have highlighted here on the bottom part of this page, the CET I fully loaded according to Basel rules. So anticipating this schedule, we are today at 14.1%, and discounting both the Citibank and Itaú BMG transactions that were announcing, we would have been at 13.6%. Both those transaction are still dependent on regulatory approval. So 13.6% after those transaction still very comfortable level and putting us in a very comfortable position for taking advantage of potential new credit cycle.

On page 24, talking about our forecast. We have reaffirmed all the lines of this forecast. So we believe that all lines will be within the range indicated in this stage. For our credit portfolio, we believe that it will be close to the bottom of this range.

For our financial margins with clients, we believe that the final figure will be between the midpoint and the lower point of the range. Provisions for our loan losses net of recovery will be in our view very close to the bottom point of this range. Commissions and fees should also be close to the bottom, and non-interest expenses, despite the extraordinary items would be still within the range although close to the part of this range.

On page 25, we give some information on Citibank's and Itaú BMG transactions that were announced, both align with our strategy of reinforcing our activity in retail in the case of Citi, and in the payroll financing companies (27:20) of BMG, both again subject to some closing conditions and approvals from regulators particularly, Brazilian Central Bank and the Brazilian (27:35).

Finally, on page 26, we invite you all to participate in our Annual Meeting, APIMEC Meeting that will take place on November 17 in São Paulo.

To conclude again, we believe that this was a robust quarter with positive perspectives for NPLs, expenses were under control and resilient margin. So thank you and now Marcelo Kopel and myself will be available for possible questions that you have. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Domingos Falavina with JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Hi. Good morning, Vassimon and Kopel and everyone on the team. First, congratulations on the strong set of figures. I have two questions. The first one regards to provisions, we noticed a significant improvement in new NPL formation I think you mentioned in fact three consecutive quarters of decrease. And if we repeat the last quarter or second quarter, we would most likely be below the guidance.

So my question is, do you have room or do you have baked in, in the forecast any increase in additional provisions or the R$23 billion to $26 billion does not incorporate any kind of rebuilding of additional provision? And then I'll go to the second question.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Thank you, Domingos. As to the provisions given what we have seen in the previous month, we are I'd say more confident in relation to provisions related to individuals. While for our companies, I think we are still in the process of stabilizing the level, but is less clear than for individuals.

So we still might see some volatility in the provisions particularly for companies. And as I mentioned during the call, seeing from today our best expectation is to be very, very close to the bottom of the guidelines, the forecast that you mentioned. We do not describe to be slightly below – it could be slightly above, slightly below it, but again we are more confident for individuals.

Q - Domingos Falavina {BIO 16313407 <GO>}

Okay. No, perfect. The second question is more on the NII and on SELIC. Itaú hedges its loan book and some peers don't and it seems like a very anticipated reference decrease in Brazil and it feels a little contra-logical to me that one bank could benefit while the other wouldn't. So in this sense my question is, how can you benefit from anticipated

SELIC decrease on the NII, can't you get that through trading gains or potentially some other line that we are not seeing?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Naturally we, in the management of our total book, we do consider economic scenarios and we tend to anticipate movements when we consider appropriate in the interest rates.

And we have done so to some extent recently, so that we can smooth the effect of reduction of interest rate. And also reduction interest rate of course normally occurs and we believe this is the case now, in a scenario, where we've seen improvements in the economic environment as a whole. So, in a scenario, where we would see more demand for the credits and reduction in NPLs. So, there is one positive sign, one positive aspect that is this improvement in the whole environment in the economic conditions.

Q - Domingos Falavina {BIO 16313407 <GO>}

I see. Perfect. Thank you very much. Congratulations again.

Operator

Our next question comes from Carlos Macedo with Goldman Sachs.

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

Thanks. Good morning, Vassimon and Kopel. Guys, thanks for taking questions. Main question here goes back to the capital. I mean, I've been asking this question I think pretty much now for three or four straight conference calls. You are accumulating 30 basis points to 40 basis points a quarter, and your fully loaded, fully mitigated Tier 1 ratio, 14.6% now include the tax credit, that's in the year and half if you keep the same trend in the asset growth, you're going to be well over 16%, and that's not efficient, right. What's the plan here? I mean, you're talking about growth coming back and at least seeing some growth, but at the same time, we're talking about maybe mid-single digits loan growth in 2017 maybe little bit stronger in 2018, that's not really going to make a dent.

You haven't really bought back any shares this year. You don't talk about increasing the payout, the acquisitions that you made were strategically important for your presence in Brazil, don't really – haven't really made a dent into that big capital level that you have.

So is it going to be acquisitions, is it going to be more buybacks, is it going to be a higher payout. How are you going to turn this around because 16.5%, I don't think many banks in the world can say that they have that and I don't think you feel comfortable with it. I remember Roberto talking at the beginning of the year that you guys want to run the bank at 12% to 12.5%. Could you give us some light as to what the current thinking is and more importantly, the time table for implementing that thinking?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning, Carlos. Yes we – as Roberto mentioned previously, we believe that 12% to 12.5% would be a reasonable level of capital in a normal, more stable condition. I think we are getting there, we're still in a not so stable economic environment and we don't see us reaching 16.5% with no action. We expect some growth starting next year and some pick-up in credit growth in 2018.

We have made those two transactions, small but together consumed 0.5%. And we will be following a possible (34:55) for acquisition, particularly outside Brazil. Of course we are in the short-term more focused on consolidating the CorpBanca deal, but if there is a good opportunity and the right timing, we'd consider expanding our presence in Latin America.

If all this is not enough, we would technically consider being more aggressive in buyback shares. And we will do this, I would say, during the next year, we will probably have a more clear picture in terms of the demand for credit, in terms of the whole economic environment, and we are not going to be sitting and just seeing the capital accumulating to 16% or 17% level.

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

Okay. Thanks, Vassimon. And just I think the most you've bought back in any given quarter has been R$1.2 billion. And again, you're accumulating R$4 billion of capital every quarter, it doesn't – again buybacks are only a part of the answer, right. Is there no chance that you raise the dividend payout even if temporarily?

A - Marcelo Kopel {BIO 16986304 <GO>}

Carlos, this is Kopel. I think what you should – the answer is, it would be a combination of things, because just one thing will not address the accumulation at all. So, it will be a combination of things, and if special dividends or temporary increase in payout is needed to address that, it could be used. But don't see one option excluding the other one. They should be probably used or they will be happening at the same time.

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

Okay. Just as a follow-up to that, because it's just capital sitting on the other side of the balance sheet. The excess reserves are now at R$10.4 billion. You're talking about NPLs improving, the cycle turning, growth coming back. Is there a plan to make use of that or again is it just going to sit there for a rainy day in case the cycle doesn't turn out the way you expect it to?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Hey, Carl. This is Vassimon. This excess provision should not be seen as a reserve for a rainy day, I mean, when we built it, most of it, we had a very low level of visibility and a crisis that was approaching in our judgment at that time.

But I think we have to see this more as a regular process of having provisions according to our expectations for losses according to our models. So, in the third quarter, we saw some – sorry, in the second quarter, we saw some reduction in this complementary provisions.

In this quarter, we have increased a little bit, so we are going to see this fluctuate according to our judgment and our models. And what we can say from now is that for next year, we expect to have a lower level of provisions – expenses.

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

And that would...

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

And that is – sorry, just to complete. So, this complementary provisions in our view should be seen as part of the management of our expected loss model.

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

So, it would be reasonable to say, I mean, a lower level of provisions that you could eventually use these excess provisions if your – or in other words, that level of excess provisions could come down, if you started seeing the risk for what you provision them for decrease?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

The level provisions it should reflect our assessment of the risk, if the environment improves, we'll have a lower level of provisions.

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

Okay, perfect. Thank you, Vassioman, and thank you Kopel.

Operator

Our next question comes from Tito LaBarta with Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi. Good morning. Thanks for the call and taking my questions. Couple of questions also. Following up, just a little bit more on provisions, just want to get a sense, looking through the cycle, as things improve over time. As we look from 2013 to 2015, you're provisioning around 3% to 3.5% of loans this year and are above (39:45) 4%.

Just like over time, once you get through the assets quality cycle, what's kind of a sustainable cost of risk in a normal environment. I'm not saying, you're going to get to the next year or 2018, just given your loan book, where it is today. Do you think in a normal environment, you'd be provisioning around that 3% to 3.5% or I don't know how long you'll take to get there. I just want to get a sense once you get through the asset quality cycle, what you would expect, things to look in terms of the cost of risk?

And my second question just following up, in terms of loan growth, which segments do you think, you could grow as the economy improves and you mentioned growing in mortgages. We saw payroll loans have been kind of flat over the last year, you saw pick up in credit cards this quarter. As the economy improves, what segments do you think, there could be some demand, where you'd be most willing to lend? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi Tito, its Kopel speaking? I think fortunately or unfortunately, Brazil (40:49) have comparable periods here in Brazil. But you mentioned something around 3.5% in your numbers, which you know looking at the history for the net provisions, that was a number that we achieved on average through several quarters during 2015 and that could be a number if you want to pencil a number that would be a number that you can pencil.

But again, we're still going through a cycle. We have many things ahead of us like elections in 2018, structural reforms that need to take place. So, in lack of a better number, you could use that – pencil that number for the time being. But it's more like a temporary thing until we can get something more longer term view, which we don't have it now.

In terms of growth, we are getting out of the cycle, but not out of the cycle. GDP growth to be in the positive territory next year, somewhere between 1.5% and 2%. So, that could provide an opportunity for the market to grow at a modest single-digit number. And throughout 2018, with the things progressing in the political and economic agenda, you can get some acceleration to that. But as of now, seeing from where we are, trying to compare that with the past growth where penetration of credit through GDP was at a much lower level, we don't envision that being the case.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Tito, this is Vassimon, just to complement. What we are seeing is that inventories are going down rather quickly. So demand is higher than production today, so the industry should show some recovery.

For individuals, demand for credit is probably taking a little bit more time, because we are still going to see increase in employment, although at a lower pace. We expect unemployment to beat in the first half of next year, but the level that we should reach by the end of this year will be already close to the peak.

So we are, I think, in the process of approaching the peak, and then, in the second half of next year, we should have starting the reduction of unemployment level. So it will be in our view a slow and gradual process.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. Thanks. That's helpful.

Operator

The next question comes from Jorge Kuri with Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning. Jorge Kuri from Morgan Stanley. Two questions if I may. The first one is on the macro environment. Can you give us a sense of what you guys are sensing being close to the economy on how things have progressed over the last three month?

We've seen some macro indicators coming weaker than expected, and consensus numbers for GDP growth next year have come down around 10 basis points now. The market expects 1.2% GDP growth versus 1.3% before, what is it that you're seeing? Are you seeing signs of improvement, deterioration? You're very close to the economy, so wondering what is it that you're seeing. And, especially in the context of your 2% GDP growth for next year, which is obviously much higher than what the consensus is today.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning, Jorge. We expect the growth to be between 1.5% and 2% next year. We are seeing mixed signals here. What I believe is rather normal in – when you are leaving economic cycle, confidence has clearly improved both for consumers, industry and entrepreneurs, commerce industry. But the signs are not yet robust.

As I mentioned previously, we believe that this will be a rather slow process of recovery. But we are confident that we are starting, we are going to see more positive figures in the next few months. Again to be slow, but the signs that we have, the indicators that we follow including some indicators that we build for credit purpose internally are showing clearly that things started getting worse and are starting to get slowly better.

And the interaction we have with main companies also show that the mood has improved, there is still some reluctance in investing, because there is – idle capacity is high. And of course the whole environment is still dependent on the consolidation of the fiscal measures as (46:46) Congress approved a very important measure – sorry the Lower House approved a very important measure the ceiling for expansion, this still has to go through to Senate, than we have social security reform, you have other relevant reform, so the mood is positive, I think the political scenario is more stable, we see I think a good environment for a more liberal approach to economic issues. That will take time, it will be a slow process, but we believe in consistently in the right direction.

Q - Jorge Kuri {BIO 3937764 <GO>}

Thanks. And I have a second question if I may, just to clarify, I saw in your institutional presentation, the new GDP growth estimate is 2% (47:38). Is that, sort of, like a – that's your economy's number, but the bank is working with a different 1.5% to 2%, just to clarify what is that you're expecting?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

That's a good question. Thank you, Jorge. Yes, our economic area is forecasting 2%. In our budget, in our model we are slightly more conservative, where we can do 1.5%.

Q - Jorge Kuri {BIO 3937764 <GO>}

Got it. Prefect. So my second question if I may is, on sensitivity to lower rates, I also saw in your institutional presentation that your economy is expecting rates to go down to 10% by the end of the next year, which is a bit more aggressive than consensus, that's also in line with what we expect at 10%, so that's a pretty paunchy reduction in rates.

And I know that these things do not work in isolation and you made it very clear, variables move all around and lower rates means other parts of the business will change, but most banks globally provide very good visibility on an all-else-equal, all-else-equal, obviously being the key word here.

And assumption, what is the impact that every 100 basis point reduction in SELIC rate has in your bottom line? We get those numbers from banks in Mexico, banks in Peru, banks in Chile, banks in Colombia, I'm sure, it's not a very difficult number to put together, so wondering, if given that 2017 is going to be a very characteristic year because of the sharp reduction in rates, in an environment of relatively modest growth. I think it's important for the market to understand, again, on an all-else-equal, what does this mean for your business?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Jorge, Marcelo, here. Yeah. I understand the context of the market providing that, but the concept of all-else-equal for Brazil is really something harder to say. So we will not disclose the number for that. But I'll make a few considerations, adding to what you already preempted in your question, which is things don't work in isolation and most of the spread is not driven by the funding costs, but is driven by the credit perception.

And so therefore, we do envision a reduction in NIM and it's a fact, we envision that, this will happen gradually for a couple of reasons. One, the portfolio duration; second, because perceived credit spreads will go down to the extent, actual credit is perceived with less risk.

Third, competition is being rational, okay, so that helps as well. And the point here is really, in the quarter, we are more let's say sensitive to that, which is in – for example, in the funding cost, this will have an impact this year making efficiency out of your volume rates.

But at the same time, we tend to increase the duration of our placements that, that protect those liabilities in the sense that, this should help smoothen the impact. So if you look at our ALM and the value add risk for this particular quarter, you would see an increase in our value add risk, which starts to having longer duration positions to smoothen the impact of that.

Needless to say that, it's impossible, in a situation like that to keep postponing forever the impact of a reduction in interest rates. The only thing that we have here is, how we transition in a scenario where you're having the pressure on the interest rates going down and we are still not ready to make growth, make up for all this reduction.

So you should see the combination of reduction in rates, bringing in down gradually, a pickup on the credit costs, which should help shelter part of that and to some extent, a modest growth in credit and in 2018, credit should accelerate further and the bulk of the reduction should be already baked in on the numbers. But that's not a perfect scenario. Apart from being perfect on economy that it's still in a slow mode.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. So in absence of you providing, I think it's basic disclosure for, for most banks globally. So what's your best guess Marcelo, a single-digit loan growth, that probably means average on average in, I guess low single-digit plus NIM compression, what does that mean for revenues? Can you see financial revenues grow next year or you think the working scenario should be flat to down?

A - Marcelo Kopel {BIO 16986304 <GO>}

I think Jorge, if we see modest growth on the portfolio, NII should be at (53:19) base than the portfolio, okay. And that just starts to what we just spoke about, NIM trending down in a gradual way, but that would be the indication we will provide in the absence of having a formal guidance we gave it to you.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. Thanks.

Operator

The next question comes from Mario Pierry with Bank of America Merrill Lynch.

Q - Mario Pierry {BIO 1505554 <GO>}

Yes. Good morning, everybody. Congratulations on the solid results. Just one question related to the competitive environments that you're seeing. We have seen a lot of consolidation in Brazil recently in light of Bradesco M&A in HSBC, you buying Citibank and now also doing a transaction with BMG to buy the entire stake there.

At the same time, we're seeing the public sector banks with some capital problems. So, just wanted to get from you, what is your desire then to – or your willingness to regain some of the market share that you were willing to lose in the last few years when you didn't feel comfortable with the economic environment especially given your high capital ratios. So can we see Itaú over the next few years regaining back some of the market share that you lost? And also what does this mean for credit spreads if the competitive environment is improving? Thank you.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning, Mario. The environment we see is a very competitive one but rational competitiveness. I mean we see both private and public banks showing a good level of discipline in pricing, in capital deployment. So, I think we have a good environment for competition.

In the past this was not necessarily the case. And although of course market share is important, we always try to price adequately the risk and we are not going to get into irrational competition. So, this caused us in the past to lose in some specific segments a little bit of market share. I think in this new environment of rational competition, given our capital position that's quite strong, I think we are well placed to possibly to regain a little bit of market share.

Q - Mario Pierry {BIO 1505554 <GO>}

And then in regards to the credit spreads given, okay, the rational competitive environment, seems like no one wants to be the first lender here, especially as no one seems completely comfortable with the economic environment yet. Does that mean then the credit spreads remain elevated for few more months?

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Yeah. I would agree with that. I believe that credit spreads of course will follow the risk perception, but I have the impression that they will go down in a lower pace than the risk itself due to this more rational environment.

So, I don't see spreads getting compressed in the short-term. And so I think, it's a favorable environment where we start to less risk and still and good level of the spreads. But of course, over time they will convert and reflect a lower level of risk.

Q - Mario Pierry {BIO 1505554 <GO>}

Perfect. Thank you.

Operator

The next question comes from Nicolas Riva with Citi.

Q - Nicolas Riva {BIO 16875766 <GO>}

Thanks, Eduardo Vassimon for taking my questions. My first question is on the fourth quarter. Typically the fourth quarter is the strongest quarter of the year. And if I look at the third quarter, you've had some one-time expenses about R$900 million in provisions for labor claims and bonus payments for the labor agreement. The guidance for loan loss provisions for the full year implies loan loss provisions about flat quarter-on-quarter in the first quarter. So my question is, in the fourth quarter, if it would be realistic to assume net income of about R$6 million net income for the fourth quarter?

And my second question is on loan growth. So you already said that for next year, we should expect to see loan growth in mid-single digits more or less for next year. Now if I look at your corporate and SME loan books. We saw a decline on a quarter-on-quarter basis. We saw a declines of 3% quarter-on-quarter for corporates and 2% quarter-on-quarter for SMEs. So my question is when are you seeing really the inflection and growth to resume really in the corporate and SME books? Thanks.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi Nicolas. Regarding the credit growth, it should be something that should materialize strongly or stronger actually in the second half of next year, okay. We're still seeing companies adjusting especially on the corporate segment, we are still seeing companies adjusting.

Vassimon mentioned before that there is a lot of idle capacity in the economy, so that typically postpones the decision for companies to be coming back to the market, and when they come back, it's going to be mostly driven by working capital than to longer-term financing given the installed capacity that they have, so this is one thing.

And needless to say that growth will be uneven throughout the different segments. So you would see segments or different pockets of the economy growing at different basis.

Regarding our fourth quarter estimates, we can really comment on numbers for the fourth quarter, but Vassimon mentioned a couple of – gave some color in terms of the intervals, so you may well get to the number you provided or something around that, but it's more upon you to put numbers, but one thing that we need to remember is the fourth quarter typically brings additional volumes on certain portfolios that when you look at on a prospective basis, regardless if they are delinquent or not, you tend to build provisions for them, just because unexpected losses.

So the trend on some of the segments is the one we've been seeing, but you may get some fluctuation as Vassimon mentioned in terms of quarter-on-quarter, but we are confident with the intervals we provided.

Q - Nicolas Riva {BIO 16875766 <GO>}

Thanks, Marcelo.

Operator

The next question comes from Marcelo Telles with Credit Suisse.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hello Vassimon, Kopel and everyone. Thanks for the time and congratulations on the results. I have two questions, the first one, you mentioned earlier that you would expect, you know, some level of decrease in provision expenses next year.

And, my question to you is what is the level of, let's say, GDP growth expected for next year that you think would prevent you from reducing provisions? I know you're expecting 2%. But what sort of level of GDP growth you think could lead your provisions not to improve next year?

And I asked that because we all know that the level of corporate leverage is very high, almost 3 times net debt-to-EBITDA, pretty much all-time high levels. And there's a big like operational leverage component there. So was wondering, if you have done any work in terms of sensitivity to GDP and cost of risk in your case?

And my second question is regarding operating expenses, you've been doing a good job on cost, but you don't want to look in terms of what you're going to achieve this year, I think your guidance is 2% to 5% growth. But you have a big decline in your loan portfolio, 10% decline more or less.

And how should we think about your operating expense evolution next year and on, let's say, if your volume stop declining, so you have maybe some modest growth from next year? Do you think you could see a pickup in OpEx or you think you can still deliver operating expense growth below inflation? Thank you.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Yeah. Good morning, Macrelo.

Q - Marcelo Telles {BIO 3560829 <GO>}

Good morning.

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

The relation between provisions and GDP, I mean, I don't have the answer. You have to make some simulations. But we expect in our base case 1.5% to have a decrease in provisions.

If it turns out to be a substantially different from that, then we could revise this expectation. But it should be something relevant to a change in the assumption. As for operating expenses, yes we believe that we will be able to deliver below inflation growth next year.

Q - Marcelo Telles {BIO 3560829 <GO>}

Okay, great. Thank you.

Operator

The next question comes from Carlos Gomez with HSBC.

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

Hi, good morning. And again, congratulations. I have another question on the capital. But I want to focus on the denominator of the capital ratio. If you look at page 41 of your MD&A and you look at the composition of the risk-weighted assets, you see a very, very sharp decline in the category of 85%, it goes from R$150 billion to R$94 billion. So I wanted to know, if there was anything specific that brought such a big decline?

And on a wider basis, if our numbers are correct, your loan portfolio, given that you purchased CorpBanca, consolidated CorpBanca has grown 4% and yet your risk-weighted assets have declined 8% year-on-year. Could you tell us how much of that is mix and how much is change in the capital allocation rule (01:04:35) of the Central Bank? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Carlos, for your first question, there was a migration from what we call SPR 85, which is the percentage that is, if we weight the asset from 85% to 100% and that's a changing classification given a clarification provided by the Central Bank. So, this is basically a migration from one line to the other line, okay. Regarding CorpBanca, as we you mentioned, I need to confirm, but it's going to have to have something regarding FX, but we will take that offline with you.

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

Okay. Thank you very much.

Operator

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

A - Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Thank you all for participating in our call. Just to reaffirm we believe this third quarter will be a solid one in terms of results, good perspective in terms of NPLs and expenses under control and resilient margins. So, thank you all.

Operator

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