Q1 2016 Earnings Call

Company Participants

- Eduardo Mazzilli de Vassimon
- Marcelo Kopel

Other Participants

- Anibal Valdés
- Carlos Gomez-Lopez
- Carlos Macedo
- Diego Ciconi
- Domingos Falavina
- Jorge Kuri
- Lucas Lopes
- Marcelo Telles
- Nicolas Riva
- Philip J. Finch
- Victor A. Galliano

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding Conference Call to discuss 2016 first 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. A slide presentation is also available on this site. The replay of this conference call will be available until May 10 by phone on (55 11) 3193-1012 or 2820-4012, access code 0027080#.

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 and CRO; and Mr. Marcelo Kopel, IRO. First, Mr. Eduardo Vassimon will comment on 2016 first 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. Eduardo Vassimon.

Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning, good afternoon. Welcome. We are starting at page two with the highlights of the period. We had R$5.2 billion recurring net income in the first quarter or around 10% below what we had in the first quarter of 2015. We consider these results to be quite reasonable given the economic environment.

I'd like to highlight some aspects in this page. In credit quality, we saw an increase in NPLs compatible with the challenging economic environment. Financial margin to market showed a strong R$1.7 billion in this quarter. Provision for loan losses, a relevant increase of 18% compared with the last quarter of 2015.

Here I think it's important to reaffirm the guidance we provided in February. We don't see this figure to be repeated in the next quarter. We're going to talk more about credit quality in the slides ahead. Non-interest expenses showed a good performance with growth well below inflation in 12 months. Credit portfolio, given the economic situation, showed a contraction of 5.6% in this quarter.

Moving to page three. This resulted in slightly below 20% return on equity. In 12 months, we have 22.7% return on equity.

On page four, we have the P&L. I'd like to call your attention to some particular points. Again financial margin with the market is strong at R$1.7 billion. Financial margin with clients in 12 months, 5% increase so below inflation, basically related to the weak demand and our more restrictive credit policies. Provision for loan losses, again a high number here, R$6.4 billion net of recovery. This is basically concentrated as we are going to see more details in the wholesale segment and have basically an anticipatory element in it. So we don't see this to be again – to be repeated in the next quarters.

We can see here also that there is a lower implicit tax rate. We had indicated in our previous call an implicit tax rate of 33%. We are revising this indication 29%. What has changed since the last call is that Brazilian Congress did not approve the limit on interest on capital for social contribution. So in average, we see 29% as a more adequate implicit tax rate.

Moving to page five, we have here the breakdown between Brazil and Latin America ex-Brazil. This is going to be more important in the future after CorpBanca operations. Here we see a 8% reduction in the bottom line for Brazilian operations and a 30% for Latin America. This reduction is concentrated in Chile due to some specific sectors.

On page six, we provide a pro forma table with the CorpBanca. As you may know, we legally started the integration on April 1. So CorpBanca will be fully integrated, fully consolidated in our figures in the second quarter. And the idea of this table is basically to show that in several lines we basically doubled the size in Latin America ex-Brazil, for instance, financial margin, 1.9 times; and assets and credit portfolio, 2.2 times.

Moving to page seven, we have the breakdown here in our P&L between: on one side, credit and trading, that's more volatile part of our P&L with more risk; and on the other side, insurance and services, that's more stable and sensitive to the economic cycles. We can see here that from the last quarter of last year to this first quarter, we had a relevant reduction in credit and trading basically related to the increase in provisions for credit, while we see some stability in insurance and service, where reduction in revenues was compensated by a reduction in expenses.

On page eight, we have the breakdown of the credit portfolio. In the final line, we see a 5.3% nominal contraction of our credit portfolio in this quarter given the economic environment. If we eliminate the FX effect, this reduction would be a little bit lower, 3.5%, in twelve months, 4.2% reduction. I'd like to call your attention to some specific lines, credit card loans, for instance. Given again the weak economic environment and also a more conservative credit criteria, we saw a reduction of 3% in credit card loans. Vehicle finance continued to go down, a very weak demand in this segment. And mortgage loans performed well with the two-digit growth, 17% in twelve months.

Moving to page nine, in the upper part, we see the loan portfolio mix. We have a reduction in the corporate segment and we see the continuation of a more structural movement of increasing the less risky lines of business. Mortgage loans and payroll loans continued to grow in relative terms.

On the lower part of this page nine, we see the financial margin with clients breakdown. And we can see that the single most important element that explains the reduction is the reduction of our loan book, reduction of the balance.

Moving to page 10, financial margin, annualized average rate, basically stable around 11%. When we include the risk elements, we see a strong reduction in this margin. We don't see this as a trend, and it's again related to the high level of provisions that we booked in this first quarter.

On page 11, financial margin with the market. We had again a strong R$1.7 billion in this first quarter. We don't see this figure as recurrent. What we consider to be a "more normal" align (10:33) with something between R$1.2 billion and R$1.3 billion per quarter. So we are reaffirming our expectation was (10:40) R$5 billion in this line for the whole year of 2016.

Moving to page 12, starting to talk about credit quality. In the upper part, we have the 15 to 90-day NPL ratio. The total ratio increased 50 basis points from 2.6% to 3.1%, of course, reflecting the challenging economic environment. When we look at the individuals, there was a 40 bps increase. Here we see clearly there is a seasonality element. In previous years, we had between 20 and 40 basis points. This year we had a 40 basis points increase. Corporate, we see a relevant increase of 60 basis points. Corporate is by definition more volatile, this indicator.

On the lower part of this page 12, we have the 90-day NPL ratio. Total ratio increased 40 basis points from 3.5% to 3.9%. Here just to highlight that this 3.5% would have been 3.7% if we had not had the financial asset transfer that we disclosed in the last call that occurred in the February. In any case, of course, there is a deterioration of the economic situation.

But here we see clearly the effect of the nominal reduction of our loan book. For instance, in the case of individuals, out of this 20 basis points of increase from 5.4% to 5.6%, approximately two-thirds is explained by this reduction of the balance. The same applies for very small, small and middle market companies. Out of this 70 basis points from 3.6 bps to 4.3 bps (sic) [3.6% to 4.3%] (13:00), 30 bps is related to the reduction of the balance.

This segment is probably the one where we are facing more challenge in terms of managing credit risk is a segment that's suffering particularly from the economic situation. Looking forward, we expect to see moderate increases for individuals and also for corporates. Corporate is by nature more volatile. But in any case, we don't see relevant increases in those indicators.

Moving to page 13. And we here show the 90-day NPL ratio, excluding fully provisioned credits. And we can see both for individuals and for companies, a stable level for individuals, actually, a small reduction from 2.3% to 2.2% and for companies, a small increase from 0.6% to 0.7%. So, showing a stability after this exclusion.

On the lower part of this page, we have NPL creation and write-offs. For the first time, we present the breakdown of the NPL creation between retail and wholesale. We see a nominal reduction of NPL creation for retail, and a relevant increase for wholesale. This increase is partially explained by the same transfer of assets that I referred to in the previous slide.

Here, I think it's important to note that the total amount of NPL creation, that would be R$5.9 billion, setting up (14:59) retail and wholesale is well below the level of provisions that we need in this same quarter. So, the ratio provisions to NPL creation is over 120% in this quarter, shown in our view the anticipatory element that we mentioned related to the wholesale book.

Going to page 14, renegotiated loan operations. We see a stability in the nominal amount around R$23 billion, despite the very challenging economic environment. We had some recovered credits particularly in the corporate segment that explains the absence of an increase in this figure.

On the lower part of this page 14, we have NPL ratio for renegotiated portfolio, increasing from 18% to 20%, compatible again with the credit environment. And we see our cost go 184% in 90-day NPL coverage.

Moving to page 15, I think it's a particularly important page, we see here the breakdown of provision for loan losses by segment. We can see here a nominal reduction of provisions in the retail segment from R$4.6 billion to R$4.3 billion. We expect this figure to increase moderately in the next quarters, in the retail element. And in wholesale, we can clearly see that the substantial increase of R$1.4 billion from last quarter to this first quarter, reaching R$2.9 billion is an element that has a strong anticipatory weight. We see this figure to going down in the next quarter in a magnitude that's bigger than the increase we will see in retail banking.

So in net terms, we see the R$7.2 billion going down. And that's again why we are confident that this provision for loan losses will be within the guidance that we provided in our previous call. We've seen here also some increase in the coverage ratio from 208% to 210%. We expect this coverage ratio to go slightly down over the next quarters.

Moving to page 16, I think here is worth investing some time. We are presenting here our allowance for loan losses in a different way. On the right side, we have the way we have been presenting these elements. Recall here regulatory breakdown in three categories: specific allowance, generic allowance and complementary allowance.

On the left side, we have a new approach, we are moving to this new approach that, in our view, reflects in a better way the way we manage the bank. We have here three categories from bottom up. We have overdue operations, so this R$11.9 billion is the amount of provisions related to operations that are overdue, and this is the minimum required by Brazilian Central Bank.

In the middle, we have allowances for loan losses related to what we call aggravated risks. Here we have the amount of provisions related to overdue transactions that exceed the minimum required by Central Bank and also allowance for loan losses related to renegotiated transactions.

In the first block, we can clearly see in green that most of the provision is related to fully provisioned operations and in the second block most is related to renegotiations.

And finally on the upper part of this chart, we see R$15.8 billion of provisions related to expected and/or potential losses. Here, we are talking operations that do not present any type of – that are not overdue but reflects our – for retail basically, our statistic models of expected loss, and for wholesale, preventive (20:39) downgrades and analysis by sector, so there is a judgment element here that constitutes this R$15.8 billion.

So in essence, we consider the complementary allowance very similar to the part of the generic allowance that's not related to overdue transactions or to renegotiated transactions. And we are moving to this new approach, also because it's closer to the concepts of IFRS 9 that we expect at some point in time will be adopted by Brazilian regulations. We are continuing to disclose the previous concept and the new one to allow you to follow the transition. But again, we believe that this new approach reflects in a better way the form we manage the bank in terms of provisions.

Moving to page 17, talking about commission and fees, and result from insurance. We have a below-inflation growth in 12 months, 4.5%. This reflects partially the economic environment and in the case of credit operation and guarantees, the reduction in our credit portfolio. In terms of credit cards, we have here also the impact of a more conservative credit policy.

In terms of the proportion of those commission and fees, and result from insurance to the sum (22:30) of the same element in financial margin, we see that we are within the historical pattern between 34% and 35%.

Moving to page 18, non-interest expenses. We have here, I believe, a very positive picture. We had a 3.4% growth in 12 months and 8% contraction in this quarter. If we exclude the operations abroad that have FX impact, in 12 months would have 1.9% growth only, so well below inflation, reflecting our efforts and our commitment to reducing costs in the bank. This is reflected in the quite positive efficiency ratio that we presented in this quarter, 43%. If we take the trailing 12 months, we see the continuation of downward trend reaching 43.9%, and a negative figure when we incorporate the risk element because, again, we had a high number of provisions in this particular quarter.

Moving to page 19, talking about capital. I'd like to focus here on the lower part of this page, on the 12.7% indicator that core tier 1 fully loaded by Basel rules, so anticipating the schedule, this figure was 11.8% in December. So, a good evolution. If we deduct CorpBanca that we show immediately on the right side, 1.1%, and this figure have been getting additional information, so allowing us to have a more precise figure, we would have still 11.6% core tier 1 after deducting the effects of CorpBanca, that again will take place in the second quarter. So 11.6% of core tier 1, we believe to be a very comfortable level of capital that allow us, if and when we feel comfortable in terms of a better credit environment, to grow our credit portfolio. So to be prepared to grow, I think we're in a very good position for that.

On page 20, talking about our forecast. We are reaffirming the forecast, the range for all lines. And we are particularly confident in, when we talk about lines related to P&L. This first line is more challenging. The total credit portfolio growth is related, of course, to several factors, including FX rates. (25:56) today, we believe we will be close to the lower bound of this range.

Financial margin with clients. Here, again, we believe we will be close to 2%, the lower end of this range. In terms of provisions for credit, we believe we will be a little bit above the midpoint here. Commissions and fees, here, again, reaffirming our guidance but closer to the low end, close to 6% growth in the year. And finally non-interest expenses again, here close to 5%, close to the low end of this range.

In the next page, stock market performance. Despite the rally of the past few weeks, historical trends are still below historical standards with 8.8% price to earnings ratio. In terms of liquidity, or good life of liquidity, with a sound equilibrium between domestic markets and external markets.

So with that, I conclude my presentation. Marcelo Kopel and myself will be available to answer the questions that you may have. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question-and-answer session. Our first question comes from Jorge Kuri, Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning, everyone. Two questions if I may. The first one is on your expectation for SELIC rates and what does that mean for your financial margins and revenues? I see from your institutional presentation you're expecting SELIC to be at 10% year-end 2017, 12.25% this end of this year. So, can you remind us what your asset sensitivity is? For every 100 basis point decline in SELIC rates, all else equal, what happens to your financial margins? What is the decline in financial revenues for you? And in the context of what could potentially be a slow growth environment on the volume side, given that you're expecting the economy to contract 4% this year, basically be flat in 2017, it's just hard to see how there's going to be any volumes? What's the expectation for revenue growth when you put together the declining rates margins and the low volume for 2017?

And then, my second question is on – I just wanted to get your general view on the ground. And I hope I'm not misrepresenting your comments, but it does seem that you are portraying us, that the first quarter sort of like to be the worst of the year, that from here, things could potentially improve. That's certainly the case when you look at how you've reiterated your guidance. Your financial revenues are running well below the low end of the guidance. And your provisions are already at the high end of the guidance and you expected them to improve from here, see the same.

So, what is it that you're seeing that gives you confidence that from here, we're going to stabilize or improve? The numbers that we see – and granted obviously, banks have a lot of lead indicators that we don't see – the numbers that we see continue to show a deterioration overall, an acceleration of the deterioration actually. If you look at unemployment, the last print that came out last week was outright scary. Chapter 11 filings, I mean most numbers that you look at still show an economy that continues to be sort of like on a freefall. Thank you.

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

Good morning, Jorge. This is Vassimon. Start with the SELIC effects, given the present position we have, a SELIC reduction would have close to neutral impact on our P&L. We have a little bit more assets than liabilities index in SELIC, actually index in CDI but that's very close to SELIC, so a reduction in SELIC will do some reduction in revenues here. On the other side, and assuming that a reduction in SELIC would be, at least partially followed by a reduction in the whole interest rate term curve, would benefit from a more structural prefixed position, loan position that we have. On net terms, in economic net terms, would be close to neutral.

Having said that, it would have a positive impact that's more difficult to measure, that would be the reduction of the costs for economic agents. So, the potential improvement of credit conditions for both individuals and companies. In terms of volume of credit, we – as I mentioned during the presentation, we are reaffirming our guidance for 2016. We are still not in a position to give a forecast for 2017. We see, as I mentioned, particularly the credit portfolio guidance to be particularly challenging given the environment.

But linking this to your second question, we started to see some signs of stabilization, some indicators. We see several confidence indicators stabilizing, still at a low, a very low level, it's true, but stabilizing those confidence indicators in our view would be the first step to a possible improvement of the whole economy in the future.

We continue to see, you are right, an increase in unemployment. They should peak close to the – in the beginning of next year. And that's why we continue to see, as I think I briefly mentioned, deterioration in the NPLs going forward. But on the other hand, we can see a better political environment. I think we are reaching a more stabilized political environment that could lead to a recovery in confidence.

We are not seeing this yet clearly. But what we have seen, yes, is the stabilization of some leading indicators, basically confidence indicators. So, that's why we are reiterating our guidance in all lines. In particular, related to provisions as I mentioned, we did a substantial amount in a more anticipatory way that we do not expect to be repeated in the next quarters.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. Thank you very much.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Thank you. Good morning, Vassimon and Kopel. A couple of questions, just following up on Jorge's question. I'm struggling to see how you're going to get to your loan growth guidance. I mean, it implies that your loans are going to grow 10% through the end of this year, which given the context – I mean, if you do grow 10%, then I would be concerned with your provision guidance because it doesn't seem like the environment to be more aggressive in giving out loans. At the same time, that underscores the concern on your NII guidance, with loans are not going to grow as much; if rates are going to come down, I know yours is neutral to slightly asset-sensitive. But you're down 4%, 5% year-on-year. To get to 1%, 2% up, it's going to be challenging. I just want to understand if there's anything that you expect to change materially over the next couple of quarters that will allow you to reach those two guidances.

And just following up on Jorge, second question, talking about asset quality, I'm not as concerned on the provision guidance, it seems fairly adequate. I'm more concerned on what to think about next year. Again, you haven't mentioned, you said you can't really do any analysis or any guidance, but when do you expect the NPL cycle to peak? I mean, Bradesco said in their call that they expect it to flatten out late this year, early 2017, but that they don't expect any improvement until 2018. Of course, it's a different bank, different portfolio, and you probably have a different answer. But what are you seeing for that and what would that imply just conceptually in terms of provision expenses for next year vis-à-vis this year?

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

Good morning, Carlos. This is Vassimon. Let me start with the second question. As I mentioned, it's too early to talk about 2017, but we are – our economic area (36:15) is revising their projections and I think we could see a better picture for 2017. We could see something around 1% growth next year, and this would lead naturally to a better environment.

In terms of NPLs peaking, we see the beginning of next year and as the most probable period for having that. So, we are a little bit more constructive on the scenario for next year with some stabilization already in the second half of this year. And I will pass to Kopel in relation to the first question.

Q - Carlos Macedo {BIO 15158925 <GO>}

Just, Vassimon, if you allow me just a follow-up on that. If that really is the environment, conceptually, would you probably see provisions coming down in 2017 from 2016, if the environment falls with what you just said?

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

Yes, no doubt. I mean, if this is the scenario, we'd see a reduction in the provision and actually, if the environment improves, we start to improve already this year, we could see some reduction in the amount of provisions we have today, because it was made in a rather conservative way and anticipatory way. And if the deterioration is not there, I think we would be in a position to reduce part of our provisions.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. Hi, Carlos. Kopel speaking here. On your first two questions which are – one linked directly to the other one. The portfolio growth is really a reflection, as Vassimon said, about the overall economic environment and how we are seeing each one of the portfolios. Obviously, there is an FX component on that which doesn't fall necessary to NII, but may distort the number. The reason why – and this is the reason why Vassimon pointed out to the low end of the guidance. It could be affected by the FX. As I said, when we provided the guidance, the FX rate at the end of the year was 4.50. We revised our economic team to 2.75. So, right off the bat, there is an element on that, so I wouldn't – it's important and that's why we're (38:47) to the low end of the guidance. Okay?

Regarding NII growth, we did see the portfolio increasing – the NII increasing year-over-year around 5%. This is below inflation but those talks to the low growth or the no growth that we're seeing in the portfolio. Some repricing that is happening in the back book and some expansion in certain portfolios. So, it is a challenging environment, meaning the guidance has its challenges as you described. Okay? But as of now, we are still maintaining the low end for both items given that there is – there could be a perspective that can change that in the latter part of the year.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. But it does – I mean, it does consider that maybe things improve towards the second half of the year.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. First, it stopped deteriorating like Vassimon described, which is confidence leveling off at a low level but leveling off. And we cannot discard that once you have political clarity and stability, the economic agents can start resuming their day to day in a more active way. And the bank is well-capitalized and ready – well-funded and well-capitalized for that moment to happen. But that's...

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. Thank you. Thank you both. Thank you. Thank you for your answers.

Operator

The next question comes from Philip Finch, UBS.

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

Good morning, Eduardo and Marcelo. Thank you for the presentation. I've got a couple of questions as well. I'm surprised but encouraged that provisions seem to have peaked and will be coming – becoming lower in the next few quarters. Related to this, you have R$11 billion of complementary provision. My question is, what do you plan to do with this additional provisioning? Is that an area of specific concern or specific company that you plan to use this for in the future?

And my second question is regarding your capital position where we've seen steady but impressive progress in terms of the capital buildup. So on slide 19 of your presentation, you show the Basel III fully applied level that you estimate at 12.6%. So here, a question first of all is, what is an optimal level of capital that you would like to run at going forward? And two, what is your estimate in terms of internal capital generation per year that you expect to achieve going forward? And once you exceed that optimal level, what are you planning in terms of capital deployment?

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

Good morning, Philip. In terms of the provision, as we mentioned in the presentation, we tend to see the additional provision – the complementary provision in a similar way we treat the generic provision that's not related to overdue or renegotiated transactions. So, the movement in this type of provision will be related to our expectation, again our models for retail basically, our judgment for retail, our analysis of the market situation, of sectors. So, if there is some improvement, we will be reducing this provision, this would be a natural movement. If there is some deterioration, we would see some migration from this block to the lower block. So, it is dependent upon the market scenario. But yes, we will consider definitely reducing the amount of this provision should the situation improve.

In terms of capital position, we believe that given the fact that Brazil lost its investment grade, we have to work with a slightly higher level of capital because of the increased volatility of a non-investment grade country. So, we would like to see core tier 1 consistently above 12% as a comfortable level. If we go consistently beyond this level, then a natural movement would be to be more active in the buyback activity. So, this would be our response to additional capital that we could have.

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

Thank you, and would it be fair to say that internal capital generation could be around 100 basis points per annum?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. Philip, it's Marcelo. Around 80 to 100 bps is a fair assumption.

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

Perfect. Great. Thank you very much.

Operator

The next question comes from Lucas Lopes, Credit Suisse.

Q - Lucas Lopes {BIO 18956724 <GO>}

Hi. Good morning. Thanks for taking my questions. I have two, the first one is very straightforward. I'd like to understand whether the 50-basis-point spike in the 60-day NPL has contributed materially to the deceleration in the market clients that are increasing the roll-off (44:43). And if you allow me to ask a second one, the banks have been expecting the liquidity to peak at the end of this year or in the beginning of the next one. I want to learn if anything has changed in that regard. And I understand that you have mentioned that provision could decline next year, which is actually more important. But I'm also interested to know your view on NPLs. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Lucas. Regarding the over 60 NPL, there was – the variance between the fourth quarter and the first quarter was around somewhere between R$500 million and R$600 million. So, the slowdown in NII does have some sort of impact from that but in a R$14 billion line, you may say that this was not a not relevant impact. Even if you consider that you're still paying for the funding cost, which shows up rather (45:39) in the margin with the clients. And you have the loans as non-accrual. So, there was an increase, the R$600 million that I mentioned to you, but this was not the main response to that. It was a factor but not a determinant factor on that. What's your second question?

Q - Lucas Lopes {BIO 18956724 <GO>}

Regarding your expectation on the peaking in NPLs.

A - Marcelo Kopel {BIO 16986304 <GO>}

Well, Vassimon mentioned that for individuals, we should probably peak in the first part of 2017 and that's correlated directly to the unemployment expectation. So, needless to say that if, for any reason, in terms of expectations and the trend of the deterioration of unemployment (46:23) being better, or less severe than what we're seeing, this could be a less severe peak. But nevertheless, in the first half of 2017 is our expectation for individual.

Q - Lucas Lopes {BIO 18956724 <GO>}

Okay. Thank you.

Operator

The next question comes from Nicolas Riva, Citi.

Q - Nicolas Riva {BIO 16875766 <GO>}

Hey. Thanks, Marcelo and Eduardo, for taking my questions. The first one is on your guidance, what it means for EPS. So, you already said that you expect to be at the lower end of the loan growth guidance and also NII and fees. So, if I assume zero percent loan growth this year, around 2.5% growth in the net interest income with clients, around R$24 billion in loan loss provisions, OpEx around 5.5% and then fees growing 6.5%, with a tax rate at 29% that you said today, then I'm getting R$20 billion for the net income, which is a contraction this year of about 15%. So, I wanted to ask you if my R$20 billion for this year, 15% EPS contraction, is in line with what you have.

And the second one, on Sete Brasil. You, of course, mentioned that you increased loan loss provisions in your wholesale book for specific economic groups in the first quarter. If you can disclose at all, now that Sete filed for bankruptcy on Friday, what's your exposure to Sete? If you increase loan loss provisions specifically for Sete in the first quarter, how much it was? And if now, when a company is bankrupt, do you need to increase your loan loss provisions for a company that already filed for bankruptcy? Thank you.

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

Hi, Nicolas. This is Vassimon. Starting with the second question, as you know, I cannot comment on a specific company. Having said that, we are very, very comfortable with the level of provisions we have for the wholesale sector. We tend to do it on an anticipatory way and particularly for companies where we see very low probability of recover, we go to 100% provision.

So – and this is reflected in the high number we have in the potential – in provisions for potential losses in wholesale. And the policy, we have at least 50% of provisions for companies that go to Chapter 11, except in very specific cases where we have very strong guarantees and I can't recall any cases recently of the situation. But, yeah, this is more when there is a surprise in Chapter 11. There are cases where Chapter 11 is not surprising. Typically in those case, we have already been provisioning for these events. So, we are very comfortable with the level of provision we have. In the most critical cases we have 100%. We are particularly well-provisioned in oil and gas sector. But we cannot comment on a specific case. I will pass to Kopel on the first question.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. On your first question, based on your assumptions, your math is okay.

Q - Nicolas Riva {BIO 16875766 <GO>}

Thanks, Marcelo and Eduardo.

Operator

The next question comes from Diego Ciconi, Scotiabank.

Q - Diego Ciconi {BIO 18634480 <GO>}

Hi. Hello. Thanks for taking my questions. Actually, I wanted to have a follow-up on Sete Brasil. They filed for bankruptcy last week and they disclosed that Itaú's exposure is about R$2 billion. So, I would like to understand a little bit if you can disclose the amount that you already have provisioned or the percentage that you have on that, so we know what to expect going forward. And also on the effective tax rate, you registered about 25% this quarter, which is a very low level. So, I wanted to understand a little bit where that came from and what we can expect going forward.

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

Good morning, Diego. As to Sete Brasil, I 'm sorry, I have to repeat the answer I just gave to Nicolas. We cannot comment on a specific case. We're very comfortable with the level of provisions we're having in the wholesale portfolio, and corporate portfolio, particularly in the oil and gas sector. When there is a Chapter 11, we provision at least 50% but this is mainly when there is a surprise. Typically when Chapter 11 is not a surprised, we have already provisioned most of the credit. And in the credits that are more critical in the sense that we have a very low probability of recover, we go for 100% provision. So that's what I can say. I cannot comment on specific names.

In terms of the tax rate, we had 26% this first quarter. And it was basically due to the effect of interest on capital. Interest on capital, as you know, is related to the size of the net worth and the GLP rate. The GLP rate increased this first quarter. Our net worth increased in the last quarter, that's the basis for that. And this amount to be the – is not related to the size of the pre-tax profit. So when we take a higher number of interest on capital compared with a lower pre-tax rate, we reach this effect. Besides that, we have a mix of financial and non-financial companies basically already or acquired company that has a lower tax rate.

Operator

The next question comes from Victor Galliano, Barclays.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Hi. Yes, I have a couple of questions as well. Just firstly to continue with the coverage of delinquencies. And just looking at your different buckets in terms of D, E, F and G categories of loans, I see that you've maintained the 100% dedicated coverage to E, F, and G, but in the case of the D loans, that coverage has halved. And at the end of Q4, there was 43% coverage, it's now 21%. I mean it's still 100% higher, more than twice what it needs to be the legal minimum.

But just trying to understand here, is this an indication that you see that the very highest risk of your delinquencies in the E, F, and G buckets and you're less concerned about the – shall we say the write-off at this point in time of the D bucket? Is that a reason for lowering the level of coverage there? Or just if you can talk us through why that coverage has come down in the D bucket?

And my second question is about capital. Just looking at your capital deductions, and the schedule anticipation of those Basel III rules on page 19 of the slide, I see that the deduction is actually lower in the first quarter this year than it was in any of the quarters last year. Can you just talk us through that as well? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Vic. Well, as Vassimon said, we did have some migrations. In this quarter, we had important migrations and downgrades that were proactively done in the portfolio and that gets reflected in the letters. And obviously, this creates some dynamic between the provisions and how we see that. So this explains why you're keeping – you're seeing a high coverage rate in certain cases.

And the reason why you see the letter D or the portfolio in D doesn't necessarily is linked to the delinquency. It's something that we are evaluating and some of the migration that went from D to E and F was also not related to delinquency. So the bottom line of that is the coverage is adequate to what we are seeing in that portfolio classified as D, and just remember that the minimum required by the Central Bank is 10% at that particular bucket. So we are comfortable with that and we'll be managing on a dynamic basis the overall portfolio.

Please keep in mind also that looking at the provisions the way we classified now then between delinquent, aggravated and the potential, the way we see the coverage is more holistically. So even though you have something classified as a D now, if it's something that was aggravated, you may not necessarily see that in the letter but you could have coverage for that.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Okay. Okay. Thank you. So we should look more at your new definitions on page 16 really of overdue, aggravated and potential.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yes, yes.

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

On your question – Victor, this is Vassimon on capital. If I understood well, you're referring to the reductions of schedule anticipation.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yes, yes.

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

And what happens is simply the fact that every year in the first quarter we have 20% lead on our (57:00) phasing in of Basel. So every year we move 20% forward. So in two more years, this number will be – by definition will be zero. That's what accompanies the reduction (57:13).

Q - Victor A. Galliano {BIO 1517713 <GO>}

Okay. Coming down those 20% (57:17).

A - Marcelo Kopel {BIO 16986304 <GO>}

And, Victor, just to add one last comment to what I said before. When you get the total provisions that we have and you use what we call in the accounting, the complementary provision, the way, the exercise we do to fill up the different buckets in our portfolio, we start from the more aggravated letter which obviously is not age because age is already fully provisioned. So we're getting to the F and the G and so on and so forth. So as you move credit upward in the scale, so we had more migration as I said from D to E and to F, you fill in more the provisions throughout those buckets. Okay?

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yeah, yeah.

A - Marcelo Kopel {BIO 16986304 <GO>}

And so that...

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yeah.

A - Marcelo Kopel {BIO 16986304 <GO>}

Okay.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yeah, yeah, so it's impressive that you've actually covered the E category by 100% because that almost doubled quarter-on-quarter.

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

Yeah. That's part of the whole exercise.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yeah, sure, sure. Thank you.

Operator

The next question comes from Anibal Valdés, Barclays.

Q - Anibal Valdés

Hi. Good morning. I just have a follow-up on what Victor just asked. Because I'm a bit lost in the numbers, trying to make sure everything is – it's okay. Related to the deductions of Basel III related, especially to common equity. Because quarter-over-quarter the deductions just went up 15%. (58:57) If we had considered that you were applying a 20% additional deduction to the stock of deduction that you would have to apply in the first quarter, that's around R$5 billion and that R$5 billion per year is consistent with the 1.4% in deductions that you say it would cost you in terms of capital ratios, if you were to anticipate those deductions. So I just have troubled looking here at the deductions that you have for the first quarter, which are R$11.7 billion compared to R$10.1 billion in the fourth quarter 2015.

And on the back of the envelope number, which would be consistent with the 1.4% in additional deduction that you'll have to impose to your capital raises (59:49) if you were to anticipate all the deductions going forward, the number would be closer to R$5 billion per year and not R$1.6 billion per year, which is the change quarter-over-quarter from fourth quarter last year into first quarter this year. So if you can let me know if something changed or you moved other products that's within the capital structure of the bank debt kind of like compensated for that R$5 billion deduction that we were expecting. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

I'll make reference to the charts we have in the presentation and the (01:00:32) chart we had in the fourth quarter, and if it's not enough, we can take the question offline. But let's start with the deductions. In the fourth quarter, we had 1.9 percentage points of deductions related to the Basel III anticipation of deductions, which basically accounted for – remember the phase-in is only five years. In 2015, we had 40% phase-in. So there was a 60% of the phase-in built in in this 1.9 percentage point. Now that number talks to the 1.4% that you see in the schedule that we have here. Okay? So this is how one thing relates to the other one.

Talking about the tax credits that we had, we did have an important use of tax credits. In the fourth quarter, these accounted for – the future use of those accounted for 1.8 percentage points. Now they account for only 1 percentage point. So this is future use of them, so the reduction of that implies that there was usage of that in the quarter, and primary related to taxable income but mostly also related to the movement of the currency because as you know, as the real appreciated, it produces local taxable income for us related to the hedges we have for our foreign investments.

So those are the two elements, and last but not least, risk-weighted assets in general also benefited from the appreciation of the real against the dollar. And we have less lending in our portfolio. So these are the elements that explain this. If this didn't cover your specific question, we can take it offline with the numbers and not the percentages.

Q - Anibal Valdés

Okay, Marcelo, that's good. I think it has to be the case that we'll take it offline.

A - Marcelo Kopel {BIO 16986304 <GO>}

Okay.

Q - Anibal Valdés

Thank you.

Operator

The next question comes from Marcelo Telles, Credit Suisse.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hello, Vassimon. Hello, Kopel. Thanks for the time. I have two questions, but I'll try to get away a little bit of the provision discussion and try to focus more on the NII performance. Regarding this anticipation of provisions that you've made in the quarter, as you mentioned, are you still recording any interest on these loans? And if you are, would you consider at some point having to stop accruing this interest on these loans and take, let's say, opportunity to move down the list categories?

And my second question is, regarding your NII growth – not for 2017 – how should we think about your top line growth in an environment – let's say, no credit growth, rates stable or potentially coming down, with your credit spreads currently at all-time highs? How confident are you that you'll be able to grow your NII next year? And I'm talking about NII with clients, right? I'm not considering NII with the treasury. Thank you.

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

Good morning, Marcelo. This is Vassimon. In terms of booking revenues, we follow strictly the Central Bank rule: up to 60 days, we book; after 60 days, we stop booking. So nothing different from that. For 2017, we still have some level of uncertainty, so it's too early to say. We are again a little bit more constructive on the scenario because we believe that a potential political stability could bring more visibility to the – and probability to the scenario that could lead to some growth next year. We're talking here around 1%. But it's too early to talk about the effect of this scenario on NII.

Q - Marcelo Telles {BIO 3560829 <GO>}

So if I wanted to follow up, so thanks for your answer, Vassimon. So based on the first, so given that you're anticipating provision, that means that you're still most likely – I would assume that you still accrue an interest on these loans for now because they haven't really gone through the NPL category, which is the majority of them.

And regarding your (01:05:43) to my second question, I mean just digging a little bit deeper, I know it's early, but what do we know right now is that your portfolio is going down. And that has certainly, let's say, a carryover effect into 2017, right? And given that the effectively reprice of the backlog should be approached its end this year, do you think that I'll be too wrong in assuming flat NII next year and that'll be kind of a reasonable scenario, or I'll be too harsh on the outlook for next year?

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

Marcelo, on the first question, yes, we continue to book revenues because we basically did some downgrades in several corporate clients but they continue to perform normally. They continue to pay normally. So they're not (01:06:44) so we are, yes, we are booking normally those revenues, provided again that it's not overdue more than sixty days.

As to 2017, again difficult to say, I believe that we could have a rather fast process of increasing credit portfolio if we are comfortable with the scenario. We have liquidity. We have capital. We'll be prepared to take advantage of a more positive scenario. So I think it's premature to say that this means a flattish NII for 2017.

Q - Marcelo Telles {BIO 3560829 <GO>}

That's very helpful. Thank you.

Operator

The next question comes from Domingos Falavina, JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Hi, good morning, all. Thank you for the opportunity. I have actually an addition to a slide that you presented showing the breakdown of financial margin, I think on slide nine of the presentation. You put in the same pie chart the delta and you put together the mix of products, clients and the spreads. If you could – my question is if you could provide a little bit more color. I'm basically talking about the R$15.5 billion in 4Q 2015 going to R$14.8 billion and the R$31 million coming from the three drivers. If you could provide a little bit more breakdown, how much has that been spread and how much that has been actually mix in products, because I believe those are very strong oscillations there in the same bucket. So we have an idea on how they're offsetting each other.

And my second question, if I also may, we continue to see very strong spread increase in Central Bank data, last month again over 100 basis points on growth. So my question is, assuming that you continue to grow zero percent in your loan book, the repricing effect given the new spreads, for how long do you believe that this could offset the mix shift or that you could still basically have a net positive effect of the loan book being repricing? Basically just to see for how long we can continue to mitigate the worsening credit quality or if we still have a booster for NII growth in 2017?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Domingos. I think part of the first answer, you already provided in your second question, which is spreads are mitigating to some extent the fact that we are growing on less risky products like mortgages and payroll. So it's getting to a point that the back book is repricing. But growing into those products brings us to a point where we will not be able to shelter indefinitely the fact that we are not growing the portfolio with the repricing of the portfolio and the mix shift. And that talks to the fact that we are signaling to the market the low end of our NII guidance. So one thing talks to the other one. And as you move forward, you would see in the following quarters that behavior to happen.

Your second point about the zero growth and spread increase and the impact of that, I mean so much you can do in terms of increasing your new originations to a point that you start getting into adverse selection. Because rates are high enough and spreads are high enough, I think what we will see, and that talks to what Vassimon said before, in the event that we see the SELIC rate going down, which is our scenario, the SELIC going down 200 basis points from the mid part of the year until the end of the year and confidence improving and things marginally starting to improve, you may see some pickup on the (01:10:59) very selectively. But everything now is basically at the same time putting pressure on NII growth. And that's why we are signaling it to the bottom part of our guidance.

Q - Domingos Falavina {BIO 16313407 <GO>}

No, perfect. Since you mentioned the 100 basis points, I remember – not the guidance but the impact of 100 basis points decrease on NII, what's the latest number on that that you believe is the impact?

A - Marcelo Kopel {BIO 16986304 <GO>}

Vassimon...

Q - Domingos Falavina {BIO 16313407 <GO>}

For earnings?

A - Marcelo Kopel {BIO 16986304 <GO>}

Well, the shift in the interest rate curve, if it's a full shift in the curve, given our structural positions, the economic impact of that is basically neutral. So what you would have to factor in is how structurally the country is behaving differently that this will allow us to resume growth. But in the positions we have today, these retro positions we have today, this is kind of neutral, that mix – that shift in the yield curve.

Q - Domingos Falavina {BIO 16313407 <GO>}

No, perfect but not the yield curve, when the CorpBanca (01:12:12) comes in and cuts rates in 100 basis points, what's the impact on that either pre-tax (01:12:16)? You used to protect R$800 million, if I'm not mistaken.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah, but that's...

Q - Domingos Falavina {BIO 16313407 <GO>}

(01:12:19)

A - Marcelo Kopel {BIO 16986304 <GO>}

...that's purely looking at the loan cash position that we have. That's why I'm giving you the answer on the overall structural positions we have because if you look at only...

Q - Domingos Falavina {BIO 16313407 <GO>}

Okay.

A - Marcelo Kopel {BIO 16986304 <GO>}

(01:12:32) On the cash yes, you could do the math. But if we look at the overall structural positions, it's kind of neutral.

Q - Domingos Falavina {BIO 16313407 <GO>}

Understood. Thank you, Kopel.

Operator

The next question comes from Carlos Gomez, HSBC.

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

Hello, good morning. Going back to the loan growth for this year. When I look at your book in reais, it's now the question at (01:13:01) about 5%, 6% per year. So it will be, as mentioned earlier by Carlos, a very quick turnaround. Which areas do you think that you can grow (01:13:09)? You're now growing mortgages, 70%. Can that grow faster? Can you start lending to autos (01:13:14) faster? What can turn around? Thank you.

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

Hi, Carlos. This is Vassimon. We do recognize first that this is a challenging guidance, a challenging forecast given the present environment. We continue to move to less risky lines of business, so mortgage and payroll lines that should grow more than average, and in a situation where we see some improvement in the economy, clearly corporate portfolio is an area where we could see some growth. (01:14:00) would reflect an improvement in the confidence, if this is the case.

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

Thank you.

Operator

The next question comes from Victor Galliano, Barclays.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Yeah, hi. Just have a quick follow-up here on moving away from all the financials. I'm thinking more in terms of strategy. If you could just give us sort of 5 minutes on how you see the digital branches strategy developing. And I can see here that you've basically cut about 150 branches over the last couple of years in Brazil. How do you see that developing? Do you see that as something that will gather momentum going forward and could it be a significant contributor to controlling costs going forward?

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

Victor, this is Vassimon. Yes, actually, we are already seeing part of this movement. The digital branches are both more convenient to the clients and much cheaper than the traditional branches. We expect this year to have a similar number of reduction in physical branch, between 100 and 150 branches, and the continuation of the migration process from customers to digital branches. The level of satisfaction that we measure very frequently is quite high. I mean clients are very happy because they have the ability to do banking in different hours in a more direct and more modern way through different channels.

So this is definitely one of the main structural projects that we have in the bank. I think this should go in a faster pace going forward. Of course, we have a process of communicating well to the client of having the adequate environment in terms of technology and people are prepared to give an adequate service in this new environment. But that's a very positive trend. That will continue to be reflected in the cost. We are – not only we are rationalizing internally in terms of using more technology in the back office in our operations. But the use of the digital branches in the front office is also a relevant source of reducing costs.

Q - Victor A. Galliano {BIO 1517713 <GO>}

Great. 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.

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

Just to reaffirm that this was a quite reasonable quarter in our view given the present economic environment. We are reaffirming our forecast. In all lines, we are confident that we'll be able to deliver within the range indicated. The provisions we needed this quarter in a relevant amount, we don't see this to be repeated in the future. And we are I believe particularly well-positioned to take advantage of a possible improvement in the scenario given our position in terms of capital. And we expect that a possible stabilization of the political situation would lead to better confidence in the whole economy and the other development of the situation as a whole. So thank you again for your attention.

Operator

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