Q2 2014 Earnings Call

Company Participants

- Cícero Augusto Vieira
- Daniel Sonder
- Eduardo Refinetti Guardia
- Rogerio Santana

Other Participants

- Alexandre Spada
- Carlos Macedo
- Domingos Falavina
- Gustavo Lôbo
- Rafael Frade
- Victor Schabbel

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen, and welcome to the Audio Conference Call about the Earning Results of BM&FBovespa for the Second Quarter of 2014. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions to participate will be given at that time. As a reminder, this conference is being recorded and broadcasted live via webcast. The replay will be available after the event is concluded.

I would now like to turn the conference over to Mr. Eduardo Guardia, Chief Product and IR Officer of BM&FBovespa.

Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you. Good morning, everyone. Thank you for joining us on this call today. I have with me our CFO, Daniel Sonder; and our Investor Relations Officer, Rogerio Santana. I will start with a few highlights about the quarter, then I will hand over to Rogerio and Daniel who will walk you through the numbers in more detail.

Before going to the numbers, I would like to give you some important information. First, we are very happy that yesterday the Central Bank of Brazil has approved our new clearinghouse. We are extremely happy; this is a very important step for us. With this approval that we got yesterday, we will be able to migrate the derivatives clearinghouse to the new one on August 18 in accordance with our schedule. And this is very important - it's a very important piece of information not only for the company but for the market, given the importance of this project that I will make a few comments on that later on, on this presentation.

The second important piece of information is that CVM has approved the day before yesterday the new access model for brokers. This is also very important. Today we - until this week, we only had one type of broker that we could call the full broker, and now CVM has allowed us to have a new type of broker that we can call the introducing broker. So this is important because these introducing brokers will be able to use the full brokers' infrastructure to operate and they will keep the relationship with clients.

This is important because we believe that this new access model will be an important contribution to reduce the industry cost. So the brokers' costs, particularly the introducing brokers' costs would be – could be reduced because they will be able – they will be allowed to use the full broker infrastructure. So this is another important news for us.

The last one is that, as you know in June, last June, the federal government has approved the tax exemption on capital gains for investors that purchase shares of eligible SME companies. So this was the measure that was spanning for us (3:35) in the set of measures we had to develop the access market in Brazil. So we had three important news from regulators: one from Central Bank, one from CVM and one from the Ministry of Finance. So these are important aspects that I would like to highlight.

Now moving on to the numbers, in the second quarter, as you know, revenue did not have a good performance. This should not be a surprise for you as we disclose volumes on a daily basis. So you have a very good view on revenues before earnings come out. I think a few facts are important to have in mind before analyzing revenues in this quarter, particularly when you compare to the second quarter of 2013. First, we had fewer trading sessions, actually we had 63 in the second Q 2013 compared to 60 this last quarter.

Second, the second Q 2013 was the all-time high volume in both segments as you know. And last but not least, we had World Cup affecting volumes. As a matter of fact, if you consider the World Cup viewers, ADTV was around R$5 billion compared to R$6.7 billion on average for the second quarter. So although we just had two weeks during the first quarter – the second quarter of the World Cup, but this has affected volumes as well.

Although this fact clearly contributed to explain the reduction in volumes during the quarter, we cannot deny that volumes in both segments are very low – at very low levels and in our view it is reflecting the deterioration in the macroeconomic outlook, particularly the perspectives of lower economic growth. As Rogerio will explain later on to you, the revenue fall is due to reduction in volumes as margins in the Bovespa segment where roughly flat and RPC in the derivatives segment was up 23%. So the reduction in revenues in the quarter is reflecting the reduction in volumes, not in the margins.

Moving on to expenses, adjusted expenses are flat in nominal terms and this clearly reflects the management's strong commitment to cost control. Daniel will give you all the details on that, but it's important to emphasize that adjusted expenses are flat compared to the second Q of 2013.

Financial reserves were up 38% reflecting higher interest rates as we didn't have any material change in the cash position. Adjusted net income down 20% mainly because of the reduction in revenues and adjusted EPS down 16.8%. As for dividend payments, yesterday our board of directors approved a payout equivalent to 80% of GAAP net income, equivalent to R$0.11 per share, or R$200 million, the payments will be made on August 29.

So now, I'd like to hand over to Rogerio.

Rogerio Santana {BIO 20317880 <GO>}

Thank you, Eduardo, and good morning, everyone. I would like to ask you all to go to slide number four where you'll find some details on the Bovespa segment performance. You see that ADTV reached R$6.7 billion in the second quarter 2014, what means 18.7% decrease year-over-year.

As mentioned by Eduardo, lower volatility levels, change in the macroeconomic outlook and also the World Cup have impacted market service (8:10) in the second quarter and also in the beginning of the third quarter 2014. In this scenario, the turnover velocity reached 60.6% compared to more than 80% one year earlier while the average market cap was roughly flat in the same comparison. When compared to the previous quarter, we see 7.9% growth in the average market cap, what shows the recent recovery in the prices of Brazilian stocks that we've seen in recent weeks. And finally, trading and post-trading margins were roughly flat, around 5.3 basis point, and this has not impacted revenues in this quarter.

Moving to slide number five, we see information on volumes and prices in the BM&F segment. The 37.9% decrease in the ADV was partially offset by the higher RPC that grew 23.1% in comparison with 2Q 2014. The volumes decrease reflects the performance of the two main contracts in this segment, the ADV of interest rates in reais fell more 50% in the period reflecting lower volatility and also decreased market uncertainty about the Central Bank's decision on interest rates that would come out in the coming months. And in the case of FX contracts, they did fell 11.4%.

Regarding the 23.1% growth in the RPC, this reflects the mix effect and the U.S. dollar appreciation versus the real. The interest rate in reais contracts which has lower prices than average had its participation in the overall volume reduced to 53% compared to almost 70% one year ago. Also volumes of this group of contracts were concentrated in longer maturities, pushing their average price up. As you know in the case of interest rates contracts, the RPC varies according to the maturity of the contract and the longer the contracts, the higher their price.

In the case of interest rates in U.S. dollars they are now also (10:36) FX contracts, their RPC were positively impacted by the 9.6% U.S. dollar appreciation versus the Brazilian real.

Now turning the page to the slide number six, once again we see how diversified are our revenues, reflecting our business model that's fully integrated and diversified and that provides us with exposure to various markets like equities, interest rates, FX among others.

As happened in the previous quarters, the main contributor to revenues was the derivatives market with interest rates in reais representing more than 16% and revenues from FX futures coupled with interest rates in U.S. dollars contracts representing more than 17%. Another highlight here is that the cash equities trading represented only 5.8% of overall revenues, in line with the numbers we saw in recent quarters that was around 6%.

And now, I would like to pass it over to Daniel who is going to drive you through our expenses and other financial highlights.

Daniel Sonder {BIO 18250247 <GO>}

Hello, everyone. I ask you to please turn to page seven where we have our second quarter 2014 expenses description. We reported adjusted operating expenses of R$134.1 million in this quarter with a growth of only 0.7% over the same period in the previous year. In comparison with the previous quarter of this year, the change was negative 1.7%.

The company remains absolutely committed to controlling its expenses, seeking to operate our business every time in a more efficient way and also seeking to offset the natural increases to inflation which we would have in our expense base while maintaining safety and the quality of our activities. Within the adjusted expenses that grew, the main one was IT expenses which essentially grew because of new projects – sorry, new platforms that came online since last year as well as inflation adjustments to some of our IT recurring maintenance contracts. We also had a slightly higher expenses in consulting and third-party services due to some projects, strategic projects and people that we have engaged to help us identify synergies in our business.

On the other hand, we have been able to materialize and gain some important expense savings related to our communication expense, communication lines which is linked to the mandate that we have to spend in statements to investors, and over the course of the last few months, we have achieved some important efficiencies by changing the way we do that. We also were able to have lower discretionary expenses in marketing. The main line, of course, is our adjusted personnel expenses that are responsible for roughly 60% of total adjusted expenses in the company, that line grew by only 0.2% over the year.

We, of course, had automatic wage increases in the company as we do every year and we were able to offset that with some reductions in our head count also through the lower accrual of profit sharing scheme that we have for employee compensation, and finally a slightly higher personnel expense capitalization which, of course, is due to some of the ongoing projects that happened in the company.

So we're very pleased to report expenses again growing below average inflation in the first half of this year. We totaled R$270 million of adjusted expenses, a 5.2% growth over the same period of last year. We reiterate and confirm our guidance to the market of total operating expenses between R$595 million – adjusted operating expense, pardon me, between R$595 million and R$615 million for 2014.

If you switch briefly to page eight, you will see that we remain a very liquid company, very robust company financially which is, of course, our responsibility to our fiduciary role as the central counterparty in Brazil. The reduction in total cash that you see there is due mainly to the reduction in third-party guarantees that we carry on our balance sheet both on the asset side and an equivalent amount on the liability side. So it's not actually cash owned by our company.

We executed R$106 million of CapEx in the first half of this year, R$41.6 million of which was in the second quarter. We again reiterate and confirm our guidance for this year and for next year, which you see on the bottom of page eight. We are executing our projects and expect that the second quarter will have a stronger CapEx expenditure than this year, but obviously within the range announced.

And finally, related to the payout and the share buyback, we, as Eduardo mentioned in the beginning, our Board again approved yesterday 80% of net accounting process distribution, and this will be paid out on August 29 to the amount of R$200 million. We're also continuing to have our share buybacks outstanding, and we have purchased 30.2 million shares of the company so far this year.

Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you, Daniel. If you move to page nine, we try to give an overview of what we are doing this year in terms of product development.

As you all know, the clearinghouse integration and the new risk model is by far the most important initiative for this year, but we believe it's important to show to you that there are a lot of other important things going on in the company at the moment, so we try to highlight a few of them in this page.

So starting with the IT infrastructure and the functionality of the systems we have today, I would like to highlight the rollout we started last – this month the rollout of the new trading screen for the cash equities segment. Next year, we will start – we roll out the new trading screen for derivatives segment. We have already built our data center, now we're starting to move into the new data center. There are important initiatives in terms of fixed income, particularly corporate bonds. We migrate all the trading of corporate bonds to PUMA, to our trading platform. The next stage is to migrate government bonds to PUMA as well.

We have a new functionality for market makers, new applications and functionality for the Tesouro Direto, a lot of operational improvements for the sec lending business, which is a very important business for us. So there is a lot of delivery to – for the second half of this year related to the IT infrastructure and functionalities of the existing systems.

In terms of new products, we have launched a product – listed an OTC product this year. We had the first international ETF, the S&P 500. We launched our OTC platform (19:19). And the next stage is to launch the COE with physical delivery, new types of time deposits, the Letras Financeiras, the financial bills and the NDFs with and without CCP. We are also launching new BDRs, non-sponsored BDRs of U.S. and European companies. And we have plans to add new market makers for derivatives. So that's just to give a fast look (19:52) on all the initiatives we have in terms of product development.

Moving on to page 10, you are all very familiar with the clearinghouse integration but I just want here to emphasize some of the benefits to the market and to the company of this important project which is not only a clearinghouse integration but also the development of a new risk model that will allow us to provide much more capital efficiency for our clients, to improve liquidity management, to provide more operational efficiency to the market and to reduce operational and IT risks.

So the first phase of the project, as I said in the beginning, is the migration of the derivatives to clearinghouse. Now with the prove – now that we've got the approval from the Central Bank yesterday, we will be able to go live as scheduled on August 18. Next year, we'll migrate the cash equities clearinghouse. I want to remember you that we have been testing and discussing this new clearinghouse and this new risk model with market participants for a long time, almost 12 months' period of intense relationship with market participants testing the new system that will go live this month.

And the expected benefits to the market, I once again would like to emphasize in terms of the expected benefits, the capital efficiency. And this capital efficiency is related to the new risk model that will allow us to do the netting between the various contracts with similar risk factors. In other words, future versus options, futures versus swaps, options with different maturity dates. Today with the existing risk model, we are not able to provide this type of efficiency and we will be able after August 18, when we launch the new integrated clearinghouse. So we are very happy with this approval and we are very excited with the decision (22:07).

Moving to page 11, I think you all know that we have already got the tax exemption on capital gains for SMEs, but the message here is that we were able to approve several important measures for our company and to the market. So the Federal government has approved the tax exemption for SMEs, as I said before. We are discussing a new, and this is very important, we are discussing a proposal to simplify the tax treatment for individual investors in equities. We believe that this may have a very strong impact on the equities market going forward, because it will simplify the income tax treatment to retail investors. So this is a very important initiative.

We got finally the definition of the tax treatment on fixed income ETF. This was a pending issue for launching this project that we believe will have a very good performance. Our expectation is to launch the fixed income ETF in the beginning of next year. And we also managed to get a clarification on the tax treatment on dividends and interest on capital related to the sec lending business.

So the message here is that again, we got several important approvals from the Federal government in the recent past. So these were the main messages we would like to convey to you.

And now, I would like to open up the call for your questions. Thank you.

Q&A

Operator

Ladies and gentlemen, we will now begin the question and answer session. Our first question comes from Mr. Carlos Macedo with Goldman Sachs.

Q - Carlos Macedo {BIO 15158925 <GO>}

Good morning, gentlemen. Thanks for the opportunity to ask questions. I have a couple of questions. The first one is on your expenses, it came down - came a little bit lower than expected this quarter, you have obviously the seasonality in the second half of the year. The question is how much flexibility do you have to manage these expenses? I think you were talking earlier to the press about coming at the low end of the guidance. Could you come in the lower end at - below the guidance if, for instance, volumes dried up in the end of the year and you wanted to deliver higher profitability, what kind of flexibility do you have given the projects you're carrying out to integrate the clearing platforms and what not?

And the second question is given that the clearinghouse integration is going forward and they're going live in derivatives in a week or so, when - is there a timetable for you to open this up for other trading platforms to use this clearing platform back to the top of the competition that has been going back and forth for a while? Thank you.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Carlos, I'll start with the second question, then I'll hand over to Daniel to talk about expense, but before I answer you, just to let you know that Luís Furtado, our CIO, has just joined us for this call, so if you have more specific questions about IT, he'll be very glad to answer - to take your questions. About the clearinghouse integration, as we said, the first stage is derivatives, we will start the second phase with cash equities after we finish this transition, this migration this month, and we expect to finish the second phase of the clearinghouse integration by the end of next year.

So we will only be able to provide post-trading services to other players when we finish the second phase of the clearinghouse integration scheduled for the end of next year. Because remember, what's being discussed at this moment is to provide post-trading services through a new trading platform. So we have to have the new cash equities clearinghouse operational to provide this type of service to possible competitors (26:40). So we are only talking about opening up the clearinghouse when we finish the migration of the equities clearinghouse probably by the end of next year.

A - Daniel Sonder {BIO 18250247 <GO>}

Carlos, this is Daniel here. Thank you for your question. I just want to make it very clear that we are reiterating our range from R$595 million to R$615 million. We are making efforts internally to, as we have done in the past, to control our expenses to the extent possible; but this is by very, very large means a company that has some rigidity in its expense base. It's, as you know, largely personnel expenses that are driven every year by automatic wage increases at the second half of the year. So that is reason to expect that we would have higher expenses in the second half of the year compared to the first half of the year. So we are trying hard, we are - in the discretionary expenses, we are trying harder even, but this is not something that I think we have a lot of flexibility on.

Q - Carlos Macedo {BIO 15158925 <GO>}

Okay. Thank you, Daniel. Thank you, Eduardo.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you.

Operator

Our next question comes from Mr. Gustavo Lôbo with BTG Pactual.

Q - Gustavo Lôbo

Hi, Eduardo, Daniel, Rogerio. I have a question on OTC derivatives. We know that under new BS3 rules, the risk weighting factor for derivatives without CCP increased a lot. And I was just wondering if you have already seen an increase in demand from banks for potentially migrating volumes from an operation without a CCP to yourself with a CCP because of that? And also wondering, how do you see volumes for your new OTC and fixed income products going forward in the second half? Thanks.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Okay. Gustavo, first, it's true. According to the new rules, there is a tendency to use more CCP products in OTC derivatives. It's important to say that today in Brazil, we have approximately 80% of the derivative market in the listed products, so in a way we are different from the rest of the world where most of the derivatives transactions are OTC and we will have to migrate to OTC with CCP or to listed products; in Brazil, it's already 80% listed. When you consider the OTC derivatives today, I think that roughly 10% of the volumes of the OTC derivatives are with CCP.

I agree with you that there will be going forward a tendency to have more OTC derivatives with CCP, and that's why the clearinghouse integration is so important for us, because we will not only consider listed products in our new clearinghouse but also OTC products. And this will start now on August 18 when we migrate to the derivatives clearinghouse, that we will already be able to consider the OTC transactions with CCP to calculate the risk. So this is a huge competitive differential that we have. I think it will happen going forward, but answering your question in a very clear way, we haven't seen yet any higher demand for OTC derivatives with CCP, but I do expect to see it over time.

In terms of volumes for the second half of the year for the OTC products, as I've said to you before to everyone, we are still working on new products that we need to launch to increase our competitive position in the OTC segment, and particularly the products that I mentioned to you during my presentation, the COE with physical delivery, new types of time deposits, Letras Financeiras. So as long as we have all these products ready to offer to our clients, we expect to see volumes picking up on a more consistent way but we had a good start. We are increasing volumes, but we know we need to launch new products to increase our competitive position in these markets.

Q - Gustavo Lôbo

Okay. Thanks. Just wondering what would be the sales pitch of these products? Do you intend to be more aggressive in prices or just to offer products that are not exactly offered by a potential competitor? What exactly is your strategy to gain market share in that?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

The strategy is not be too aggressive in fees. We know we have to have lower fees because we are the new player in this market, but we don't want to be – to start an aggressive price war. We don't think it makes sense. So depending on the product we are talking about, if you are talking about COE, I think the best sales pitch on our side is to differentiate our platform not only with the physical delivery, that's something that we will be the only one able to offer to clients, but we do believe we have a very flexible and good platform for structured notes, the COE registration. So when you talk about COE, I think it's possible to differentiate based on the platform that we have. And as we started from scratch, we do believe we have a very good platform that will be even better with the physical delivery.

When you talk about time deposit, the strategy is to try to reduce the bank's cost, the bank's back office cost, and one example I can give you is that our platform is able to register – to identify, sorry, the final beneficial owner of the time deposit, independent of the amount of the time deposit we are talking about. So that's one example on how we can help clients to reduce their back office cost. Another aspect that we always emphasize is that we believe we have a very simple fee structure dependent on if it's more or (33:55) how cheaper it is, but we believe we have a simple fee structure because we don't charge based on transaction. So we believe that's something important to our clients.

So that's the way we'll try to differentiate ourselves and, of course, when you talk about OTC – so there are two markets here. You have the registration of fixed securities and you have the OTC derivatives. When you talk about OTC derivatives and if you believe that over time there will be more demand for OTC with CCP, then the biggest competitive advantage we have is the integrated clearinghouse and the capital efficiency we will provide to clients, not only by lower collateral requirement now with the new risk model, but also to be able to provide efficiencies in collateral management, so that's the idea.

Q - Gustavo Lôbo

Thanks. That's very clear. Thank you.

Operator

Our next question comes from Mr. Alexandre Spada with Itaú BBA.

Q - Alexandre Spada {BIO 16687974 <GO>}

Hi, gentlemen. Good morning. Thank you for taking my question. It relates to margins on your equities business. Despite the reduction in equities ADTV on the year-over-year comparison, the margin was virtually flat versus the second Q of 2013. My understanding is that the comp bases are really adjusted now for the most important adjustments introduced by that new pricing scheme in the equities segment starting in April 2013. That said, I would like to understand why we did not see margins improving year-over-year given the reduction in volume. Was that caused by mix factors such as maybe an increase in HFT or day trade versus the second Q of 2013?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Yes, Alexandre, as you correctly said, the impact of the changes we have made in the fee structure are fully reflected in the numbers, so you can compare the numbers. And going forward, what we explained reductions or not or (36:09) increase in margins in the equities business is the metering effect, (36:18) and particularly the day traders, not only the high frequency traders, because remember now we don't differentiate high-frequency traders in the cash equities segment. We provide the discount based on volumes to all day traders, so that's what will drive margins going forward.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you. And if you allow me a second question...

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Sorry to interrupt. When you talk about the mix effect, we will also have to take into consideration the derivatives on single stocks, because this business has a higher margin.

Q - Alexandre Spada {BIO 16687974 <GO>}

That's clear. Thank you. And if you allow me a second question...

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Please. Go ahead.

Q - Alexandre Spada {BIO 16687974 <GO>}

We see on a monthly basis when you publish your operating figures that the number of individuals with accounts open at the exchange keeps falling despite all of your efforts and campaigns to increase the number of accounts from individuals. So can you provide us an update on your most recent efforts to change that trend?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Okay. First, it's very important to have in the mind the environment we are living in and, of course, it affects our ability to bring new individuals to the exchange. Having said that, there are two aspects I would like to highlight. On the one hand is that all the initiatives we have to launch fixed income products. And we have the Treasury Direct, and by the way, if you look to the performance of the Treasury Direct, there was an important increase in revenue this quarter and an important increase in the number of individuals trading Tesouro Direto. If I'm not wrong, the number of individuals has increased 23%, 22% compared to the same quarter of 2013. So now, we have approximately 114,000 investors in the Treasury Direct. Is that correct, the number of 114,000?

So this is one initiative, the fixed income. ETF is another initiative. I think these products are very appropriate for retail investors. And remember that in order to buy these products, these retail investors have to have a broker. So they have to open an account in a brokerage house, and in many cases, this is the first contact they have with the exchange. If you look to these 110,000 retail investors that have Tesouro Direto today, only 50% of these individuals are trading stock. So this is what I'm trying to say is a very efficient way to bring new retail investors to our environment. So this is one initiative, to offer more fixed income products.

The other one is the initiative that we launched last year. It's a very important partnership with the brokerage house. We create - we made - we launched an incentive program to help the brokerage house to bring new retail investors to the exchange. Important to say that from our perspective, we are not giving up existing revenue and giving it to the brokers. What we are doing, we will split the future revenue of these new retail investors that will be attracted by the brokers and we will split part of this future revenue with the brokers. As we have the final beneficial owner model, we can monitor the new retail investors that are bringing - coming to the exchange.

So this is the strategy. The strategy is to work together with the brokers to set up, to put in place efficient and rational incentive programs that will help the brokers to do this job, because we believe they can do it in a much more efficient way than we will be able to do. So instead of trying to attract the clients directly, we will use - we work together with the brokers and have efficient incentive programs that makes sense for us and the brokers. So this is the strategy.

Q - Alexandre Spada {BIO 16687974 <GO>}

And can you just update us on when is the timing for this program to be fully implemented? I know it has already started. I'm not sure how many brokers are already participating.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

The program was launched last year. We have maybe it's not precise number but approximately 30 or 35 brokerage houses that are working together with us in this project. Since then, I would say that most of the new retail investors that have come to the exchange where attracted by companies that are part of this incentive program and - so but of course as I said in the beginning, we know that the environment, the macro environment is not helping at the moment, but it's important to have these programs in place to be able to capture the opportunity when they show up. So the answer is almost 30 or 35 brokerage houses in this program.

Q - Alexandre Spada {BIO 16687974 <GO>}

Okay. Thank you very much.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Before the next question, just to let you know that Cícero Vieira, our COO has joined us. So if you have specific questions about the CORE or the clearinghouse integration, Cícero also will be glad to take them.

Operator

Our next question comes from Mr. Rafael Frade with Bradesco.

Q - Rafael Frade {BIO 16621076 <GO>}

Hi. Good morning, everyone. Just a question about a point that maybe I missed from Eduardo in his first statement regarding the tax treatment of capital gains on secured lending. You understand now it's clear what will be the treatment, or if you understand it, you can still get better understanding from IRS about this? And second, there are some arbitrage (43:06) that market participants do related to this that seems to have some relevant volumes, and if you have any view of if this arbitrage is not more possible, what could be the potential impact in volumes, if you have any data that you can share with us?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Okay, Rafael, first, what I said is when you talk about the sec lending business, there was some doubts about the treatment on the reimbursement of the dividends paid. Let me give you an example. I have the stocks, I lent my stocks to you, then there was a dividend payment, you received this dividend and this dividend is exempt. But when you transfer this dividend back to the owner of the stock because that's the rule we have to date, it was not clear in the current legislation that this transfer from you to me was also exempted and that's what the Revenue Service has done with the last Provisional Measure 651. They made it very clear that this transfer of the dividends that the borrower receives is not subject to tax payment from the lender. So it was not clear before this Provisional Measure 651. Now it is very clear, so that's what I was emphasizing, and some clients were not lending the stocks because they were afraid of potential tax liabilities with the Revenue Service, so this was very important.

The second aspect that you mentioned, it's true, with the tax treatment we had before, it was possible to have some arbitrage because you have some investors that are exempt from interest on capital and others that are not. So if you have a borrower that is exempt, this borrower could lend from an investor that is subject to the tax and they could split this benefit. So this type of operation we saw in the past, everyone knows that it was happening but that's something that the Revenue Service said very clear that they don't want to see anymore. My point, it may affect volumes, yes, because we know that there was some transactions that were based on this type of loophole in the tax regulation.

But my message, my clear message to you is that we see a huge potential in this sec lending business and the potential is to bring more foreign investors that are not lending their stock, to bring the pension funds that are not lending their stock; there is a huge demand from the borrowers that wants to have more access to sec lending. It's important to develop the long and short industry in Brazil so there's a huge demand from the local asset managers for more offer of stocks in the sec lending business. So my message is clearly although there will be some – it may have some negative impact because of this transaction, the potential of this business is huge and to have clear tax rules is extremely important to develop the sec lending business. So I'm extremely optimist with the potential of this business.

Q - Rafael Frade {BIO 16621076 <GO>}

Okay, Eduardo, very clear. Thank you.

Operator

Our next question comes from Mr. Victor Schabbel with Credit Suisse.

Q - Victor Schabbel {BIO 17149929 <GO>}

Hi. Good morning, everyone. Sorry if this question was already being made, but my question would be in regard to the buyback program and the dividend payout ratio. Earlier this year, you guys announced a very aggressive buyback, 100 million shares. The share price was down close to R$10, R$9, and now the share price bounced back and the likelihood of the shares to get back again to lower levels hopefully is right now much lower. So the question would be can you guys think about increasing the payout again to 100% instead of the 80% and not really having to carry out the full buyback program with the shares at these levels which could be seen as less attractive? Thanks.

A - Daniel Sonder {BIO 18250247 <GO>}

Thank you, Victor. It's Daniel here. The dividend level is set out by the board in each meeting. Right now, we decided to – they decided to do 80% as has been the case. We do not expect to see any changes in that, so I don't think we would expect to see that. However, it is their decision every time they review our financials in each one of the board meetings.

Q - Victor Schabbel {BIO 17149929 <GO>}

Okay. Great. Thanks, Daniel.

Operator

Our next question comes from Mr. Domingos Falavina with JPMorgan.

Q - Domingos Falavina {BIO 16313407 <GO>}

Hi. Good morning, all. Thank you for taking the question. Yeah, I'm sorry, I also came a little bit late here in the call in light of the several calls taking place, so apologize if this has been answered. I know you mentioned something with regards to lowering the cost in light of Basel III implementation towards the end of the year, and more strongly in upcoming years and the derivatives that will be cleared will demand lower capital. And my question is have you actually performed a little bit more in detail an investor study that you could share with us, the risk weighted assets, how much would it weight, and the difference exactly for the cost of bank in doing a derivatives cleared versus uncleared? Thank you.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Domingos, as we said, we agree with Gustavo that there is a tendency of having more OTC derivatives with CCP going forward. But as I said, we haven't seen yet an increase of demand of this type of OTC derivatives with CCP. The only, let me say, guidance that we provided related to the integrated clearinghouse that will be operational this month, is that on average we can expect a reduction in collateral requirements around R$20 billion considering only the derivative clearinghouse. So we don't have yet specific numbers for OTC derivatives, although I do believe that going forward, there will be more demand for OTC derivatives with CCP.

Q - Domingos Falavina {BIO 16313407 <GO>}

Understood. And the second question, more directionally. I mean we're noticing a worldwide reduction in volumes and I think a lot of it is associated with also some deleverage from the financial institutions. Do you also have a feeling with regards to how Basel III will impact, not only on this which will actually be at the margin maybe a positive outcome for you but if volumes should stabilize or should even decelerate further from the current they are?

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Cícero would like to take this question.

A - Cícero Augusto Vieira

Yeah, so what I think is important to share with you and investors is that due to Basel III, CCPs and international CCPs in the U.S., Europe and Brazil will be – will have to be qualified. The term, the name used by BIS is qualified CCP or QCCP. If you are considered by your regulator to be a qualified CCP, then local banks and international banks that have exposure to you as a CCP, they get the minimum possible percentage for capital allocation and this is the risk weighted capital allocation.

And for CCPs generally, the risk weighted capital allocation can – there is a range from 2% to 150%. Of course, 150% are regards CCPs that have very low risk management standards, which is not the case of BVMF, and we registered our application with ESMA in Europe a few months ago and we are sure that BVMF is going to be considered a qualified CCP by the European regulators, which means that European banks which trade in Brazil or have affiliates that trade in Brazil, they will get the minimum possible capital allocation ratio, which is 2%, and the same applies to the U.S.

In the U.S., there is no application process. The U.S. process for CCP qualification is decentralized. Each U.S. bank has to perform its own analysis and conclude that the CCP is or is not qualified CCP, and that's why we provided to U.S. banks self-assessment of BVMF considering the principles defined by the BIS for qualified CCPs, and we are also sure it's the same in the U.S. and Europe. We are extremely confident that in both jurisdictions, we are going to be considered a QCCP.

Q - Domingos Falavina {BIO 16313407 <GO>}

Very clear. Thank you very much.

Operator

This concludes today's question-and-answer session. I'd like to invite Mr. Eduardo Guardia to proceed with his closing statements.

A - Eduardo Refinetti Guardia {BIO 2126991 <GO>}

Thank you. I just want to thank you, again, for joining us in this call today. If you have any other doubts, please do not hesitate to contact myself or Rogerio. Thank you very much.