Q3 2015 Earnings Call

Company Participants

- Eduardo Mazzilli de Vassimon
- Marcelo Kopel

Other Participants

- Aníbal Valdés
- Boris D. Molina
- Carlos Gomez-Lopez
- Carlos Macedo
- Eduardo Nishio
- Marcelo Telles
- Philip J. Finch
- Saul Martínez
- Tito LaBarta
- Victor A. Galliano

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding conference call to discuss 2015 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 broadcast 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 November 10 by phone on 55-113-193-1012 or 2-820-4012, access code: 9067132#.

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 2015 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. Welcome again. For those that are following us at Internet, we are at slide number 2. I start highlighting the recurring net income of the third quarter, R$6.1 billion, we consider to be robust result particularly considering the environment in Brazil, the economic conditions prevailing in the country.

This result is stable considering what we saw last quarter and is roughly 21% higher than the same result in the first nine months of last year. Recurring return on equity was 24%; credit quality stable both for NPL 90 days and 15 to 90 days. We are going to talk a lot about credit quality in the next slides because we consider this to be one of the main points of interest throughout (03:03) the market.

Moving to slide number 3, given the particular relevance of nonrecurring events, this quarter we produced this slide, where I would like to highlight two main events as a positive nonrecurring event, the social contribution rate increase that was basically R$4 billion impacting bottom line. And as a negative impact, the main event was complementary provision for loan losses, R$2.8 billion after taxes. Before tax, this figure is around R$4.7 billion. We are going to talk more about this in the next slides.

Going to slide number 4, here again, 24% return on equity. On a trailing 12 months, we have 24.5%, very similar to the figures we saw in the previous quarters. And recurring return on average assets is stable in the several former quarters at 1.9%.

Moving to slide number 5, we have the P&L. I'd like to highlight here the positive increase in financial margin with clients, 4.4% in this quarter, and 16.4% in 12 months. This increase is related to the repricing process of risk that we have been conducting in the several previous quarters and we continued this quarter. Higher funding efficiency and a higher SELIC rate also contributed to this positive growth.

Another point that I'd like to highlight is the financial margin with the market, R$2.3 billion. That's an unusual result, higher than what we consider to be unusual result. We are going to talk more about that in the next slide.

Commissions and fees showed 10% growth was slightly above inflation. Result from insurance, 1.5% drop. This is related to the fact that the bank is no longer operating in some segments of insurance that we do not consider to be core, like the large risk and extended warranty.

And I like to call your attention to the fact that the retained claims dropped 22% in 12 months, so that the net between results from insurance and retained claims showed a nominal increased in nine months. Operating expenses in 12 months grew 8.5% below inflation. Here, again, I'm going to give you additional details a little bit ahead.

And the bottom line in terms of recurring net income, around 21% growth when compared to the first nine months of last year.

Going to slide number 6, we have the credit portfolio. The total credit portfolio showed a 10.1% growth in 12 months. If we exclude FX rate variation effect, we reach a flattish number and - in 12 months - in the quarter, a reduction of 1.1%. This, of course, is related to the challenging economic environment where we see a lower credit demand and also reflects tighter underwriting credit standard that we have been adopting now for several quarters.

And we look at specific business here. We see that payroll loans have grown 25% in 12 months. But when we see the growth in this particular quarter was a modest 0.4%. This is basically because the process of buying portfolios have ended. And so now, we are going to see a more organic growth. Another line that shows good growth in 12 months is mortgage loans, close to 22% in 12 months and robust at 5.5% this quarter.

Vehicle loans continue to go down 9% in this quarter. Corporate loans, 9%, slightly below inflation But if we take out FX rate variation effect, this would be a negative growth. So, this shows very clear the challenging economic environment we are living.

Moving to slide number 7, we have here the – a breakdown of our P&L in two pieces. On one side, the credit and trading, that's more related to the economic cycle. And one, the other side, insurance and services, that's more resilient to economic cycle. The first piece shows a return on equity 15%, a little bit below cost of capital, while insurance and services shows a very strong return on capital.

Moving to slide number 8, we have the financial margin with clients' breakdown. We see on the right side of the upper table the three lines of business that have been showing a more robust growth in the past few years; Latin America consistent with our regional expansion strategy and mortgage loans and payroll loans consistent with our strategy of moving to lower risk lines of business.

The corporate segment also shows an increase, and this is to a large extent related to FX effect. On the lower part of this page, we see a positive evolution of the financial margins with clients, basically related to the repricing process and the increase of the SELIC rate.

Moving to page 9, we see the financial margin average rate in annual terms. Spread-sensitive operations shows stability at 10.8%. If we consider the FX effect, this would be 10.9%, so a slight increase. Adjusted by risk, we see a reduction, the green line, from 7.1% to 6.9%. This 6.9% will be 7.0% considering the FX effect.

Moving to slide number 10, and talking about financial margin with the market, as I mentioned, this – we do not consider this R$2.3 billion as a unusual – as a usual result. This was due to the very high volatility we observed in this third quarter. Just to give an example, FX rates showed 28% devaluation in the period. So, the ability to take advantage of higher volatility and some directional positions in FX and interest rates allowed us to produce this very robust result.

But again, what – we do not consider this as a usual result. A more usual result would probably be around, in annual terms, R$5 billion that would be more in line with the historical standards for this line, considering of course that this is intrinsically a volatile line of the P&L.

Moving to slide 11, and starting to talk about credit quality on the first part of the slide, we'll see (12:35) the 15 to 90-day NPL ratio. We see a stability at 3% for the total portfolio. Excluding effect of FX rates, variation of the total portfolio would have increased – the NPL would have increased 10 bps.

For individuals, we see a small reduction here that we believe to be consistent with the process of adjusting our credit policies that is starting to show consistent results for this 15 to 90-day NPL rate. Companies showed an increase of 10 bps in this period.

Going to the lower part of the slide, the 90-day NPL ratio is stable in the total at 3.3%. That would have been 3.4% excluding FX rate variation. When we look at the individuals, we see a relevant increase of 50 basis points from 4.6% to 5.1%. That's above what we expected in this particular line of business. Looking ahead, we expect to see additional increases in NPL of individuals for 90 days although at a slower pace, a more moderate pace. The companies' NPL ratio for 90 days showed a reduction of 20 basis points. Here also, we expect to see in the future increases of this indicator, particularly because we have some particular cases of corporate loans, relevant corporate loans that will roll over to 90-day past due situation and those loans are already, to a large extent, provisioned.

Moving to slide number 12, we see here the 90-day coverage ratio, very relevant increase from 187% to 214% of the coverage ratio basically due to the complementary provision we made in this quarter of R$4.7 billion. Just to remind that this is above – this R$4.7 billion is above the minimum required by local regulators.

As we mentioned already in the past, we don't manage the bank in looking too much to this coverage ratio. We follow it of course, but this is not something where we have a specific target. And we possibly are going to see a reduction in this figure, looking ahead as some transactions may become past due or roll over to 90-day past due.

Looking at the lower part of this page, we see the coverage ratio by segment. In the Retail Banking segment, we see a figure this quarter similar to the one we observed in June. And in the Wholesale Banking portfolio, we saw an increase given the more anticipatory aspect of this provision.

Moving to slide number 13, we compare here the individuals 90-day NPL ratio with the same figure, the same indicator, excluding fully provisioned credits. In the second concept, we see a much more modest increase of 20 basis points for individuals. For companies, we see a stability around 0.5%, 0.6% of 90-day NPL when we exclude fully provisioned credits.

And finally in this page below, we have a breakdown between very small, small and middle market companies on one side and corporate on the other side. And we see a reduction in corporate indicator and a slight increase in the very small, small and middle market companies. That's naturally a segment that's more sensitive to the economic cycle.

Moving to slide number 14, we are showing this for the first time given the present challenging credit scenario. We are showing here renegotiated loan operations. We see a nominal increase of R$1 billion in this portfolio from R$12.5 billion to R$13.5 billion. Roughly speaking, one-thirds of this increase is related to FX effect. When we consider this as a percentage of the total loan portfolio, we see 2.8%. That's historically low and basically stable when we look back the several quarters before this one.

On the lower part, the delinquency and allowance for loan losses coverage, we see a consistent increase in this indicator reaching 233%. The 90-day NPL balance here showed a nominal reduction from R$2.7 billion in June to R$2.5 billion in September bringing the 90-day NPL ratio down from 21.5% to 18%.

Moving to slide number 15, loan loss provision expense as a percentage of total – or loan portfolio, basically stable, around 4.8%, 4.9% in the past few quarters. In the lower part, we see a reduction in NPL creation from R$5.6 billion to R$5.2 billion and also a reduction in write-offs from R$4.7 billion to R$4.3 billion. So NPL creation as a percentage of loan portfolio, basically stable around 1%, 1.1% in the past few quarters.

The last slide on credit, slide number 16, we see the evolution of loan loss provision expenses by segment. As expected, we see here a decrease in the Wholesale portfolio from R$1.8 billion to R$1.4 billion and an increase of the Retail portfolio expenses from R$3.7 billion to R$4.3 billion.

Moving to slide number 17, going quickly here just to highlight that we've been growing commissions and fees and result from insurance is slightly above inflation, 10.2%. On slide number 18, non-interest expenses. In 12 months, we show a 8.5% increase. That's below inflation. If we do not consider operations abroad that are, of course, affected by FX, this would have been 6% growth only in 12 months.

If we take the particular quarter, the third quarter, there is a substantial increase of 9.3% basically due to the 15.2% increase in the personnel expenses. And here it's important to explain that when we booked this in September, we were still negotiating – we banks were still negotiating with the Union. And what we booked in September was the proposal we had on the table that time that was a combination of a percentage increase with a lump sum payment. So this lump sum payment was booked.

At the end of the negotiations, this turned to be only a percentage increase with no lump sum. So that we are going to see in the first quarter a reversal of this lump sum payment provision and all considered, we are going to see a small reduction in the fourth quarter of personnel expenses. In the lower part of this page, we see the trailing 12 months efficiency ratio continue to going down, although in the particular quarter in the third quarter, we saw some increase.

Moving to page 19 talking about capital, we had a 90 basis point reduction in common equity Tier 1 from 13.2% to 12.3%. The net income of the period was basically offset by a increase in tax credits and the combination of dividend distribution mainly and the growth in RWA, and in this case, related to FX produced this reduction.

When we look at the CET 1 fully loaded, we see a reduction here coming from the common equity Tier 1, 12.3%, and anticipating the schedule of Basel rules to reach 9.8%. This is influenced by the FX, the valuation in the period given the structure of our investment abroad and the hedge of this investment.

Considering the FX rates prevailing in the past few days, this 9.8% would be today something between 10% and 10.5%. So we are very confident that we are well-capitalized. And given the ability to generate positive and the prospective of loan (24:26) growth in our credit portfolio, we expect to see this figure increasing in the next 12 (24:32) quarters.

Going to page 20, just to quickly highlight here that in this historical series, we are seeing the high in terms of net dividend yield and the low in terms of price/earnings, we consider to be attractive (24:57) the stock price of our bank today.

Moving to page 21, just to briefly mention the shares buyback program. This year have been particularly active in buybacking shares for capital management or for compliance with our long-term compensation programs. We have bought close to 87 million shares so far this year. We have an open program of 50 million shares, of which we have already used 13.3 million shares.

And finally, moving to slide 22, the 2015 outlook, our expectations for this year. For the total loan portfolio growth, given the FX devaluation, we expect to be above this 7%. That's the top of this interval here. In terms of managerial financial margin, given the good result with markets and the re-pricing risk process, here again we expect to be slightly above the top of this interval.

For provision for loan losses net of recovery of loans, we expect at the end of the year to be around R$18 billion. That's the top of this interval. For services fees and result from insurance operations, we're probably going to be closer to the low end of this range. And finally non-interest expenses, we are probably going to be closer to the high end because of FX effects. We are here very committed to working hard to deliver not only this year, but the years ahead below inflation expenses growth.

So with that, I finish my presentation and Marcelo Kopel and myself are available for possible 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 Philip Finch with UBS.

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

Thank you, Eduardo, for a comprehensive presentation. I have three quick questions. First in terms of credit quality, you talk about how delinquencies will likely go up in the coming quarters on the one hand and then you've also been adding to your complementary provisions and boosting your coverage ratio. So going forward, what sort of costs of risk or provisions to loans can we assume going forward? You mentioned that you've been running at around 4.8%, 4.9% in recent quarters. Is that the run rate that we can still assume or should we assume higher costs of risk going forward?

Second question is regarding your loan growth. Stripping out FX, loan growth was flattish year-on-year. Looking into 2016, can we assume this remains the case? Are we going to see negative loan growth, in which segments, and when can we anticipate any form of recovery in credit demand? And lastly, in terms of geographical revenue diversification, what are you planning to do outside Brazil? Obviously, you got CorpBanca with Chile and Colombia but are you looking beyond that to Mexico or Peru? Thank you.

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

Good morning, Philip. Well, we are still in the process of working on our 2016 budget. Given the level of uncertainty that we still have in the Brazilian economic and political scenario, we don't have any specific expectations regarding the ratio you mentioned.

What we can say is that given the economic scenario, yes, we expect to see NPL ratios to continue to go up on a moderate pace. But it's premature to have any more precise assessment on the ratio mentioned and also the same is true for credit growth. We do not see any relevant – by all means any relevant credit growth next year. The Brazilian economy most probably are going to contract further next year, although possibly in a lower pace than what we are seeing this year.

In terms of geographical diversification, we have this strategy of over time reducing a little bit the dependence on Brazilian business. Of course, we will always be a very Brazilian-based banks but with the merger with CorpBanca, we are probably going to be close to 20% of revenues arising from...

A - Operator

Credit assets.

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

Sorry of credit assets, not necessarily revenues – our credit assets outside Brazil. Yes, Mexico and Peru are countries that we'd be interested to be in the future, but we don't see this frankly in the near future. Our focus now is to consolidate CorpBanca operation.

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

Okay. Thank you very much, Eduardo.

Operator

Our next question comes from Carlos Macedo with Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Good afternoon, gentlemen. Thanks for taking questions. First question regarding the excess provisions you made in the quarter, you now have a very large balance of excess provisions. You haven't used those excess provisions, if I'm not mistaken, for six or seven years. Under what conditions would you use these excess provisions? What would be the situation which you're prompted to use them?

Second question regarding the securities in your book, I mean we saw on the held-to-maturity book, there was a fairly substantial decline in the market value, the securities also available for sale to some degree. Is that something that concerns you regarding capital for the near future? I know what's the maturity - once those securities continue to mature, is that something that we should be concerned about? We saw the impact that they had on Bradesco's capital not as much for Itaú. Is that something that should be something that we worry about over the next few quarters? Thank you.

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

Hello, Carlos. To your first question, we have built this additional provision cushion precisely to face possible more challenging environment in the future. I think that we would possibly use this if conditions continue to deteriorate further in the next quarter. So, it's not something that we don't - we cannot exclude using this in the future again if conditions continue to deteriorate. We don't have any particular trigger for that to be, to some extent, a judgment call, but this was just precisely to use in a more stressful scenario.

In terms of reduction of our bonds held (33:39) for sale and held to maturity, given the volatility in the third quarter, yes, we had some reduction. But as I briefly mentioned during the call, we are not - by all means we're not worried about our capital bases. Again, our full CET 1 ratio, given present market conditions, would be already above 10%. The ability to generate profits combined with the lower credit demand, I think will put us in a very comfortable position in terms of capital both in absolute and relative terms.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. Thank you, Eduardo. One question regarding the first answer. You said that you don't manage the bank looking at the coverage ratio and obviously you have a lot of rules that you need to follow. Is there - and there are no specific triggers that will lead you to use that excess provision, but just conceptually thinking, would this be - because of the chunkiness of the wholesale book, would you think that it would be something that would be driven by, say, a onetime event in wholesale as opposed to a more structural event in retail or is there really no rule that you will follow for that?

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

There is really no rule, but both the events you mentioned are theoretically covered by this increase in provisions. We could use these conditions in general deteriorate (35:17) and affect the retail portfolio. It could be used if there is a specific large cases in the quarter. As we mentioned, we don't have a target for coverage ratio. But as you can see in the charts is we are probably at the high point ever in terms of coverage ratio. So looking ahead, I think it's reasonable to expect some reduction, some conversions to the historical levels.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay, perfect. Thank you, Eduardo.

Operator

Our next question comes from Tito LaBarta with Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi, good morning. Thanks for the call. A couple of questions as well. Just following up a little bit more in terms of asset quality, I know it's hard to see into next year just given the environment, but maybe if you can provide - maybe quantify a little bit when you say some moderate deterioration next year. I mean would you say that what we saw in the consumer portfolio about 50 basis points like that type of deterioration per quarter or even maybe a little bit less as you mentioned? Is that what you would consider to be moderate?

Also in terms of the corporate NPLs that can pick up, if you can maybe just give some color on how you see moderate, is that a couple of basis points per quarter or anything significant that worries you? Particularly with the additional provisions that you're booking, is there anything that could kind of surprise you or be worse than expected? As much color as you can give on that, would appreciate it.

And then also in terms of your margins, you continue to see some margin expansion. How do you see your margin evolving into next year? Do you think you can see further margin expansion? Has that now peaked in terms of your ability to increase spreads? And then just finally, in terms of the trading gains, I know this quarter was very high, but do you think that could reverse a bit in the fourth quarter or at least what you've seen up until now, do you think you could get back some of those gains this quarter? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Tito. It's Kopel speaking. Let's start from backwards on your questions. Talking about the trading gains, when we talk about unusual level of gains – and this is an example. This quarter in particular has an unusual level for the gains. What we've been saying to the market is that the usual level we could expect is around R$5 billion for the year, which will mean R$1.2 billion, R$1.25 billion a quarter. So, that's something that you can keep in mind for that, okay?

Then your question about margin expansion in 2016, when you look at our NIM for this year, it's been slowly growing throughout the year as we've been increasing prices on our spreads, on the new originations, and as we've been – on the renewals of the back book, we've been re-pricing those as well. This is an ongoing process, okay? Part of the book has been re-priced and the new originations are coming day after day. But for next year even if things stay at where they are, the average NIM for next year should be higher than the average NIM for this year. So, that's something that you could work with.

And the third part or the beginning of your question, which is asset quality and to your point about this level of increase, this 50 bps that we saw in individuals, to be fair, they were above our expectation. When we mentioned that we were expecting a moderate increase in the second quarter, we were not referring to a 50 bps increase. So, it's somewhere lower than that that we consider moderate and we don't see that happening quarter-over-quarter.

And just to finish and wrap up to that point, when you talk about – and you may ask about the peak of the delinquency which you could – in our base case now, we're talking about more towards the end of 2016 and beginning of 2017. So, these are the things that we can consider and we don't consider 50 bps as a moderate increase.

Q - Tito LaBarta {BIO 20837559 <GO>}

Great. Thanks. That's helpful. Just how about on the corporate portfolio, also when you kind of say moderate there and given that probably there could be some chunkiness there or something major? But how do you see that evolving because you're already at pretty high levels compared to over the last year-and-a-half? So, if you could maybe give some color on the corporate side as well?

A - Marcelo Kopel {BIO 16986304 <GO>}

Right. Corporate is more discrete behavior, right, so it's not that you model and use the statistics. We had a meaningful step-up on our comps base for this year. There could be additional cases next year, but we are departing from a meaningful base for this year. So as Vassimon mentioned during his presentation, we are seeing some cases that we have been providing already to preempt the provisioning for those, which will probably show up in the NPLs of the fourth quarter, but those are basically being, to a large extent, already provisioned. So we depart from a high cost base for next year. There could be some increase, but departing from a very high level so, therefore, that increase should be something lower than the increase you could see on the individuals.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay, fair enough. That's very helpful. And then sorry, just one follow-up on the trading. I understand on average about R$1.2 billion per quarter makes sense. I was just trying to get a sense, given you had such a huge gain in the third quarter, do you think you could give some of that back in the fourth quarter? Could it be lower than that or does it continue to be high? Just kind of get some more color on the fourth quarter given we're already more than a month into it.

A - Marcelo Kopel {BIO 16986304 <GO>}

I mean you could use that number as a proxy for the fourth quarter as well.

Q - Tito LaBarta {BIO 20837559 <GO>}

Yeah. The R$1.2 billion.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yes, something in that neighborhood.

Q - Tito LaBarta {BIO 20837559 <GO>}

Great, fair enough. All right. Thank you very much.

Operator

Our next question comes from Marcelo Telles with Credit Suisse.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hi. Hello, everyone. Thanks for the time. I have two questions. The first one is still regarding the trading. Looking at how much you've been hedging of your investment in foreign subsidiaries, it seems that you remained under-hedged versus your dollar exposures, which mean in theory you'd be let's say long dollars at that stage at least at the end of the third quarter. So there'll be probably the second quarter in a row that you'd be with that position.

Is that something that you could expect that to be more structural and be there for some time given the high market volatility, which of course, in fact, this has helped you should (42:41) your balance sheet to some extent compared to some of your peers? So would expect that to change at some point or do you think we should see that to last a little bit longer?

And the second point regarding asset quality, what is the scenario that you are working in terms of GDP growth next year? What are the downside risks that you see and in your view, how would the loss of investment grade by Moody's would impact the quality of your loan book? Thank you.

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

Hi, Marcelo. This is Vassimon.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hi, Vassimon.

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

Hi. On your first question on trading, as we mentioned, the figure you see is a picture of the position at the last day of the third quarter, so it does not necessarily reflect our position that's much more dynamic. Having said that, we have a part of our investments abroad, a small part but still, where the hedge is more difficult because of liquidity aspects of markets, for instance, say, in Argentina and Paraguay. So this is one of the factors that explains why in a certain point in time, you may not see a fully hedged figure.

And of course, the other aspect is FX positions that we may have from time to time that are dynamic, and in this particular case, cannot be considered a structural position. So coming back to the previous question, I think these trading results are by nature volatile, but our best guess as a more "usual" result would be around R$1.2 billion, R$1.3 billion per quarter.

Your second question about asset quality and GDP growth. I will recall the call of our economic department today is a drop of 1.5% GDP next year. What starts to seem a little bit optimistic from (45:24) now, so we're probably going to see a reduction in GDP that's higher than that. Of course, this impacts the whole credit environment.

And in terms of the possible loss of investment grade, I believe that to a large extent is already priced in. I know you'll see the prices of Brazilian AMB (45:53) or CDS. It's already a price of a non-investment grade country. Of course, this makes the refinancing abroad more expensive, but a relevant part of this could be refinanced domestically, either through institutional investors or banks. Of course, we are following this process very cautiously and analyzing companies on a case-by-case basis.

Q - Marcelo Telles {BIO 3560829 <GO>}

Excellent. Thanks for your time.

Operator

Our next question comes from Saul Martínez with JPMorgan.

Q - Saul Martínez

Hi. Good afternoon, guys. I have two questions. I'm going to follow – first, I'm going to follow up on the question of cost of risk and follow in that was asked earlier and understanding that you can't give a specific guidance or specific numbers, I'll ask in a little bit more of a conceptual way how you think about it and how we should think about it.

This credit cycle's obviously challenging to analyze because, on the one hand, you have de-risked as you've explained many times before pretty aggressively. There is a mix shift, you are not growing into the cycle, but at the same time Brazil's going to have a contraction in GDP that over a two-year, three-year period that it hasn't seen probably since the 1930s at least, which obviously is going to hit asset quality.

But looking at your cost of risk metrics, net cost of risk is up about 100 basis points this year versus last year. In the last couple of cycles, you've seen I think 2011 and 2012 about 120 basis points, 130 basis points increase. In 2008, 2009, you saw I think a little bit more than that. Previous cycles, you may have seen more than that. How should we think about the increase in cost of risk from trough to peak?

Given the moving parts and the trends that I mentioned, do you think this is a cycle that because you have been de-risking that wins out and you don't see as much of an increase or do you think that we should be working with an increase in the cost of risk from trough to peak, whether it's 2016 or 2017 – it sounds like you think it's 2016 – that is worse than in past cycles? So, conceptually, how do you think about it and how do you think the market should think about it?

The second question is somewhat related. It's on corporate credit. Clearly, this is a product where a relatively small number of cases can impact provisions quickly. Your expected losses are generally lower. I realize that you were starting from a high level, as you mentioned. But unexpected losses can be much bigger given your concentration risk. How are you seeing the tail risks today associated with corporate credit? Do you think the economic backdrop - a further downgrade that limit the company's ability to fund themselves externally, how do you see the probability or the likelihood of that producing a stress scenario? But again, I realize it's not the base case scenario, but how relevant a risk do you see with corporate credit and provision spiking much more than what the base case suggests?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hello, Saul. It's Kopel. Let's start with your first point regarding what could be - how we go between the low end of the NPLs into the high end of that and to give you like a more - a short-term answer. From what we have seen internally - and we are still working on that and finishing - if you take the 2009 number, which were we peak there (49:51), given all the different component you saw said about de-risking, about GDP contraction, about - and I'm adding to that, the slow growth we've been having in the portfolio, all that combined at this point makes us understand that we will not reach the peaks that we had in 2009. That's the view we have at the moment, okay?

Moving into your corporate lending question about they are more binary or they are more or like big - onetime events in each of the cases given that they are big credits, if - and these happened, and the market has been working on some cases, and we are part of that work with the market. So, if that happens and these credits are not necessarily fully provided for which we've been downgrading quite a bit of them in advance, there is this additional provision that could help us shelter at least part of this pressure.

Q - Saul Martínez

Okay. No. That's helpful. I guess now my first question now, Marcelo, it wasn't more related to you reach the peak of the NPLs because your mix is dramatically different. It's more the delta that you've seen in 2009, the delta that you've seen in 2012 versus 2010, and how that compares to the delta on whether it's NPL or really I was asking more on cost of risk provisions to loan. And the question is more along the lines of how likely - if my numbers are right, 100 to 150 basis points from trough to peak in the last two cycles, you've had 100 basis points already. Do you think that they could get worse than what you've seen in the past cycle? Or is it too early to tell?

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

Hi, Saul. This is Vassimon. I think it's too early to tell because we are still in the mid of the process. I think we could not describe (51:59) the possibility of being higher than what we saw in terms of difference between bottom and top, what we saw in 2009. But it's really difficult to call it at this point. We are definitely in a very severe economical situation. So, again, we are going to see NPLs going up. I think from now, it's difficult to say, but we cannot exclude the possibility of having delta that's higher than we observed historically. Having said that, as Kopel mentioned, we've seen from today, we do not expect to reach the levels we saw in the last cycle.

Q - Saul Martínez

Okay. That's great. Thank you very much.

Operator

Next question, Aníbal Valdés with Barclays.

Q - Aníbal Valdés

Hi. Good morning, Eduardo and Marcelo. So, I'm more interested in the underlying dynamics of the loan portfolios. So, the first question is, as related to the indicators, so we saw increase in the individuals' portfolio NPLs. But the early delinquency rates, which is between 15 to 90 days, didn't show a pickup.

So, it clearly comes as a surprise. So, how can you explain that the early delinquency rate doesn't show such a dramatic increase in the previous quarters, while you have the increase of 50 basis points over 90 days? So, that's one of the things that I would like to further understand.

And the other one, regarding that individuals' portfolio, what things are you seeing in that portfolio? Is it deterioration across the board and in credit card, consumer loans, and vehicle financing? Or is it specific product in a specific region? And is – or is it a broad problem in the loan portfolio? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Aníbal, let's start with – where we're seeing the increase in NPLs is coming from credit cards and personal installment loans, which aren't secured lines. And these are more sensitive to an environment where we are. But just to make a point on the credit cards, as you probably have seen three-quarters of our portfolio are comprised of transactors. And where we are seeing the increase in NPLs is not coming from transactors that are becoming revolvers and getting delinquent.

But we are seeing that the increase in NPLs within the revolvers portfolio. So, it's not that people are changing their behavior and where they are typically people who use the credit card as a means of payment and are transactors and becoming revolvers. So, that's one element that I would like to make on the credit cards. And I mention also decrease (55:00) in NPLs for personal installment loans.

Then, regarding the NPLs, the short term – and I talked to this, short term and the long term, as we've been dynamic in our managing our credit qualities, the fact that we have a reduction in this quarter shows that certain vintages were – that we did raise the bar and cut the – increase the underwriting standards have a better behavior, and therefore, rolled over to a lesser extent than the vintages that rolled over this quarter, okay?

But that doesn't mean that we expect that the next quarter, you would have a similar behavior. Therefore, we are still expecting an increase in the NPLs for individuals in the following quarter – in the following quarters, actually.

Q - Aníbal Valdés

Thank you, Marcelo.

Operator

Our next question comes from Victor Galliano with Barclays.

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

Hi. Yes. Just a couple of follow-ups from me. In terms of capital and you show us that you're fully loaded Tier 1 for 3Q. Does that also include the impact of CorpBanca? That's my first question. And my second one, on renegotiated, you give us a broad picture of the amended portfolio and then you give us the renegotiated loans, which are R$13.5 billion out of the – I think R$21.9 billion portfolio you have there. Those R$13.5 billion, are those all loans that are overdue? Or how do you separate the R$13.5 billion from the R$21.9 billion, if you see where I'm coming from?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Victor. It's Marcelo. Talking about the renegotiated loans and as you correctly pointed out that there is a larger portfolio of R$20 billion, which is comprised by two pieces, and the renegotiated loans are inserted into that portfolio, which is the R$13.5 billion that we have. These are – and in this portfolio, what you have is, on page 14 of our presentation, the breakdown of how much of that are overdue credits, which is R$2.5 billion out of the R$13.5 billion renegotiated loans. So, that's how you should read our numbers, okay?

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

So, those R$2.5 billion are overdue from more than 90 days or starting from one day overdue? How do we...

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. It's 90 days overdue. Sorry, its 90 days overdue.

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

Okay, okay.

A - Marcelo Kopel {BIO 16986304 <GO>}

Okay? And then, your second question about the capital, CorpBanca is not included in that 9.8% that we show on the capital projections. And neither are the future profitability. So, CorpBanca will be an impact of approximately 80 basis points in our numbers, okay? Therefore, you should do the math and also take into consideration that since FX has an important influence in our number, the sensitivity now is – looking at current FX rates, we are more like between 10% and 10.5% at the moment.

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

So, an 80% (58:31) on 10%, 10.5% is what you're saying?

A - Marcelo Kopel {BIO 16986304 <GO>}

I'm saying that the 9.8% today that we show in page 19...

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

Yeah.

A - Marcelo Kopel {BIO 16986304 <GO>}

Talks to 10% to 10.5%, and given the FX movement, okay?

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

Right. Yeah, and CorpBanca...

A - Marcelo Kopel {BIO 16986304 <GO>}

Which basically (58:48) – yeah, we do see the DTAs and so on and so forth.

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

All right. Thank you very much.

A - Marcelo Kopel {BIO 16986304 <GO>}

You're welcome.

Operator

Our next question comes from Carlos Gomez-Lopez with HSBC.

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

Hello. Good morning. And thank you for taking the call. Just to give you a break on asset quality and questions on different matters. First, in the use of the DTAs that you make, you mentioned a R$540 million provision for contingencies. And in the notes, you mentioned it - at least largely refers to economic plans. That's a large amount. That's almost R$1 billion pre-tax. Is this something that you expect to be a one-off? Is it recurrent? And would it include provisions for collective claims? And the second question is what do you expect your tax rate to be in 2016 given the past changes? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Carlos. It's Kopel speaking. The R$540 million that we had as a nonrecurring is comprised by a number of things, including the economic plans. Well, we did have a corporate restructuring or legal entity restructuring, which accounted for less - for more than - for approximately more than half of this R$540 million. So, this is not something that will be repeating itself, okay? And that's why it was classified as a onetime or as a nonrecurring item, okay? And then...

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

Sorry. Could you give more details about that legal entity restructuring or...

A - Marcelo Kopel {BIO 16986304 <GO>}

Sure. We reorganized our legal entities abroad - outside Brazil. And by doing that, certain taxes were triggered. And this is the reflection of those taxes related to this reorganization.

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

I see. Thank you.

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

Then on - this is Vassimon, Carlos. On your question about the tax rate, with the increases, we expect to see this close to 37% next year.

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

All right. And that includes already the reduction of interest on capital to 5% presumably?

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

Yes.

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

Thank you very much.

Operator

Our next question comes from Boris Molina with Santander.

Q - Boris D. Molina {BIO 1904979 <GO>}

Yes. I had a question regarding the outlook for pricing and corporate spreads. If you look at the spreads over SELIC of non-earmarked loans in Brazil, it's probably (01:01:30) the largest driver of your corporate spreads. These are have – and continue to expand on a pre-provision or pre-NPL level view (01:01:42) throughout the last year-and-a-half. Even in the last month in spite of the headline spreads decline, the relevant spread continued to expand.

However, when you deduct (01:01:51) the non-performing loans or non-earmarked loans or the private sector, basically the risk-adjusted spreads on that measure have been flat for almost a year-and-a-half, almost two years. And so, the behavior of the banking industry seems to be that they are increasing spreads along with cost of risk.

Now, my question has to do – what is the behavior going to be like if you have pre-provision cost of risk ahead of time? Is there any room for the spread for companies to continue to expand because when we look at it on a cyclical adjusted basis, for secured personal loans and credit cards, you see the spreads going back to record highs and peak levels we've seen in past cycles, but this is not the case for corporate lending?

So, if we think that (01:02:37) becoming fairly dysfunctional in terms of the way the fiscal accounts are being managed and very ineffective management, is there room for the industry to price higher the current cost of risk going forward related to the levels we have right now? Do you think that corporate spreads can continue to expand in 2016? (01:02:58) what is your kind of like your outlook for further spread expansion in 2016?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi. Boris, thank you for your questions. Let me just put things in the context of – yeah, as you pointed out, banks have been pricing the increase in risk. When you look – depending on how you look at the series (01:03:18), the fact that spreads after cost of risk have been relatively stable, it confirms that banks have been pricing that accordingly. In the scenario described where risks tend to increase, two things can happen in our case.

To the extent the credit is the credit that we would like to underwrite, we will price it accordingly, okay? But there would be cases where we may forego credits in the sense of making new credits, given the fact that it's not a matter of price, but it becomes – it's the fact that they became riskier than we would like to underwrite. And therefore, you would have a volume impact and – because we will forego those particular credits to the market, okay? So, in another words, we will probably not put ourselves in an adverse selection situation just because we can price it more.

Q - Boris D. Molina {BIO 1904979 <GO>}

Okay. Wonderful. So, basically, you could price if right (01:04:24) and the operation could take place at the right price, but because of the risk you will just basically decline to take the volume?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. There are situations where certain clients, it doesn't become a matter of price, but it becomes – they don't feed our credit appetite.

Q - Boris D. Molina {BIO 1904979 <GO>}

So, if you think about it in this context, then the buildup of excess provisions of – that we've seen in the last year-and-a-half is truly alarming because it gives an idea of the level of expected losses you expect on your corporate loan book where the provision coverage has been higher. So, seen in this light, it's not that the spreads to good borrowers subsidize weak borrowers; it's that the weak borrowers are pretty large and that is reflected on your wholesale corporate coverage ratio?

A - Marcelo Kopel {BIO 16986304 <GO>}

I don't think the word should be alarming because, as you will recall, at the end of last year, we expected a softer economy and we built R$1.1 billion of additional complementary provision, okay? And this is another buildup we've been doing for a softer economy. And as Vassimon mentioned before, there could be instances that we may possibly use this coverage, okay?

But again, there is – the visibility is low at the moment. Therefore, where we are now, we will continue to proactively provision credits to the extent we feel then (01:05:51) they are weaker. I'm talking about to the corporate loans specifically. And we'll continue to do that on the rollovers of the individual portfolio as well. So, I wouldn't use the word alarming as for the situation, but it's a delicate situation in the sense that they are very careful of the underwriting standards.

Q - Boris D. Molina {BIO 1904979 <GO>}

Okay, wonderful. Thank you so much.

Operator

Our next question comes from Eduardo Nishio with Banco Plural.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Thank you for taking my question. I have two questions. First one is regarding your Wholesale Banking. If you look into the performance of the Wholesale Banking unit, you see that they are underperforming for quite a while the other units. And it has been widely commented in the press that the Wholesale Banking is under a deep (01:06:44) reorganization. I was wondering if you can comment a little bit more, give us a little more color what's going on there. And if you can give us the broader plan and if we can expect some improvements in the near term or when it's going to happen? I'll appreciate it. That's the first question. Then, I will do my second later. Thank you.

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

Hi, Eduardo. This is Vassimon. Yes, it's true that results of the Wholesale Bank division were not brilliant recently, but it's basically related to the economic situation in terms of increasing cost of credit risk. So, this is the main driver of the underperforming of this division. And the adjustments that have been made in the structure of the bank are – reflects of a major restructure of the executive committee of the bank in beginning of this year and are not related to the recent performing of the division.

Historically, Wholesale Banking has been performing very well. In this particular year, again, given the economic situation, it was a poor performance. And the changes are adjustment in the structure without changing by all means the focus and the relevance and the importance of the division.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Okay. Thank you. My second question is a follow-up on a comment that the peak in delinquency would be in the first half of 2016. I was wondering if you can develop up a little bit more. If we look into the past environment, the economic downturn has been worse than I think most expected, we're probably going through the worst economic environment since the 1930s, and the unemployment is expected to peak in the second half of 2016. Just wondering if you – how comfortable or confident you are with the delinquency peaking in the first half instead of a more prolonged difficult scenario? Thank you.

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

Eduardo, I think it was some type of misunderstanding. What we mentioned is that we believe, seeing from today and given all the uncertainties of the environment, that we expect the delinquency to peak between the second half – the end of next year and the beginning of 2017. So, not in the first half of next year because again, we are expecting 2016 to show another GDP drop. So, we don't see situation improving in the first half of next year. We're expecting again to have it peaking by the end of next year, beginning 2017.

Q - Eduardo Nishio {BIO 15333200 <GO>}

Perfect. Thank you so 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>}

Thank you again for participating in our conference call. Just to reiterate our message that we believe that third quarter results were quite positive given the very challenging environment of the Brazilian economy. We believe that we have reinforced and protected substantially our balance sheet with additional provisions that were built in this quarter. We believe that we are well capitalized and prepared to take advantage of the improvement of the environment that we may see within one year or two years in the future. Thank you again.

Operator

That does conclude our Itaú Unibanco Holding earnings conference call for today. Thank you very much for your participation and have a good day.