Company Participants

- Eduardo Mazzilli de Vassimon
- Marcelo Kopel

Other Participants

- Aníbal Valdés
- Boris D. Molina
- Jorge Kuri
- Marcelo Cintra
- Marcelo Telles
- Mario Pierry
- 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 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 broadcast live on the Investor Relations website at www.itau.com.br/investor-relations. A slide presentation is also available on the site. The replay of this conference call will be available until August 11 by phone on 5511-3193-1012 or 2820-4012 access code 6138281.

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 comment as a result of macroeconomic conditions, market risks and other factors.

With us today in this conference call in São Paulo are Mr. Eduardo Vassimon, Executive Vice President, CFO and CRO; and Mr. Marcelo Kopel, Investor Relations Officer. First, Mr. Eduardo Vassimon will comment on 2015 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, afternoon. A pleasure to be here with you again to talk today about second-quarter results. For those that are following us in the Internet, we will start with slide number two, we had a R$6.1 billion recurring net income, what we consider to be a positive result considering the more difficult economic environment we are facing. I'd like to highlight the 17% financial margin with clients' growth in 12 months comparing to the first half of this year with first half of 2014.

Financial margin with markets, although 17% below first-quarter results, is still a very robust R$1.6 billion result. Loan loss provision expense flat - basically flat in relation to previous quarter. We are going to talk a lot about credit quality. Understand that it is a point of particular interest of the market.

Moving to slide number three, we had 24.8% recurring return on average equity. When we did 12-month figures, we have seven quarters in a row of increasing this metric. The recurring return on average assets is stable at 1.9%. In the past few quarters, when we take into consideration the risk element, we see a nice trend of increase of recurring return on average assets, reaching a robust 3.2% this quarter, what I believe to show that we are pricing well the risk in the present environment.

Page number four. And again here, good increase in financial margin with clients 4% in this quarter, 17% in 12 months. Result from loan and lease losses in net terms is more reduction around 2%. And I'd like to call also your attention here to the increase in non-interest expenses in 12 months 6.7%, well below the inflation in the same period at around 9%.

Moving to page five, we have the loan portfolio, where we can see in 12 months, 9.3% growth, so basically around inflation. When we exclude the effect of foreign exchange variation, we see a much smaller figure below 3%, 2.6% here, reflecting low-growth economic environment.

The two main products in terms of growth in the past 12 months continue to be payroll loans with 52.3%. This is partially offset by acquisitions of portfolios that we made in the past month. And this is basically a process that has ended in the first quarter of this year. And also mortgage loans with a robust 21% growth in 12 months.

Moving to slide number six, we have been showing this breakdown since the end of last year. We basically divide the P&L in two main categories here Insurance and Services on one side and Credit and Trading on the other side. Insurance and Services are revenues or business lines that are less related to the economic cycle. And in this particular quarter, we had a positive growth of around 10%, moving from R$3 billion in the first quarter to R$3.3 billion in this quarter.

In the Credit and Trading that is a little bit more volatile, more related to the economic cycle, we saw also some increase. And here we basically can see that for Credit and Trading, we are showing returns that are similar to our cost of capital, while in the Insurance and Services, we show a robust 49% return.

Moving to page seven, we have the breakdown of our loan portfolio. I would like to here to call your attention the upper side of this page to the fact that the mortgage loans and payrolls together represent around 20% of our portfolio today. That's basically the double what they represented two years ago, so in line with our strategy of moving from more risky to less-risky product.

Another business that has been growing in terms of participation is Latin America business, here again aligned with our strategy of regional expansion. This is also positively affected by the FX rates. On the lower part of this slide, we can see the evolution of our financial margins with clients. The main factor was the mix of products, clients and spreads and here spreads played a particular positive role. We're also helped by a higher number of calendar days despite lower loan balance.

Moving to page eight, we can see here the net interest margin going up from 11.1% to 11.3% in this quarter. When we exclude the provisions, we see an increase from 6.9% to 7.2%, although below the historical levels. Net interest margin with clients stable at 9.6% and when risk adjusted slightly better than the previous quarter.

Moving to slide number nine, talking about financial margins with the market, here again, we had a very positive quarter, R$1.6 billion. Although below the previous quarter, is a very strong figure. We cannot consider this as a recurrent level of market results. Although historically, we have been able to generate good results in more volatile environment like the one we are living today.

Moving to page 10 and starting to talk about the credit quality, we saw in the 15-to-90 day NPL ratio as anticipated an increase – small increase here from 2.9% to 3%, both at the same level of increase in individuals and companies.

In the lower part of slide 10, the 90-day NPL ratio, here we see a higher increase from 3% to 3.3%. And we can see in this chart that is basically concentrated in the company's portfolio, individuals showed a slight increase. And here, to be transparent, we have calculated what would have been this metric if we had not made this transfer of financial assets to have reached the 3.5%.

This was a transfer of one single client relevant amount around R$1 billion of an asset – a particular asset that has a very low probability of recover that was already 100% provisions. So, there was no effect on bottom line. But because it was booked in offshore vehicle, it was showing some volatility among different lines of the P&L; although, again, in the bottom line the effect was zero.

Moving to page 11, we see here the coverage ratio. Again here, as expected, we had a decrease in the coverage ratio from 200% to 187%. We can see that although there was this reduction, the level of complementary allowance for loan losses was kept at the same level, R$6.3 billion. That's the amount we have in excess of regulatory requirements by Brazilian authorities. And in the lower part of this page, we have broken down this coverage ratio by segment. And we can clearly see that the Retail Banking segment shows stability in this figure.

So, in the past 12 months or more ranging from 131% to 135%, so basically stable. And all the difference of this metric was due to change in the Wholesale Banking, because we had started already in the end of last year. Preemptive move in building up provisions have increased substantially the coverage ratio for Wholesale Banking operations. And at that time, we expected some transactions to become overdue. This actually happened. And then because of those transactions, we saw these reductions in the coverage ratio.

Moving to page 12, here we made an exercise to give additional transparency and excluded the fully provisioned credit in the company's portfolio, 90-day NPL ratio. So, the 2.2% figure goes down to 0.6% when we exclude those fully provisioned credits. And this 0.6% historically is quite stable. So, most of the increase was due to credits that were already provisioned.

On the lower part of this slide, we provide additional breakdown in the company's 90-day NPL portfolio. We have divided between very small, small and middle-market companies on one side and corporate companies on the other side. And for us, middle market goes until R$300 million of annual revenues. And this shows that the increase was clearly concentrated in large companies. The SMEs portfolio is doing quite well. Actually, there was a small reduction in this quarter compared to March 2015.

So, all those elements give us a good level of comfort in relation to the level of provisions we have. So, the increase in NPLs was, to a large extent, due to company's portfolio. Within company's portfolio, this was related basically to large companies. And in the company's portfolio, when we exclude the fully provisioned credits, we see a stability in the 90-day NPL ratio.

Moving to slide 13 and talking about credit quality for individuals. Here, again, on the left side, on the top, we see the movement that we mentioned briefly before, moving and increasing lines of business that have higher level of guarantee. So mortgage and payroll together increased from 19% three (16:03) years ago to 41% today.

On the right side, we can see that within payroll loans, the public sector that's more stable and less related to economic cycle in terms of employment represents the vast majority of our portfolio. So, only 11% is private sector payroll loans. And even in this part, in the selected companies we operate with. On the lower side, on the left, just to update a little bit the recent vintage in terms of vehicles and mortgage financing. So, we are generating, originating new loans with loan to value slightly below our historical pattern.

And in the middle and the right side below, we talk a little bit about credit card. What we have done here, we took public information from Brazilian Central Bank about non-performing loans of the system. We excluded Itaú Unibanco figures, and then we compared the system without Itaú Unibanco with our own figures.

And in 100 bases, we can see that the quality in terms of non-performing loans for our credit card portfolio is substantially better than the average of the system. Two – three years ago we were 20% below the average today, we are even better, 32% below the level. So, in relative terms, we are doing quite well.

And this is related to the figures on the right side that is the breakdown of our portfolio. We spoke about it in the first quarter call. We have basically three quarters of our credit card portfolio as transactors. So, this includes site payments – the site payments and installments without interest, so with a lower level of risk. While in the market, this portion represents 70%, roughly speaking. The more risky part of our portfolio that's the revolving credit, in our case, represents 15% compared with 24% in the market. So, here again, we show a good relative position to the market in terms of risk for credit card portfolio.

Moving to page 14, loan loss provision expenses, as I mentioned, basically flat in this quarter when compared to the previous one, giving stability to the ratio at 4.8%. The net one was a little bit below previous quarter, bringing 3.9% down to 3.8%. In the lower part, we have NPL creation write-off and I think it's interesting to make the relation between the two charts here. We can see very clearly that starting the last quarter of last year, we started to make provisions in a level that was substantially above the NPL creations, anticipating possible overdues for some specific clients, what happened in the second quarter that explain that in this particular quarter the level of provisions was very close to the level of NPL creation.

Moving to slide number 15, we showed a similar chart in the previous quarter. And as anticipated, we saw some increase in the Retail Banking portfolio in terms of provision expenses and some decrease in the Wholesale Banking portfolio. Looking forward, we expect to see this movement to continue. So, in this environment, we believe it is reasonable to expect slight increases in Retail Banking provision expenses and some reduction in the Wholesale Banking portfolio.

Moving to page 16, very briefly, we had a 10.5% increase in commission fees from insurance in relative terms was a little bit below the level of previous quarter, because the margin has increased substantially. Moving to page 17, again, quickly here, just to mention that we had a good two-digit growth in our revenues for core insurance activities, when comparing 12 months. Claims ratio and combined ratio at good levels, reasonably stable compared to the previous quarters and a robust market share for insurance, pensions funds and premium bonds.

Next page, slide 18. We mentioned already, we had a 6.7% growth in 12 months on our (22:26) expenses. And if we do exclude offshore operations – operations abroad that are affected of course by FX effective, it would have been 4.5%. So, I think this shows our commitment to keep making strong efforts to keep cost below inflation level. This is reflected in the bottom of this page, in what we consider to be a very good efficient ratio, 42.9% in this quarter. The best figure in this area (23:06). And when adjusted to risk, 61.8%, that's a very good level in opinion, showing that we are pricing well risks.

Moving to slide 19 and talking about capital. We had a special increase in our Common Equity Tier 1 from 11.6% in March to 13.2% now in June. This is basically related to three factors. First one is the result of period itself. The second one is new consolidations that reduced the risk-weighted assets. And third factor was the effect of the FX appreciation of real in the quarter that decreased tax loss carry-forward, so improving this ratio.

Fully loaded Core Equity Tier 1, we now have a level of 11.3%. If we consider our investment optimization and full use of tax loss, carry-forwards would reach 12.7%. And again this was positively affected by FX. If we take the prevailing FX rate in the today or yesterday, the present market that is 11.3% would be around 10.5%. So, it's an index that sensitive to the FX rate. In any case, it's a very comfortable level of capitalization what has encouraged us to renew our buyback program and we will be following closely the market to possibly take advantage of prices that we deem to be attractive.

Moving to page 20, we see low level historically - low historic level of price to earnings at 7.7x. And in terms of net dividend yield, when we take the Bloomberg consensus, keeping the same dividend policy and starting using the price at the end of last month, July, we reach 4.1% dividend yield that's high for historical - compared to historical standards. Liquidity has been divided basically 50/50 between domestic markets and New York markets.

On next page 21, we are keeping our outlook for 2015. This outlook, as you know, was reviewed last quarter. Despite the more challenging economic environment, we are keeping this outlook for all the lines we have here.

Finally, slide 22, just to reinforce the fact that shareholders for both CorpBanca and Itaú Chile have approved the merger. This was a important step in our Latin America expansion strategy and now we are waiting for the authorization of the Chilean regulator what to expect to obtain in this third quarter of 2015. And finally, to invite you all to be present in our APIMEC Meeting that will take place in São Paulo in about two weeks.

With this, I end this part of our presentation. Thank you for your time. And Marcelo Kopel and myself will be available for possible questions that you may have. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now being the question-and-answer session. Our first question comes from Philip Finch, UBS.

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

Good morning, everyone. Thank you for the presentation. I've got a couple of questions, please. First is regarding your loan loss provisions. On the first quarter earnings call, I recall that you said that the Q1 level should be the peak level. And obviously we've had Q2 at similar levels, maybe just slightly higher. Going forward, I mean, are we going to see this provisioning trend continue upwards or can we safely say provisions have peaked for rest of this year?

Secondly, it's regarding your repricing of the loan book, given you're clearly in a more challenging lending environment, asset quality environment, are you repricing risk in your loan book given the higher credit risk out there? And if so, can you just share with us how much was the magnitude of this and thereby what could the implication be for margins over the next 12 months, 18 months? Thank you.

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

Thank you, Philip. Talking about loan loss provisions, as I mentioned, we keep our outlook between R$15 billion and R$18 billion of net provisions for this year. Given the more challenging environment, it is reasonable to assume that would be in the higher part of this interval, so between the midpoint and the ceiling. This means that in terms of the amount of expenses, we expect this to be in the next two quarters slightly below the level we had in terms of provisions - net provisions. In terms of NPLs, we are probably going to see a continuous increase - slight increase in the portfolio.

In terms of repricing, we have done a rather substantial movement in terms of repricing as we can see in our margins. This is, of course, a dynamic process; as risk moves, we also change our price policies. So, we have done these basically in the short-term portfolio that has matured. We'll keep doing this as risk moves and we will start to do this in the longer part of the portfolio. It's difficult to quantify this, but the trend should follow the risk environment.

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

Thank you. Can I just follow up on that? So, in terms of net interest margins, should we assume that margins next year should be higher than this year, given that the repricing of the back book takes maybe 12 months, 18 months to filter through?

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

It's difficult to talk about 2016 in this environment that's still full of uncertainties (31:09). But for 2015, we will be probably close to the upper part of our expectations in terms of financial margin growth.

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

Great. Thank you very much.

Operator

Our next question comes from Marcelo Cintra, Goldman Sachs.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Hi. Good morning, gentlemen. Thank you for taking my question. My first question will be basically a follow-up on the previous one regarding 2016. I understand that it's a little bit too soon to talk about next year. But maybe I just would like to hear from you your expectation given that the bank recently revised the GDP for next year for minus 0.2% and maybe just hear a little bit about your expectation for asset quality for 2016? I understand that you mentioned that for the following quarters, maybe a gradual increase in NPL ratios. But how should we see the mid-term? Thank you. And then I will follow-up with my second question.

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

Thank you, Marcelo. Again, we are not in a position yet to make projections about 2016. What we can say is that would be still quite a challenging environment. We don't see growth next year. Most probably the economy will continue to contract little bit. So, in this environment, it is reasonable to assume that the risk will be still very present. But we are not making any specific projection yet.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. Perfect. Thank you. And my second question is related to the evolution of the non-interest expenses. So, basically, growth seems to be very under control and running at the low end of the guidance for this year. So, it is just for us to assume that it could be maybe a positive surprise, no (33:35) interest expense growth, maybe below 7% growth? And also, in this front, maybe a quick update on the new data center in Mogi Mirim. The productions are already fully running or do you guys still have maybe operations running in two different centers and then maybe could be some upside here as well? Thank you.

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

Marcelo. Seem from today, we believe that the best expectation we can have in terms of non-interest expense is the middle of the outlook, particularly because environment is still uncertain in terms of the level of FX rate and inflation itself. And as you know, we'll have there reached (34:28) agreement negotiations in the second half of this year. So, seem from today, I think the midpoint is our best expectation for that.

The new data center is going as planned, the immigration. It's a very careful process that has been planned in detail. We have basically immigrated around 40% of our operations and this will continue until basically to the end of next year. And then, at some point, we start reducing the processing of our old data center.

Q - Marcelo Cintra {BIO 16463628 <GO>}

Okay. That's perfect. Thank you very much for the clarification.

Operator

Our next question comes from Mario Pierry, Bank of America Merrill Lynch.

Q - Mario Pierry {BIO 1505554 <GO>}

Good morning, everybody. Let me ask two questions as well. Want to look back at your NPL, your corporate NPL specifically, since the merger with Unibanco, we see a peak of 3.7%. Your corporate NPL is running at 2.2%. Do you think that we could see this level, given the weak economic conditions in Brazil, given the sharp evaluation of the currency? I think that when we compare the consumer loan book, it's hard to look historically given the changes in your loan mix. But could we use your historical numbers here to try to gauge what is the potential peak that we could see in corporate NPLs?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi Mario, its Kopel speaking. The point on the portfolio is that at that point in time we had much more presence of SMEs than we actually have today, which, at the end of the day, end up pushing up the NPL ratio itself. So, even if things stood at the same pace, you would have a lower NPL just by the mix of the - the profile of the portfolio. What we mentioned before and we've been talking is the NPL in the corporate portfolio has gone up by specific cases and not that it's a general behavior that we see in the portfolio. So, trying to model that is really a case-by-case discussion that we've been having internally. And I can't really give you a number, but one thing I can give you is that if you look at the portfolio mix and even do the - recalculate the numbers based on what you mentioned, you would probably get it to a lower number than it was in the past given the profile.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Okay. That's clear. My second question then is related to - you're likely to book some gains on your tax credits in the third quarter from the increase in the social contribution tax. So, I was wondering if you can quantify to us this amount and possible use of the proceeds, if you could be using this to boost your balance sheet and specifically to be boosting your reserve coverage.

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

Mario, this is Vassimon. We are following very closely the process in the Brazilian Congress. As you may know, there are several proposals of change in the original bill that was sent by the Federal Government. So, I would say that's still premature to quantify that. But certainly, there will be - this will be a relevant figure. Our policy of provisions is independent of the existence of one-off positive gains. But we could be encouraged in this more challenging environment to revise our provision criteria. I'm not talking here necessarily about credit provisions, but in general. But it's still premature to comment on that.

Q - Mario Pierry {BIO 1505554 <GO>}

And just to give us an idea of potential size of this gain?

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

I would prefer not to comment at this point, because again there are several possible alternatives being discussed in Congress.

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah, Mario, just to add to what Vassimon said. Depending on if it's – the new ruling is for a certain time period, you have a number; if it's something that is definite, is a different number. Therefore, we would skip on the comment based on that.

Q - Mario Pierry {BIO 1505554 <GO>}

Okay. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Thank you.

Operator

The next question comes from Jorge Kuri, Morgan Stanley.

Q - Jorge Kuri {BIO 3937764 <GO>}

Hi. Good morning, everyone. I have two questions. The first one, can you explain exactly what is this, quote-unquote, a transfer of the financial assets? I'm assuming you sold a portfolio of bad debt...

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

Sorry, Jorge.

Q - Jorge Kuri {BIO 3937764 <GO>}

Yeah.

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

Jorge, sorry, we didn't hear the beginning (40:04). If you could please repeat it.

Q - Jorge Kuri {BIO 3937764 <GO>}

Sorry. All right. Sorry. Sorry. So, two questions, the first one is can you explain the transfer of financial assets? What exactly is that? I'm assuming you sold portfolio of bad debt. I guess that's what I conclude from your comment. I understand that it was fully provisioned. But if you're selling something that is fully provisioned, you should get some sort of positive impact as you recognize part of a gain, right? I mean, normally, when you sell by (40:39) assets, if you're already provision and write them off, you got some sort of recovery. Was that not the case? Can you just walk us through exactly what is it that you did and what the different impact is across your balance sheet and income statement? That's my first question.

Second is, in the last quarter's conference call, you seemed pretty confident that second quarter was going to be the peak of NPL problems. We did see a sharper delinquency this quarter versus last quarter. And given how delinquency move, which is sort of like in waves, it's just hard to see that 2Q will be the peak. And so, just wanted to get your updated view on what do you think delinquency will look like the rest of the year. I'm assuming that if someone had asked you at the beginning of the year that your NPLs would have gone off (41:39) 50 basis points, in six months, you would have thought that was almost impossible got them; and they did. Same thing with NPL creation, if someone had told you you're going to have the numbers at sort of like a 10-year high, you would have said no. So, what gives you the confidence on what you're going to tell me about next six months and how does that look like? Thank you.

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

Yeah. Thank you, Jorge. So, in relation to the first question, the transfer of assets, so we made a sale of asset to an internal company, was one single client, one single operation, a relevant amount R$1 billion. And those information, those details are in our MD&A. And this was, yes, fully provisioned, was sold by very small amount, because the way I see the possibility of recovery is very limited. So, no impact whatsoever in the bottom line. And even the remaining amount that was small, that was sold to us, again provisioned. So, there was no effect – zero effect in the bottom line.

So, if it's not clear, please tell me. I'm moving now to the second question. In terms of NPLs, in previous quarter we basically said that we saw the level of expenses to be the peak. Actually, this quarter is basically the same level in terms of gross provision and a little bit smaller in terms of net provision. In terms of NPL, we anticipated some increase. And looking forward, we keep seeing a slight increases in the portfolio.

We expect to have reductions in the expenses, loan loss expenses in the company's portfolio, because as we explained during the call, this was related to a limited number of large clients, when we see our SME portfolio is doing well. So, the larger client segment should show some decrease. Altogether, we expect some increase in the NPL that's compatible with this more challenging environment.

Q - Jorge Kuri {BIO 3937764 <GO>}

Thank you, Vassimon. And is there a way that you can help us quantify the extent of how much do you think NPLs will increase? Look, the provisions don't really matter much, because you can take the provisions out of the P&L, you can take them out of balance sheet. You can get to your guidance of provisions through the P&L, if you just use your excess provisions. So, that doesn't really help us much. I was really thinking more about delinquency and how bad do you think it's going to get. So, we saw 50 basis points in the first six months of the year. How much do you think we are going to see over the next six months to 12 months? If you can help us understand better what you think on a numerical way the NPL cycle is going to look like, I think that would be great. Thank you.

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

Jorge, it's difficult to quantify it, but we are seeing a slight increase in NPLs. We don't see any strong movement. Of course, we are assuming here that we won't have any major problem in large companies. This is more uncertain. But when we talk about retail portfolio, given all the measures we have taken in the past several months and this is a dynamic process, we keep adjusting our credit policy constantly, we don't see any major increase in NPLs for the individual portfolio.

Q - Jorge Kuri {BIO 3937764 <GO>}

All right. Thank you very much.

Operator

Our next question comes from Tito LaBarta, Deutsche Bank.

Q - Tito LaBarta {BIO 20837559 <GO>}

Hi. Good morning. Thanks for the call. Also a couple of questions. First, maybe in terms of your loan growth, just given the weak economy, growth continue to be pretty slow. And given now you're expecting a very weak growth also in 2016, could you maybe give us some color on how you see loan growth should continue to evolve, do you think you continue to be sort of at the lower end of the range that you provided, maybe even if the next year continue to growing in the mid-single digit? And also continue to grow in that same segment that you've been growing in like payroll, loans and mortgages, given you've been growing a lot more in those segments; do you think that's still sustainable given how weak economy continues to look?

And then second question, in terms of profitability you've reached a very strong levels of profitability even in spite of the weak economy. But how long do you think that's also sustainable? I mean you still benefited a bit this quarter from relatively high trading gains. So, when you think of the bottom line of all the moving parts. What type of ROE should we expect? Is this 24% level sustainable? Should it go down maybe closer to 20%? If you can maybe just give some color on your first answer and to the profitability. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Tito. It's Kopel speaking. In terms of loan growth, what we provided an outlook for the year is 3% to 7%. If you look into our portfolio, we have something around between 20%, 25% of our credit portfolio denominated in non-local currency. So, within that number, the 3% to 7%, obviously, the FX can play some role on that. But we are – as of now, we are working from the midpoint to the low end of our outlook for the year. And that's just a function of how much we are seeing in terms of the market and then business confidence and consumer confidence. So, for this year, that's what we see going on.

In terms of the strategy going forward, we will continue pursuing less-risky assets. We've been doing a lot on – you said are for individuals on payroll and mortgages. And for companies, we are looking really – especially the lower you go in the portfolio, we are really looking for secured lending. A lot of activity going on with the acquire, the bank is very present with the acquired, so we now continue to foster the prepayment business there. So, that's the way we're growing our portfolio without necessarily adding risk one-for-one into our balance sheet.

In terms of your last point on profitability, the three – let's say, if you consider, there are three major avenues here. One is portfolio growth, which we already said, odds are there is going to be a slow growth portfolio; then, services and cost efficiency. So, we really continue to be very keen on penetrating with more services into our client base. Needless to say that in a slower economy, it gets more difficult to have very high growth rates on that. But still, by introducing new products and different channels, we still have room to grow on there.

And on the cost discipline, I mean, we've been showing a lot of discipline and executing very thoroughly our plans and we will continue to pursue that. So, predicting an ROE going forward is hard, but you should really look at, out of the three elements that we spoke, two of them are – we are capable to maneuver, one more than the other one being the cost base. And that's how much we can talk about the ROE going forward.

And just one comment from Vassimon now.

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

Yeah. Just to complement, you mentioned trading gains. Just to point out that part of our margin with markets is related to the banking book activity that's a little more stable. And we have a strong activity of market making. And again, in more volatile times, we tend to perform well. So, it is not that volatile, this particular line.

Q - Tito LaBarta {BIO 20837559 <GO>}

Thanks. That's very helpful. So, is it safe to say that trading gains, while maybe not staying at these levels, could stay somewhat high, at least in this somewhat volatile environment? And then, also following up on the cost discipline, I mean, do you think cost can continue to grow below inflation? Or maybe looking at it more from an efficiency point of view, your efficiency has improved quite a bit, is there a room for efficiency levels to continue to improve into next year?

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

Yeah. This is a constant effort we make to improve our efficiency ratio and we are seeing a kind of a structural movement in terms of client's demand for more digital channels. So, this produces lower-cost transactions for the bank. So, this I think encourages us to believe that it's possible to continue to pursue lower levels of efficiency ratios. In relation to trading again, I think, it's reasonable to assume that in more volatile environment, we would do a little bit better than we do in less volatile environment in terms of financial margin.

Q - Tito LaBarta {BIO 20837559 <GO>}

Fair enough. Thank you. It's very helpful.

Operator

The next question comes from Saul Martínez, JPMorgan.

Q - Saul Martínez

Hi. Hello, everybody. I am going to push a little bit more on 2016 and ask maybe a question that you've answered in pieces to the various others, in response to the earlier questions. But when I look at 2016, there seems that there are a host of factors that make the earnings and profitability outlook more challenging...

A - Marcelo Kopel {BIO 16986304 <GO>}

Saul.

Q - Saul Martínez

Yeah.

A - Marcelo Kopel {BIO 16986304 <GO>}

So, it's Kopel. I think (52:40) we missed the beginning of your question. Could you please repeat the beginning of your question?

Q - Saul Martínez

Yeah. Sure. Can you hear – let me pick up the handset. I'm going to be a little bit repetitive and really push you on 2016 again a little further, because when I look at the profitability and earnings outlook for next year, it seems like there are a number of factors that are making it more challenging. You have cost pressures associated with the wage hike that you're negotiating in September, especially given inflation tax rates are going to go up probably least five percentage points for financial institutions, maybe more, the SELIC may come down in the second half of the year, as quality issues could persist, loan growth is probably going to continue to be weak. How do you think about all of this and how do you think about your ability to sustain returns on equity in that environment that are comfortably above your cost of equity? That's my first question. And then I'll follow up with, say, an additional question on corporate credit.

A - Marcelo Kopel {BIO 16986304 <GO>}

Okay. Let's start with – you mentioned cost pressures and it's known for everybody, there is a wage agreement that happens every year. And the way we have to deal with this is we have to obtain and be more productive year-after-year. So, our workforce has a certain turnover number that is a natural turnover of the workforce. By reviewing our processes and doing further automation and also with the behavior that the clients have, choosing to use more digital channels, what we – the path we're following is that we have the opportunity to be less labor intensive in certain channels than we actually are and that provides an opportunity, not by necessary restructuring the workforce, but basically just managing down the workforce by simply managing the turnover. So, that's one area that helps us do this.

Tax rates going up is a function of what has been announced. And the 5% announcement doesn't hit us in full, because the 5% applies only to financial institutions. Given our earnings mix coming from different companies, including non-financial companies, that number tends to be lower. So, there'll be an increase because of that, but in a lower amount. SELIC going down, yes, but average SELIC next year still going to be higher than this year and the average spread, given that we are still repricing, tends to be a higher than this year. And you can end up the year with a lower number, but the average of the number should be higher. It's a fair assumption at this point to be a higher number than this year.

And you mentioned – the last factor you mentioned is weak loan growth, it's true. This year, we are seeing weak loan growth, next year, as per – to the extent, we have or the information we have, it shouldn't be materially different than that. So, all those things consider, just makes us having to work more on the efficiency gains by making the equation between revenues outgrowing expenses, putting more focus on being more and more efficient on the expense side. And that's something that we – I'm not going to use a word control, but we have better conditions to tackle, given the weak economic environment that you outlined.

Q - Saul Martínez

Okay. Great. No, that's very helpful. Let me ask on corporate credit. Can you give us any color on what common threat (56:44) you saw in terms of the deterioration? Is this – it seem with the very small group of credit Lava Jato related, any sectors that you can give any color on. And it seems like your commentary for some NPL pressure here, but lower provisions in – but you're guiding to lower provisions in wholesale, but do we see a risk of worsening in corporates, for which you have not yet provisioned? Because obviously this quarter you provisioned for those corporates who had fell into NPL status, but why are you comfortable that in the coming quarters you won't see additional worsening that could – for companies you have not yet provisioned for, for which you would have even more pressure on your loan losses?

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

In terms of the corporate cases, there is no particular concentration in terms of sector. A little bit related to Lava Jato, but no specific concentration. Of course, there is a possibility of having a no risk (58:02) environment, but to the best of our knowledge, it seem from today, we expect this to reduce a little bit because we had some specific cases with relevant amounts that were provisioned in these two first quarters. So, no other factor that the makes us confident that we'll keep within the guideline, within the expectations we have provided, is a good performance we have seen in the SMEs portfolio.

So, in our view, the increase we had in the NPL in the corporate sector is really related to some specific cases that we don't see repetition of those cases in the near future. Of course, all this is dependent on the evolution of the economic scenario. But seem from today, we believe that we'll see some reduction in the level of expenses for corporates. Having said that, all together, NPLs should continue to go up a little bit, we see a slight increase in the next quarters.

Q - Saul Martínez

Okay. So, to summarize, you're not seeing any - many particularly large warning signs in terms of specific economic groups or corporates that you feel are vulnerable to a deterioration?

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

I think that's a fair statement, Saul.

Q - Saul Martínez

Okay. Very good. Thank you very much.

Operator

The next question comes from Victor Galliano, Barclays.

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

Hello. Yes. Thanks for the opportunity. Just a follow-up really from me, my main questions have been answered, but on the transfer of financial assets, again, I'm afraid. This affiliated company, is that a subsidiary of yours? And therefore, wouldn't that be consolidation within the group numbers? I'm just trying to get my head around this, or is this a company you have a minority stake in? I just want to understand that a bit better, if I could.

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Victor. It's Kopel speaking. Yeah, it's a fully owned subsidiary. So, basically, what we have is - since this is a consolidated entity, any impact it would - since the credit was fully provisioned, basically, what you did see is a write-down of the asset to the value of the transaction, but with no impact. So, it's basically a reduction of the asset - asset value in book, but P&L-wise, it was neutral.

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

So, it's freeing up - is it freeing up capital effectively, this move?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah. I mean, from a capital perspective, you're basically writing down the asset and you have a full provision to that.

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

Yeah. No. I recognize there is no P&L. I just wanted to understand the sort of mechanics and rationale. Thank you.

A - Marcelo Kopel {BIO 16986304 <GO>}

Right. Thanks.

Operator

The next question comes from Aníbal Valdés, Barclays.

Q - Aníbal Valdés

Hi. Good morning, Eduardo, Marcelo. Thank you for the opportunity. I have two questions, one related to liquidity and the other one from capital. So, the question on liquidity is that, with still (1:01:47) a sharp decrease in all across the board in deposits quarter-over-quarter and also I – as you noted also time deposits continue to drop sharply year-over-year. Just wanted to better understand the story of the bank behind the management of deposits and if this is more than just asset liability management of deposits or you are seeing some sort of light (1:02:14) outflows – you saw some sort of outflows from the bank? That will be the first question. And I'll stop there, and then I'll ask the capital question. Thanks.

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

Okay. Aníbal, this is Vassimon. The reduction in the deposits reflects the decrease in creditor (1:02:33) demands. We basically manage our pricing for deposits according to our financial needs in terms of profit. As you'll know, in this weak economic environment, the demand for credit has reduced. So, we have just accordingly adjusted our price. So, the reduction in the deposits is basically related to this weak credit demand. And there was also some migration to other products of the bank, basically funds that may offer additional use for our clients. So, it's basically an asset management liability issue here.

Q - Aníbal Valdés

Thank you, Marcelo – Eduardo, sorry. Let me stop there. I understand a less demand for credit, but demand deposits went down 11% quarter-over-quarter and time deposits are down 25% year-over-year. So, I feel like there is more – there has to be something more behind that, just like liquidity management of the bank. It seems like a sharp reduction quarter-over-quarter, even though the credit portfolio is slightly increased. I mean, it was a risk, but not by that amount.

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

No. There is nothing really different from what I mentioned. It's really asset management liability strategy. And you can see that most of the reduction in deposit was migrated to funds and to other products. And also, it's normal that in a weak economic environment, there is a reduction in deposits from clients, and also in higher inflation environment, clients tend to reduce the amount they leave in demand deposits and look for ways of protecting the real value of their savings.

Q - Aníbal Valdés

Okay. Understood. Thank you. So finally, the question on capital. So, we saw a material increase in the capital ratio of the bank. And one of the reasons you mentioned for that it was the BRL appreciation during the quarter. But this quarter, I just like to understand what will be in the pro forma capital ratios of two quarter – second quarter of 2015, if we consider the already depreciation – the already 10% plus depreciation of the BRL?

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

The end of your question?

Q - Aníbal Valdés

Sorry. So, in terms of the capital we saw a sharp increase in the capital levels during the second quarter relative to the first quarter. And one of the reasons that you mentioned for that increase was – I think on the press release was that the reduction in risk-weighted assets related to credit and had to do somehow with the BRL appreciation during the quarter. So, considering the BRL depreciation that we have already seen since June 30, which is 10% plus, plus the future integration of CorpBanca in Chile and also the potential downgrade of Brazilian sovereign, what is your, more or less, pro forma capital ratio for the bank?

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

Okay. In terms of Core Equity Tier 1 fully loaded, the figures we showed now in the first semester is 11.3%. And I briefly mentioned during the call that this would be – considering the present FX ratio, this would be around 10.5%. So, the depreciation of the real in this third quarter will reduce this figure. CorpBanca will represent an impact of around 8 bps in terms of capital ratio. So, still comfortable levels, giving particularly the ability that we have shown of producing returns and increasing the capital coming from the cost (1:07:19) itself.

In terms of downgrading, we believe that the government is working hard to avoid this possibility. I think the government is taking measures in the right direction. But of course, this is a process that's outside the control of the government. And although we do not consider this to be the most probable scenario, we cannot completely discard it. The impact would be in the bank limited. Markets have, to a large extent, already priced the deal (1:07:52), when you see, for instance, price of CDS. And in our particular case, I mean, as you may know, the bulk of our funding comes from domestic deposits. So, we would have some increase in the foreign funding, but that's not a relevant part of our business.

Q - Aníbal Valdés

Okay. Thank you. Just to clarify the impact of CorpBanca would be 8 basis points or 80 basis points?

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

80 basis points.

Q - Aníbal Valdés

80 basis points, okay. Thank you.

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

80 basis points.

Q - Aníbal Valdés

Okay. 80 basis points. All right. Thank you. Very much.

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

Thank you.

Operator

The next question comes from Boris Molina, Santander.

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

Yes. I have a question regarding your deferred tax assets. We've been noticing how you deferred the taxes for non-performing loan provisions regulatory and excess (1:08:49) has been increasing at a much faster rate than the increase in provisions to the fact that in over last three years they used to track the – deferred tax assets were basically equaled to tax rate applied to your provision stock. Now, they are double. So, it seems to be that there is a difficulty in converting the different tax assets into cash. I'd now like to see – understand how this goes forward, because this growth is obviously not deducted from your fully loaded Core Tier 1, because there is this current guarantee, but we can debate whether this is valid capital or not, but it's a little bit of concerned situation? And my second question is regarding the impact of the deconsolidation of credit card from your capital ratio. How big was the impact from this change in consolidation perimeter and in the quarter?

A - Marcelo Kopel {BIO 16986304 <GO>}

Hi, Boris. Let me start with the second one and then I'd go back to the first one. Credit cards still is being consolidated under our numbers. So, maybe I didn't get your question, but it's still consolidating to our numbers.

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

Yeah. What happens is that when you look at the Pillar 3 disclosures, you find that credit is not consolidated for capital calculation. So, this reduces risk-weighted assets. So, how much of the impact in risk-weighted assets reduction was because of this change?

A - Marcelo Kopel {BIO 16986304 <GO>}

It does – Boris, sorry. We can take it offline, but it does consolidate into our numbers. So, let's take it offline. But it certainly does consolidate. Your first question is regarding the build up on DTAs, on different tax assets, right, related to credit?

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

Yeah.

A - Marcelo Kopel {BIO 16986304 <GO>}

Okay. If I recall, there was an e-mail from yesterday to Marcelo and how we build that. We're going to take it offline, but let me anticipate part of the answer. The timing of how we take the deductions and the timing where we take the write-offs and we've booked the assets in the books – the differed tax assets in the books, it doesn't necessarily one is married to other one. Okay? So, you can have a lag between one and the other one, therefore you can have a distortion when you simply do the math and work backwards of how much you have of a DTA and how much it means in terms of your loan book that was written-off. But we'll get back to you specifically on that on your e-mail.

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

Yes. Because it appears that – I was under the impression that once you write-off the loans, you probably sell the loans off to asset-recovery companies and then you're able to claim your tax benefit on those loans. But this seems to have been broken down over last couple of years?

A - Marcelo Kopel {BIO 16986304 <GO>}

No, it's not the case, Boris. And if that was the case, you would see it much more often in our disclosure that assets were sold. And we do it very – last year we probably – if we did it once, it was a small amount and we disclose that very thoroughly, like we did this quarter. So, it's not the asset sales to crystallize, let's say, the tax deductibility that drives that.

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

Okay. Wonderful. Maybe, if I may, just one additional question on capital. The impact of CorpBanca of 80 basis points, does it assume an additional capital injection? Because when we look at CorpBanca and the dividends that were paid out in the second quarter and the one that is going to be paid at the beginning of the year, on a fully-loaded basis, this bank is going to be left with around 3% Core Tier 1 and that is related also – in this capital calculation, do you foresee an additional capital injection in Chile?

A - Marcelo Kopel {BIO 16986304 <GO>}

Well, as part of the agreement, there is a $550 million capital injection that we will do prior to the merger. Did you factor that $550 million in your calculation?

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

No, but it's - the payments are much larger...

A - Marcelo Kopel {BIO 16986304 <GO>}

Higher than $550 million.

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

We can take this offline. But the bank is going to require, probably, capital increase?

A - Marcelo Kopel {BIO 16986304 <GO>}

Well, the bank will be properly capitalized, that's the assumption you can make, for us to continue to grow and benefit from the opportunities there. That's as much as I can tell you now. But please do factor in that there is a $550 million capitalization that will happen prior to the merger. Okay. And it turns out to be that this will be a very well-capitalized entity in Chile.

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

Okay. Wonderful. Excellent. Thank you.

Operator

The next question comes from Marcelo Telles, Credit Suisse.

Q - Marcelo Telles {BIO 3560829 <GO>}

Hi. Hello, everyone. Thanks for the opportunity. My first question is regarding asset quality. Actually, I like to ask some more broad questions on asset quality. What is the - I mean, at what point of the asset quality cycle do you think Itaú is right now? I mean, are we reaching a peak? If not, when do you think the peak for delinquency should be reached? And my second question is regarding the increase in spreads that we've seen based on the Central Bank data that all banks have increased spreads quite materially, and of course Itaú was well, particularly on the revolving credit lines.

So, one of the doubts I have is, you have the increase in social contribution tax. So, once the higher social contribution tax is effective from September on, would you intend to increase the spreads further or the spreads that we've - the increase in spreads you've seen so far, they are already in anticipation of, let's say, the higher social contribution tax or - and of course, a worse asset quality environment? Thank you.

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

Marcelo, in terms of spreads, this is a process that has been going on already. But the market is very competitive, so the ability to price it depends on competition. But of course, there will be a net negative impact on the banks, in general, given this increase in the taxes. We - as I mentioned during the call answering other question, it's still early to define the level that will be these one-off gain related to tax gain. Our provision policy is independent of this type of event. But we are always revising this and in a more challenging environment, we could be even more conservative. But it's premature to mention that.

Q - Marcelo Telles {BIO 3560829 <GO>}

Okay. Thank you.

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

Sorry, Marcelo. Talking about our position in the cycle, we expect still this to keep going up slightly, NPLs. We don't see that we reached the peak of this cycle. The peak of this cycle is related, of course, to macroeconomic situation. And we still see unemployment going up this year and probably going further up next year. So, we will probably see these going up. But we don't see any major movement in this process.

Q - Marcelo Telles {BIO 3560829 <GO>}

Perfect. Thank you very much.

Operator

The next question comes from Victor Galliano, Barclays.

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

Sorry, just a quick follow-up. I just wanted to clarify. You were saying that sort of like-for-like – on the capital side like-for-like fully-loaded Basel III, would that be 10.5% you were saying, if factoring in no FX effect? Is that correct?

A - Marcelo Kopel {BIO 16986304 <GO>}

Yeah, Victor. That's 10.5% – that will bring the number to 10.5%.

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

Okay. And that has no mitigations in there of any kind?

A - Marcelo Kopel {BIO 16986304 <GO>}

No, no. No. If we – had we run our capital position of 11.3% today, it would have been 10.5%, for reference, on page 19 of the presentation, it's where we are taking this number from, the 11.3%.

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

Okay. Okay. Thank you. Thanks, Marcelo.

Operator

This conclude today's question-and-answer session. Mr. Eduardo Vassimon, at this time, you may proceed your closing statement.

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

Thank you all for the time in our call. We believe, as I mentioned in the beginning, that we had delivered good results in the second quarter, particularly considering the challenging economic environment. An increase of loan loss expenses is, of course, inevitable in this type of environment. But on the other hand, we are increasing margins, financial margins with clients, meaning that we believe we are pricing well this new risky environment. We are keeping costs under control, aiming at having them below inflation and take advantage of more volatile environment in terms of market results.

So, thank you very much again and hope to see you in the next call. Thank you.

Operator

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

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