Q2 2016 Earnings Call

Company Participants

- Eduardo Mazzilli de Vassimon
- Marcelo Kopel

Other Participants

- Carlos Gomez-Lopez
- Carlos Macedo
- Jason Mollin
- Jorge Kuri
- Mario Pierry
- Nicolas Riva
- Pedro Fonseca
- Philip J. Finch
- Tito LaBarta
- Victor A. Galliano

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Itaú Unibanco Holding Conference Call to discuss 2016 Second Quarter Result. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time.

As a reminder, this conference is being recorded and broadcasted live on Investor Relations website at www.itau.com.br/investor-relations. The audio webcast works with Internet Explorer 9 or above and Chrome, Firefox and mobile device iOS 8 or above and Android 3.0 or above. A slide presentation is also available on this site. The replay of this conference call will be available until August 9th by phone on (55 11) 3193-1012 or 2820-4012, access code 3452156#.

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

With us today in this conference call in São Paulo are Mr. Eduardo Vassimon, Executive Vice President, CFO (Chief Financial Officer) and CRO (Chief Risk Officer); and Mr.

Marcelo Kopel, IRO (Investor Relations Officer). First, Mr. Eduardo Vassimon will comment on 2016 second quarter results. Afterwards, management will be available for a question-and-answer session.

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

Eduardo Mazzilli de Vassimon {BIO 5349410 <GO>}

Good morning. Good afternoon. Welcome again. We will start at page two with relevant information. We are in this quarter consolidating in our financial statements, the operations of CorpBanca, given the fact that the merger between Itaú Chile and CorpBanca was concluded on April 1st at controlling shareholders, although with a 33%-34% ownership only. We are then consolidating our (03:00).

We are presenting historical data pro forma to allow a better comparison with previous periods. With inherent limits of this type of information. So we are including in our income statements, all the lines – in all the lines, 100% of old the CorpBanca results. And the minority shareholder is shown (03:31) our shareholder line with that from the bottom line.

Going to page three, I'd like to call your attention to some particular points. In general, we believe that we had a good quarter, particularly considering there's still a challenging environment. We start to see some more positive elements that allow us to be more constructive on the development of the Brazilian economy.

We had in this quarter R$5.6 billion recurring net income in the consolidated figure and R$5.2 billion in the Brazilian Corporation. Given the CorpBanca operation and the importance that the Latin American operations became after CorpBanca deal, we are going to present several indicators segregating the total on Brazil.

In terms of ROE, both in the consolidated and Brazil, we run in this quarter around 21%. In terms of credit quality measured by NPL 90 days, we had a small increase of 10 basis points, both in Brazil and in the consolidated revenue, I'll talk a lot more about credits in the next slide.

Going to page four, so here, we are now back again to the 20% level return on equity in the consolidated, keeping this leveled (05:17) in the Brazilian corporation, both shown an increase compared to the previous quarter.

Going to page five, we have the main lines of our P&L. I'd like to call your attention to some points. First is a reduction of 5% on the managerial financial margin in this quarter compared to the previous quarter. This is partially due to the reduction of financial margin with the market, from 1.7 in the first quarter that was a particularly strong quarter to R$1.5 billion in the second quarter.

Commissions and fees showed a strong growth of 6.6% in this quarter. We had some seasonality elements here. The first quarter tends to be weaker. In 12 months, we have a

7.1% increase, so a little bit below inflation.

Another relevant point is, relevant stronger reduction in the results from loan losses, 23% below the level we had in the previous quarter. Non-interest expenses, we had 4.6% increase this quarter, there are here again a relevant seasonality. So it's now be more prepared (06:48) to look at 12-month period. So comparing the first half of this year, the first half of 2015, we have a 6.3% increase, so well below the inflation in Brazil.

Income before tax and minority interest showed a 19% contraction when we compare with the first half of this year with last year. When we go to the bottom line, recurring net income, this reduction is 10%, so well below the 19%. And this is basically related to the – a lower increase to tax rates. Looking forward, we believe that in the whole year of 2016, the increased tax rates should be something between 27% and 28%.

Going to page six, we have the breakdown here in Brazil and Latin ex-Brazil on the P&L. I'd like to call your attention to the evolution of financial margin, which climbed in Brazil. We showed a reduction of around 3% here. But we had a specific events of impairments of around R$540 billion. If we do exclude this element, we have had a growth of around 1% in this period in Brazil. Commissions and fees again a strong increase. So the bottom line, both for Brazil and Latin America shows a good improvement compared to the previous quarter.

Going to page seven, we have this breakdown between credit and trading one side and insurance and services on the other side. The insurance and services business that's more a stable and less related to the economic cycle, so the relevant increase from R$3 billion to R$3.4 billion for the first quarter to second one.

While credit and trading showed a reduction from R$2 billion to R$1.8 billion. This is as I already mentioned partially related to the lower performance of margin with the market. If we look at the recurring return on equity for our insurance and services, we show a strong 36%. While for credit and trading, we are around 13%, so below cost of equity.

Going to page eight, we have here the credit portfolio as a result of the economic situation and a weak economic performance of the country, we have the reduction – a nominal reduction of 4.5% in our credit portfolio, expanded the credit portfolio, so including private securities, endorsements and sureties. And if we exclude FX variations, this reduction would be a smaller 1.6%.

Credit card loans, basically flat in this quarter compared with the previous ones and a 3.2% reduction in 12 months. Two lines of business show here a nominal increase in 12 months; payroll loans and mortgage loans particularly stronger. And this is aligned with our strategy of moving our credit portfolio to lower risk lines of products.

Corporate loans suffered from both the Colombian (11:08) and the appreciation of the real in this quarter. That was around 10%. The same is true for Latin America with 8% nominal reduction. In the lower part of this page, we see the breakdown of our Latin America credit portfolio. Here becomes clear that CorpBanca operations that comprise both Chile and Colombia represent 85% of our Latin America credit portfolios.

Moving to page nine, we have here the evolution of the Brazilian loan portfolio in percentage. And here, again, we see strong increases in mortgage and payroll loans; a stronger reduction in vehicles and some stability in corporate, personal loans and credit cards and a very small, small and middle market some reduction over the previous years.

On the upper part of this page, we include the Latin America portfolio that (12:19) incorporation of CorpBanca operations now shows a strong number here, in terms of percentage, 26 percentage – 26%, sorry, of the portfolio is now related to Latin America. Because we have only 33%, 34% in terms of economic interest, these would be 12.3% if we calculate this considering one-third of Chile and Colombia operations, a 100% of Argentina, Paraguay, and Uruguay.

Moving to page 10 and talking about financial margin, taking here the spread-sensitive operations, we see a reduction from 11.1% to 10.9% in this quarter. And this was – this 10.9% was impacted, again, by the impairments that I mentioned previously. Without this element, this financial margin would have been 11.4%.

In the risk adjusted curve, we see a stronger recover from previous quarter, from 6.1% to 6.8% or 7.2% without the impairment. And here, again, is related to the fact that the previous quarter was – we had a particular high number in terms of provision for loan loss.

Moving to page 11, we show the financial margin with the market, again a quite good number of R$1.5 billion, although lower than R$1.7 billion we saw last quarter. In this line, looking ahead, given the good performance of the first semester and the incorporation of CorpBanca, we believe that we should reach something around R$6 billion in terms of the final number for the year, so up from the R$5 billion that we had indicated before the CorpBanca operation.

Moving to page 12 and starting to talk about credit quality; on upper part of this page, you have the 90-day NPL ratio on the consolidated basis. You see on the green line a stability in Latin America NPLs. This, of course, is related to the less risk environment that we have in other Latin America countries other than Brazil.

In Brazil, we have a small increase of 10 basis points, from 4.4% to 4.5%, leading the total also to 10 bps increase, 3.5% to 3.6%. On the lower part of this page, we see Brazil only 90-day. So the breakdown by segments. For individuals, we see a small reduction from 6% to 5.9%. Showing our (15:43) review that we are probably approaching the end of the cycle of increasing NPLs. And we believe that this should occur probably between the end of this year and the first half of next year.

For SMEs, we see a relevant increase here from 5.6% to 6%. This is a segment that's suffering a little bit more than other segments. But here we have also an effect related to the reduction of the portfolio itself. So the denominator here has decreased. In a stable portfolio, we'd have had 10 bps increase only. For corporate, we see a small increase from 1.5% to 1.6%.

Moving to page 13, the 15-day to 90-day NPL ratio and here is Brazil only. We have here some technical limitations to have the CorpBanca operations. So we are focusing here on Brazil only. We see stability for individuals; a small increase for SMEs and a very relevant increase on the corporate NPLs. This is totally due to a particular case that is already 100% provisioned, but became overdue in this quarter and this has no effect on the bottom line. But this overdue will roll out to the 90-day NPL next quarter. So we should expect a relevant increase on the 90-day NPL for corporate next quarter, but again, without any impact on the bottom line, impact on the provisions, given the fact that's already 100% provisioned.

In Brazil, as we may know, we are only allowed to write-off a transaction 180 days after its registered as – its 100% provisioned. So, by the way, in the last quarter of this year, this particular transaction will be in the write-off portfolio. So this increase will come back, in essence – NPLs will come back in the last quarter.

Going to page 14, we have here the NPL 90-day excluding fully provisioned of credits, we see stability – and this is Brazil only. We see a stability in the individuals portfolio around 2.3% and some increase for companies from 0.9% to 1.1%.

On the lower part of this page, we see the NPL creation where we can observed a nominal reduction for retail, for wholesale and for the total portfolio. So we believe this is a positive information. The ratio between NPL creation and loan portfolio for the wholesale showed a reduction from 0.9% to 0.7% And this NPL creation given what we explain about the specific transaction view (19:47) go up substantially in the next quarter, again without any impact on the P&L.

On page 15, talking about renegotiated loan operations. Here, it's important to mention that the figures is (20:12) before this quarter do not include CorpBanca, so this increase of R$1.4 billion in the renegotiated loan portfolio. Out of this R$1.4 billion, R$1 billion is related simply to the fact that we are incorporating CorpBanca in those figures. So, Brazil, as we highlight here, shows R$400 million increase.

On the lower part of this page, we see the 90-day NPL coverage for renegotiated loan operations. So quite high at 210%. And this figure will go down on the next quarter again for the same reason. This particular transaction that will go to the 90-day overview range.

Next page, page 16, provision for loan losses by segment. We saw some increase in the retail portfolio, a relevant decrease in wholesale, and also on the total substantial reduction. Looking forward, we expect to see some increase both in the retail and the wholesale provisions. (21:50) you saw in this quarter, but in any case, below what we saw in the first quarter that we believe to be the peak in terms of total provisions and the peak for wholesale.

Going to last page, coverage ratio 90-days NPL. We see what we believe to be very sound figures, so reaching 250% increase in the total coverage ratio, not only in consolidated but also in Brazil. This shall go down the next quarters because particularly, related to this particular transaction that I mentioned several times.

Going to page 18. (22:47) new way of presenting the breakdown of allowances for our loan losses by type of risk. So we saw some migration from the potential to the aggravated because we had anticipated some provisions particularly in the wholesale segment. I would also call your attention to the green part on the bottom, in the overdue part of this chart, substantial amount is fully provisions.

Next page is the same chart now on the consolidated figures. And here, just to mention that CorpBanca are fully included in the wholesale. Here we have some limitations we have for the time being, including everything in wholesale.

Moving to page 20. Provision for loan losses and NPL creation by segment. We see on the top the retail line consistently above 100% and reasonably stable. The nominal NPL creation here again showing a reduction from previous quarter. Wholesale is more volatile by nature, a very high 146% figure. And we can see here clearly that we have anticipated provisions both in the first quarter and this quarter. So we shall see this coverage going down probably below 200% (24:43) in the next quarter. Again, here related to this specific relevant case that I mentioned several times, and again, that's already fully provisioned. And the total on the bottom are sound 119% ratio.

Going to page 21, commissions and fees and insurance. I believe that we had a particularly stronger quarter in this respect. Again, there is some seasonality. The first quarter tends to be weaker, but even so was a strong quarter. When you look at 12-month evolution, we see 71% still below inflation. But you can see that one particular line showed a negative – the only one that showed a negative behavior is credit operations and guarantees. And this, of course, is directly related to the reduction of credit operations.

Moving to page 22. We showed here 4.6% increase on our non-interest expenses or 6.7% if we exclude operations abroad. It's a high figure, but here you can have a strong seasonality element. So I believe that is more appropriate to look at the 12-month growth figure. That's 4.6%, so well below Brazilian inflation. And this is – as we are going to see, we are very confident that we will be able to lower expenses well below inflation as we are going to talk more on the guidance. On the bottom part of this page on the right side, just quickly mention that we continue to – the process of migrating physical branches to digital branches, basically responding to our clients needs.

On page 23, the efficiency ratio, basically stable both at the consolidated and Brazilian levels.

Moving to page 24. I'd like to call your attention to the very strong figure in terms of capital measured as CET1 fully loaded. So anticipated in the schedule of Basel, 13.2%. So this is after CorpBanca. This is related to the good profit generation that we had in this quarter. This is related also to an increase in use of tax credits that is partially due to the

FX behavior. We had a 10% appreciation in this quarter. And finally, to the low or no growth of our credit portfolio.

Moving to page 25. We had some changes in our 2016 forecast. I'd like to highlight here that on a consolidated basis, the previous and the reviewed forecasts are not directly comparable because the reviewed incorporates CorpBanca. So, for instance, when we see in the provision for loan losses a nominal increase in the range from R$22 billion to R$25 billion, to R$23 billion to R$26 billion. This reflects simplify the fact that we're incorporating CorpBanca provisions.

We had substantial change in the portfolio growth. And this is to a large extent due to the fact that the previous forecast was related to very different expectation for FX. So we had the R$4.5 at the end of this year, we changed it to 3.25%. And the same is true in relation to the Brazilian GDP expectation. So now it turned to be worse than when we built our previous expectation. So the combination of FX and GDP explains substantial part of this change.

In terms of financial margins. We had also a reduction here, and here again there is an impact of FX. We are keeping our provision for loan losses forecast. We are very comfortable with this range R$21 billion to R$24 billion. Same is true for commissions and fee and insurance keeping the 4.5% to 7.5% range. And we are improving here the non-interest expenses range. So the new one from 2.5% to 5.5%. We believe the combination of those change are positive in the total results.

Going to page 26. Just to mention that we announced the (30:45) this week bonus in shares of 10%, following the practice that we had in previous years. This will have to be still approved by shareholders in a general meeting that will be called. And also to mention that we have kept the monthly dividend value at R$0.015. So representing a 10% increase in the monthly remuneration.

So, with that, I conclude my presentation, and of course Marcelo Kopel and myself are ready to answer your questions. Thank you.

Q&A

Operator

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

Q - Mario Pierry {BIO 1505554 <GO>}

Good morning, everybody. Congratulations on the results. Let me ask you two questions, please. This first one has to do with your effective tax rate. You're paying an effective tax rate in the first half of this year of 25%. Last year, you were paying close to 30%. So what I wanted to understand is your ability to pay an effective tax rate so much lower than the corporate tax rate.

Right now, the corporate tax rates was officially increased to 45% recently. So in the Portuguese call, you mentioned that you do expect a tax rate of 27% to 28% this year. So, if you could help us understand how you're able to maintain such a low tax rate. And if you have any guidance for next year. And then I'll ask you my second question later.

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

Good morning, Mario. The reason to have an effective tax rate below the corporate one basically two, the reasons. The most relevant one is interest on capital that represents a substantial part of this reduction. You may know that we had an increase in the GLP rate. That's the rate that apply to the net worth to calculate the deduction. And the second factor is the results coming from a non-financial company. So those are the two main elements. And yes, as I think I briefly mentioned, for the whole year of 2016, we are forecasting something between 27% and 28%. For next year, it's too early to say.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. That's clear. And then second question is related to your excess reserves (34:08) you used about R$700 million this quarter, but your excess reserve still total around R$10 billion historically or recent. In previous few years, you were running of an excess reserves of about R$5 billion to R$6 billion.

So the question is how should we think about your excess reserve, your ability to continue to draw this down? As the economy starts to improve, I think there's a lot of evidence that the economy starting to bottom here in Brazil. So would this be a source of potential earnings tailwinds for you going forward?

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

Our, what do you call, excess reserves, we see these as provisions for potential losses. And we have a dynamic process of setting the level of provision for potential losses. Yes, we had a net reduction of around R$700 million, as you mentioned. And this is the result of transfer from what do you call the excess provisions confirmatory allowance to a regulatory one because we had anticipated in previous quarters provisions that somehow materialized this quarter.

So, looking forward, I mean, again, this is a dynamic process we have our models. We have our judgments. But even if we do not change the level of excess reserves, as we call them, we are very comfortable with the level of provisions that we are indicating in the range, and (36:13) our best estimate is the midpoint for that.

In terms of the whole economy, I agree that we might be approaching the bottom. Of course, in this assessment we are considering that we're going to see further stabilization in the political scenario, and some relevant improvements in the fiscal situation until (36:45) the end of the year. This should be discussed in the Congress. So in this scenario, we expect the economy to grow around 1% next year. We know that some analysts have higher figures, 1.5%, 2%. So in this more constructive scenario, I think, we should – it wouldn't be a surprise if we do not increase our provisions next year.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Just to be clear, what you said at the end, so you think that provisions next year, they should stay stable, or you said they shouldn't increase next year. Correct?

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

Yes. In this scenario, I believe, they should not increase, (37:41) could be either flat or lower.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you very much.

Operator

The next question comes from Tito LaBarta, Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi. Good morning, and thanks for the call. A couple of questions also. One, I guess following up on the question on excess reserves. Just to clarify, that did not go through the income statement. I just want to make sure. So the forecast or the guidance you're giving for provision expenses this year does not include the use of excess reserves. I just want to clarify that from an accounting perspective. And then I have a second question on insurance which I'm going to ask afterwards.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Tito. It's Marcelo. On the use of excess reserves, the way we see it is, we have in the potential allowance sectors flagged with the potential names that could be comprising in those particular sectors as potential risks. As they materialize, there could be a transfer from potential into aggravated risk. And that's how it took place in this quarter. Nevertheless, to the extent we feel that we have more potential risks, the net of these could be zero because you're basically keeping the provision flat by having other names added to that, or other sectors added to that. Okay. So that's how we see it. So to the extent we feel comfortable with the provision level, it's a transfer. Otherwise, it's a transfer with the replenishment of the provision. And that is incorporated in our guidance.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. So you would offset any provisions with the potential use of excess reserves, and that is in the guidance you're saying, correct?

A - Marcelo Kopel {BIO 16986304 <GO>}

If they are in the base case we have, yes. If they are not contemplated, you would see additional buildups, and this is included in our guidance.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. Thanks. That's very helpful. And then my second question is on insurance. This is also a non-recurring charge here from the liability test around R$140 million. So, just want to understand that. Is that something – it's non-recurring here, but that is something that happened again particularly I think with rates movement and interest rates. I just want to get a little bit more color on the liability adequacy test.

A - Marcelo Kopel {BIO 16986304 <GO>}

So, Tito, we do that test twice a year. The last test we did, if I'm not mistaken, was at the end of last year, and it was a positive amount also shown under the non-recurring. And the way we see this every time we run the test in the scenario provided that rates are going down, that could be the case depending on the dynamics of the portfolio that this could be a negative amount or not, but the fact is that we will flag that and present that as a non-recurring item.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. So the next test would be in the fourth quarter?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yes.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. And that would also be – any movements would also continue to be non-recurring in there?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah, and you would be able to see it.

Q - Tito LaBarta {BIO 20837559 <GO>}

Okay. Great. That's very helpful. Thank you.

Operator

The next question comes from Carlos Macedo, Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Hey, guys. Good morning. Thanks. Two questions. First is a little bit broader question on capital. I mean, you're at 14.1% fully loaded and this is assuming now until you get to 2019 you're going to accumulate more capital at least because of the growth in the short term. So three things come out of this, either you expect loan growth to accelerate very quickly. Or two, you think that asset quality will take a precipitous nosedive and put some pressure on your capital despite all the excess provisions you have. Or three, you're gearing to make some acquisition that will dilute capital. I mean, is there a strategy for capital here? 14.1% is well above anybody else in the industry, and it's probably well above, I mean, I remember asking Roberto at the end of the year, and then he said that he wanted to wanted to run the bank at 12%. What's the plan for this excess capital? Dividends, capital reduction, saving up for any day, I mean what's the plan here?

Second question, I'll ask once we're done here. It's about the guidance for (42:19) CorpBanca then.

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

Good morning, Carlos. It's Vassimon. We see 12% as the minimal level to run the bank, considering that we are operating basically on a non-investment grade country. So I believe that it's important to have a higher level of capital. Yes, we are now at well above that. It has some volatility that as you know it's related partially to the level of FX because of the impact on tax credits. So we'd like to see more stability on this level. We do expect some growth on the credit portfolio but that is not a substantial one. We expect to grow a little bit our portfolio in real terms next year. We are basically forecasting inflation of around 5%, close to 1% GDP growth. So we expect to have in today's scenario a growth that goes a little bit above 6%. Of course, we always look at opportunities of acquisitions. In Latin America, we are presently very focused on integration of CorpBanca. And if there are no opportunities in terms of investment, if the credit growth is not relevant, we are going to most probably to keep our dividend policy distribution between 30% and 35%, and we could consider in this scenario being more aggressive in buybacks.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. That's because – just following up here, Vassimon. I mean, you're going to add probably another 50 basis points through the end of the year in capital, even if the real were to go to R$4, you basically net at 14.1%. Are buybacks really going to make a dent? How can you deploy all that capital in the near-term? Even if you grow in real terms next year, you're talking maybe 1% or 2%. It's still not sufficient with your, in doing 16%, 17% ROE?

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

Yeah. As you may recall, last year, we had around 2% of (45:01) we bought back of the shares. So we are prepared if we feel comfortable, if there are no other use of capital, have a more aggressive behavior in this respect. We are not considering at this point changing our dividend policy. I mean, we might see opportunities in terms of acquisition. We are going to follow this to see a more stable environment in growth capital and then we want to avoid keeping excess capital for a long period.

Q - Carlos Macedo {BIO 15158925 <GO>}

Thank you. Thank you. So, just going back to the guidance. I mean, you're preparing the guidance including CorpBanca for prior periods. Should we look at Brazil guidance in a standalone basis to understand what the trends that if there are any changes to trends that we expect for the year, I mean particularly for expenses and fees.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. You should look at Brazil on a standalone basis because I'll give you a few examples here. The increase in loan loss reserves, they went up from R$22 billion to R$25 billion, to R$23 billion to R$26 billion is primarily due to CorpBanca. The fees line for example, Brazil we've kept flat and the change you have is primarily related to FX movement that makes our revenues from abroad (46:29) the same thing applies to expenses. Brazil was trimming its expenses and the overall number is also (46:39) by the effect of Brazil and the effects on the operations abroad.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. So, the...

A - Marcelo Kopel {BIO 16986304 <GO>}

So, Brazil – Sorry. Go ahead.

Q - Carlos Macedo {BIO 15158925 <GO>}

Go Ahead. Sorry. I was just going to ask if on the provision for loan losses, the R$23 billion to R$26 billion that the reviewed guidance, it includes the first quarter for CorpBanca as well right?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yes. It's in the proxy. If the numbers turn out to be comparable. They are made to be comparable, the R$23 billion to R$26 billion.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. Thank you.

Operator

The next question comes from Jason Mollin, Scotia Bank.

Q - Jason Mollin {BIO 1888181 <GO>}

Hello, everyone. My first question is about the bank's disclosure on the impact of the impairment of securities on financial margin. Can you give us a little more color on the impairments taken this quarter and the expectation for more impairments in the future? And my second question is on non-performing loans and the impact of loan portfolio sales in the quarter. If you can talk about if that impact was significant and the decision the bank makes to sell portfolios, or what's going on in that marketplace today? Thank you.

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

Good morning, Jason. And escrow impairments, we had some cases, corporate names with a concentration on one particular name. So it's a company where we had a security held to maturity. And in our judgment, it does represent a definitive loss, so that's why we had this impairment. Looking forward, this might happen again. It's a part of the business.

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This particular quarter was larger than historical level. But in any case, it's incorporated in our margin guidance.

As to the sale or transfer of financial assets, we have a detailed explanation in our MD&A on page 19. And there was absolutely no relevant effect on the bottom line. Most of the sale of assets was completely written down portfolios, so zero effect on bottom line. And we have a small effect on the portfolio of only R$26 million, so completely relevant on the bottom line. Looking forward, we are going to continue to sell portfolios when we believe that the sale of the portfolio would produce better opportunities for recovery than would have making the collection internally.

And I'd like to highlight the fact that we bought, at the end of last year, a company called Recovery here in Brazil that specialize in recovering assets, so it's controlled by the bank. And we have sold, in this particular second quarter, R$5 billion of completely provisional (50:26) portfolio already written down – we're writing off. And we intend to increase this activity because historically Recovery has a better performance than our, let's say, internal collection area.

Q - Jason Mollin {BIO 1888181 <GO>}

Thank you very much. Disclosure is very helpful.

Operator

The next question comes from the Jorge Kuri, Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning, everyone. I have two questions. The first one is can you give us an assessment of the leverage level and health and the outlook for recovery of the corporate and the consumer sector? How long do you think it's going to take for it to repair and what does this mean for credit recovery? Vassimon mentioned, 2017 is probably not going to be a year with a strong growth in real terms. I think you said 1% or 2% real credit growth next year. So where are we in that repair process of consumers and corporates and when do you think we could potentially see recoveries? Is it 2018, is it 2019? And I'll ask my second question later. Thank you.

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

Good morning, Jorge. Of course, given the still challenging environment, it's difficult to look much ahead of next year. But in the base scenario, we see, as I mentioned on, if you recall I (52:15) real growth of the portfolio next year. And we could have a more relevant growth in 2018. We are seeing a better behavior in terms of NPLs and possibility of reducing provisions. In the individuals portfolio that has been more, let's say, predictable, more stable and probably would peak a little bit earlier than the corporate or the company portfolio. I think that more relevant recoveries will – probably we'll have to wait until 2018 and not in the next year.

Bloomberg Transcript

Q - Jorge Kuri {BIO 3937764 <GO>}

But is it a matter – thanks, first of all Vassimon. But is it a matter basically of NPLs, you getting comfortable with that and then opening the pipes or is it a matter of seeing better leverage levels at the consumer level of debt service ratio where you think the consumer has to be in order for it to continue to take credit again?

Same thing for the corporate, net debt to EBITDA has (53:31) remained very high. Is it a number or is it GDP growth? How do you think about it and how can you help us understand what are the triggers for you to see stronger credit growth? That's what I was looking for.

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

Yeah. Okay. I think the basic indicators here are indicators related to GDP. Of course, as we get more comfortable in the macro environment and here, I think it's important to mention that this fiscal stabilization is relevant, I think, by approving a fiscal measure in the second half of this year. The government should give a strong signal of potential stabilization of debt to the P/E (54:18) ratio is something that we are following closely.

And the growth of the portfolio is related to both the increasing demand in our own comfort with the whole environment. We are starting to see a better sign in terms of confidence. Industry, for instance, seems to have bottomed in terms of activity. Inventories are going down. So there's a lot of indicators that we are following.

In terms of leverage of individuals, we are seeing a reasonable level. No relevant increase, particularly in the clients – in our own clients that we have more information. So, there are several indications, but all related, to some extent, to the GDP. So the combination of higher (55:22) come in our view from increasing confidence. And not so tight credit criteria will allow us to have this growth in terms of credit portfolio. But again, nothing particular substantial next year, but we could have a much better environment in 2018.

In terms of NPLs, just to emphasize that we are going to see a relevant increase in NPLs of our corporates next year because this specifically that we'll roll out – or next quarter, sorry, that we'll allow to the 90-day overdue range.

Q - Jorge Kuri {BIO 3937764 <GO>}

Great. Thank you. So my second question – thanks for that. My second question is on car lending. That's an area where, if I look at the last five years, almost 60% of the market share you lost of lending in Brazil, was explained by moving out of the car loan business. What is the appetite for returning to that business? Is it just a structurally broken business that we're now going to see Itaú move into for the foreseeable future or if it's more of a cyclical issue and we could potentially see you coming back to it, say, in 2018? Again, I think that's where probably the biggest market share opportunity is on the rebound, but wondering if that's something that is broken or not.

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

Here, Jorge, of course, the market share is important. But we are basically driven by the expectation of the bottom line and I'm looking to reach the ideal balance between top line and provisions.

Yes, we have lost a lot of market share particularly in this car loan business. We'd also (57:30) believe, by all means, that's a broken business. But it's important to remember that the business as a whole shrunk dramatically. I mean, we had, at some point, a couple of years ago, a production around 3.5 million cars per year. We are down to below 2 million cars. So the market, as a whole, shrunk. And the combination of top line and the provision, I mean, the economics of this line of business was not particularly interesting in our view, so we have reduced dramatically. We're ready to grow when we feel comfortable again. But I don't see frankly speaking any relevant growth in this particular line of business this year or next year.

In other lines, I think we could be a little bit more optimistic and again I believe that we are in a very privileged position in the Brazilian market to grow portfolio when there's demand, when we feel comfortable given that our (58:36) of capital.

Q - Jorge Kuri {BIO 3937764 <GO>}

Thank you. Thanks for the detailed answers.

Operator

The next question comes from Nicolas Riva, Citi.

Q - Nicolas Riva {BIO 16875766 <GO>}

Thanks, Eduardo and Marcelo for taking my questions. The first one is on the net interest margin. So, if I look at your guidance for loan growth, the midpoint of the guidance for loan growth implies 1%, quarter-on-quarter, loan gross in the third quarter and fourth quarter. However, if look at your guidance for net interest income with clients, the midpoint implies about 4% quarter-on-quarter growth in the next two quarters. Now, I know that you probably want to (59:14), again, the impairment (59:16) R$40 million that you have. But besides that, what should drag that expansion in the interest margin with clients in the second half and if you expect the spreads maybe to continue going up on less competition from government banks.

And the second question on NPLs, but specifically on consumer NPLs, because your NPL ratio for the consumer loan book went down, improved for the first time since the first quarter 2015. And you already said that in the case of the corporate loan book, we will see the increase in the NPLs in the third quarter because of this specific cover. However, in the case of a consumer, do you think that we could be that probably we are passed already the peak in NPLs for the consumer loan book? Thanks.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Nicolas. Yeah, let's start with the NPLs and then we'll go back to the NII question. On NPLs, it's a fact that we did see a reduction of 10 basis points here. But as we see unemployment still going up, we will still see NPLs for consumers going up in a controlled way. As Vassimon mentioned before, the peak for that probably will be somewhere in the first half of 2017. Therefore, we expect it to go up in a controlled way.

Regarding NII, when you adjust for the impairment and back out the impairment, implicit increase is somewhere around 2% per quarter, okay? So we think it's doable. It will probably come through the pricing that reflects the risk in the market. And that's basically how we built the view for the second half of the year.

Q - Nicolas Riva {BIO 16875766 <GO>}

Thanks Marcelo.

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

This is Vassimon. Just to add here that we are seeing repricing opportunity in a level slightly better than we anticipated. So this, I think, will help us to reach the level that Kopel mentioned.

Q - Nicolas Riva {BIO 16875766 <GO>}

Okay. Thanks.

Operator

Our next question comes from (1:01:33), Banco Safra.

Hi, everyone. Thank you for taking my question. Actually, my question is related to provision charge. We saw along 2015 that credit recoveries were coming at a level and then dropped at the beginning of 2016 and when many problems had worsened. And now, with the expected signs of this improvement, the economic scenario for 2017, what is the amount of (1:02:01) level of credit recovery that bank is expecting for the next year which you would have to reduce provision expenses and be another variable that improves the earnings growth? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, (1:02:14), it's Marcelo. At this stage, we haven't really done any exercise for 2017. But what we can anticipate is it's a cycle that we go through and 2017 shouldn't be a year that you would see a material difference in the recovery levels. As I mentioned, the unemployment is still growing in this year. Our forecast for this year is to end the year at 12.5% and next year at 13%. therefore, the recovery should probably accelerate more not in 2017 but beyond that.

Q - Operator

Okay. That was very helpful. Thank you.

The next question comes from Philip Finch, UBS.

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

Good afternoon, gentlemen. Thank you for the presentation. I have two questions, please. First, can you remind us how you're positioned for falling interest rates and remind us the sensitivity to margins for every 100 basis fall in the sleek? Whether there are ways to offset this and the time lag typically for the impact to filter through?

And my second question is regarding your digital banking strategy. So on slide 22, you show how you're switching away from traditional brick-and-mortar branches to alternative digital distribution channels. Can you share with us how much more scope there is for branch closure? And what sort of cost savings can you generate from this and more generally from the move towards digitalization? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Philip. In terms of sensitive to interest rates, I think it's important to segregate the margin declines and margin with markets. Margin declines is basically related to credit spreads and this tend to be reasonably stable, not directly related to the nominal level of interest rates. Of course, in an environment of lower interest rates, meaning that the whole environment is more positive, you would have a low spread, but as a result of lower risk. So the risk adjustment margin, the risk adjustment spread should be reasonably stable over time.

When it comes to the margins and markets, then we could have some effect of the reduction in interest rates in our banking book. This is an active management that we do in our – on capital, in our liquidity. But this is – it would be felt over time. Just to mention that given the recent communication of Brazilian Central Bank, we now believe that interest rates should drop by 75 basis points this year in the last quarter. And in the base economic scenario, additional 250 basis points during 2017.

So, we would have some impact on the margin with the market. But the whole environment would, in this case, be more favorable. In this environment, we should have some credit growth and a reduction in risk.

Going to the second question of digital bank strategy, the digital branches have basically two advantages. I mean, it's a more intelligent and more friendly way of interacting with our customers. Customers are going less and less to physical branches. And so it's not only more convenient to the client, but it's more efficient to the bank in terms of costs.

This is now review of our (01:06:33) process, and the reason of migration would follow our client's demands and, of course, our own ability to implement this change in terms of IT.

We have closed about 150 branches last year. We expect to have the same written this year. So, this is something that will be felt over time. But we are very confident that this is a reversible process. And typically, what we do is we observe a reduction in the flow of clients to physical branches, and then we merge to physical branches so that – and we migrate clients to digital branches.

And we are going, in the near future, and this quarter is still we are going to start opening digital accounts on a digital way, let's say, on a remote way. Because today, what we call digital accounts or digital bank is basically the migration from (1:07:58) originated in the physical branches and now migrates to digital ones. And of course, we'll keep this process, but we will also start to originate let's say pure digital clients. So, clients will be able to open accounts without going to the bank. This is a new legislation that was released by Brazilian Central Bank a couple of months ago, and we shall be ready soon to run this type of account as well.

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

Great. Thank you. That was very comprehensive. Thank you.

Operator

The next question comes from Victor Galliano, Barclays.

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

Hi. Thank you. Yes. A couple of questions from me. Just on the credit quality continuing there, you've given us your indication or your thoughts as to where and when potentially we could see a picking in the consumer cycle. What are your feelings with regards to SME and corporate? I understand that maybe a bit harder to call, but I would imagine that we're thinking in those terms that it might lag the individual pick. But I would love to hear your thoughts on that, and in particular with SME, which looks more troubled.

And my other question is on REDE, if you could just talk to us a little bit about the loss market share there. What's driving that? Is it more aggressive competition from Santander (1:09:47)? And in terms of your strategy there, are you willing to give up market share in order to retain profitability? Is that the game that's being played there? Thank you.

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

Good morning, Victor. It's Vassimon. As to credit quality, yes, we're probably going to see the pick of NPLs for individuals earlier than for SMEs and corporate. It's hard to say how earlier it would be. But SME is a segment is suffering a little bit more.

We have tightened our credit portfolio (1:10:32), particularly in this segment. We have reduced our portfolio, but the pick should be a little bit later than for individuals.

For corporate it's even harder to say, because corporate depends of course on some specific case. We have the impression that we have methods, let's say the potential cases and we have provisioned (1:11:07) for those potential cases. But of course by nature of the business, there is always the risk of some surprise.

But we haven't seen any new relevant case let's say in the past quarters. So, I think their (1:11:24) potential problems are basically normal. But corporate should recover also a little bit slower return than individuals.

As to REDE, I will on pass to Marcelo.

A - Marcelo Kopel {BIO 16986304 <GO>}

Victor, the strategy at REDE is really to work differentiating ourselves with products and service and not go after price. For us, share is important, but most important is profitable market share and not simply going after very large clients that obviously can dilute your fixed cost base – our fixed cost base, but not necessarily aggregate to the profitability of our company.

So, yes, we are focused on keeping share, okay, but in profitable segments. Therefore, we just believe a specific project that caters for one specific segment of the market or a group of clients that want to have their – they want to know upfront, how much they're going to pay for the usage of their terminals including rent and the MDRs and all, anything that could be charged to them. So, that is a specific demand from clients that we are basically offering them the solution for it. So this is how we intend to grow the client base. Not through pricing.

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

Okay. So it's offering a more broader solution really and trying to cross-sell as much as you can, really...

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah.

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

...and not in turn a direct price competition with the others? Great. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Right. Because price competition, we know where it ends.

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

Yeah. Thanks.

Operator

The next question comes from Carlos Gomez, HSBC.

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

Hello. Good morning. I have two questions. The first one on provisions. So you have typically given guidance in absolute numbers, R$21 billion to R$24 billion in Brazil for this year. You have repeated this in the conference call that you don't expect provisions to be higher next year and this year. Are you referring to that in terms of absolutes? I mean, R$21 billion to R$24 billion? Or in terms of relative as a percentage of the portfolio, since the portfolio is going to be smaller?

The second question refers also to your growth rate. You have said you expect small, but positive real growth rate next year, let's say, about 6%. Right now, if our numbers are correct your real portfolio is declining at a rate of 7% year-on-year, so that would be a pretty quick swing. Have you seen any evidence so far that demand is turning around and will start to stabilize before it grows to 6%? Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Carlos. Let's start with the growth. What we are seeing is, if we strip out the FX components and put the things in context that there are – there is demand that is basically sitting on the sidelines waiting for the scenario to be more clear and have more visibility in the scenario.

So, one could argue that in the fourth quarter, after we see certain things approved in the economy and even on the bigger-picture scenario, we will see demand coming back. And this will be basically through investments and things like that. Consumption will not accelerate and the leverage is still here with the consumers, it has not increased (01:15:10) but people are very – they're still postponing their consumption decisions. Therefore, the resuming credit growth will come more from investments than from consumption. So, this is one thing.

On your comment regarding provisions in absolute terms, we're coming from a very severe year in terms of provisions. When you put 2015 and 2016 all together, the accumulated growth in loan loss reserves, net of recovery is more than 80%, okay? So, saying that, we don't see room to grow in 2017, stops to the accumulation of two years where we've been consistently increasing provisions. And you could see specifically on the corporate portfolio, we are running probably at 3 times the level we've run historically on this portfolio. So, I think it comes together with the context not only of 2016, but also what we have been doing before that.

So, I don't know if that – so that's why we are giving the guidance, forecasting NPLs on the corporate portfolio is harder, especially because of the write-offs that will start to show up in the portfolio, as these are fully provisioned in a very large number of phases. So, I don't know if that answers or you want to follow-up on that.

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

Well, as you say, NPLs will continue to rise, and that's totally understandable, and you have explained it very clearly. It's actually on the other side, you have already provisioned a lot last year and this year. So, actually, I would expect your provisions to decline next year not just to be stable at the elevated levels that we have seen in 2015 and 2016. I see that you are not seeing that yet. You are being conservative about it, so I would get to see if there is any specific reason for you to expect still this elevated level given that you expect also a recovery in demand and activity.

A - Marcelo Kopel {BIO 16986304 <GO>}

I think, Carlos, we say that – when Vassimon said provisions will not go up, it doesn't mean that they cannot go down. That's what he said.

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

Obviously (01:17:22).

A - Marcelo Kopel {BIO 16986304 <GO>}

And the second thing is as we start going up the portfolio, okay, just the fact that (01:17:32) real provisions, implicitly you're diluting the provisions, right, because as a percentage of the portfolio, if the math works, even you're diluting your percentage over the cost of credit over your portfolio.

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

Okay. But, again, at this point, you are not – I mean, you could, but you are not saying that you will reduce your provisions next year?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah, it's too early. We're probably going to have better visibility as I said. The whole scenario for next year is heavily dependent on certain approvals in the Congress and as we go through that threshold, visibility will be much better. So, we will probably – hopefully, we're going to be talking about that with more visibility during the course of the third quarter.

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

Thank you very much.

Operator

Our next question comes from Pedro Fonseca, Haitong.

Q - Pedro Fonseca {BIO 7271227 <GO>}

Hi. Good afternoon. I have one question left. It looks to me, it's my understanding that the Central Bank is now taking a closer look at provisional requirements for bank guarantees. Do you envisage any sort of impact in terms of requirements you may have to do in terms of bank guarantees or off-balance sheet items?

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

Good morning, Pedro. You're right. Last week, Central Bank announced there's a new rule for provisioning for guarantees. In our case, we had already provisioned these in our complementary allowance, so there will be no impact for us given the fact that we had already been provisioning for this type of risk.

Of course, it's a lower type of risk, because we know it is mainly related to fiscal guarantees that have a very low level of losses. But in any case, we have (01:19:48) provisions, so there would be no impact in our balance sheet.

Q - Pedro Fonseca {BIO 7271227 <GO>}

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>}

Well, thank you for your attention. Just like to emphasize that we believe this was a good quarter with solid results. We are starting to see better concrete signs in terms of improvement of the economic environment. So, we believe that we should be approaching the end of this credit cycle. We see a better dynamics, reduction of (1:20:50) potential losses. We continue to emphasize the generation of fees that will represent a very relevant part of our bottom line. We continue to be very focused on cost control, and we are very well capitalized, and I believe in a privileged position both in terms of capital and liquidity to take advantage of a change in the cycle when the conditions are there.

So, again, Thank you 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.