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Research Update:

Banco do Brasil S.A 'BB-/B' Ratings Affirmed On Recovered Profitability, Outlook Remains Stable

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Overview

- Despite no loan growth, Brazil-based government-owned bank BdB has recovered its profitability due to improved net interest margins (NIM), better efficiency, and lower credit losses.
- Additionally, the bank improved its capital metrics following stronger internal capital generation, deleverage of its exposures, and lower dividend payments than its historical figures.
- We're affirming our 'BB-' long-term global scale local and foreign currency ratings and our 'B' short-term foreign currency rating on BdB. We're also affirming our national scale 'brAA-' rating on Ativos S.A., a core subsidiary.
- The stable outlook on both entities is based on our outlook on Brazil, and we expect the ratings on the bank to move in tandem with those on the sovereign.

Rating Action

On April 25, 2018, S&P Global Ratings affirmed its 'BB-' long-term global scale local and foreign currency ratings and our 'B' short-term foreign currency rating on Banco do Brasil S.A. (BdB). We're also affirming all debt ratings on BdB and our national scale 'brAA-' rating on Ativos S.A. Securitizadora de Creditos Financeiros, a core subsidiary. The outlook is stable. In addition, we assigned our 'B' short-term local currency rating on BdB.

At the same time, we're improving the bank's stand-alone credit profile (SACP) to 'bbb' from 'bbb-'. The very high likelihood of support from the government to the bank remains unchanged.

Rationale

We're affirming BdB's ratings following the bank's recovery of its profitability after posting weaker results in 2016. Despite no credit growth in 2017, BdB improved its NIM as funding costs continue to decrease, helping it maintain stable operating revenues. Moreover, the bank went through a significant organizational restructure aimed at improving its efficiency and cost control. Finally, a more favorable economy enabled the bank to improve its asset quality metrics, requiring lower credit loss provisions and boosting its earnings. As a result, BdB established stronger internal capital generation than we anticipated in our previous forecast while deleveraging its portfolio, leading us to improve our view of its capital position.

The long-term issuer credit rating on BdB is at the same level as the long-term foreign currency rating on Brazil. We rarely assign an issuer credit rating on a bank above that on the sovereign because the bank would have to demonstrate capacity to maintain sufficient capital and liquidity to cover the significant stress that accompanies a sovereign default. Additionally, BdB is a government owned bank that has significant asset exposure in the domestic market and to the sovereign because its liquid assets are largely invested in government bonds.

As the second largest bank in Latim America with total assets of R$1.4 trillion as of Dec. 31 , 2017, BdB has changed its strategy in the past two years towards efficiency gains and a more conservative credit underwriting approach in light of Brazil's economic struggles, which has led to lower revenue accrual from its loan portfolio. However, Bdb's revenue base has stayed relatively stable given its diversified business activities--it provides banking, asset management, and insurance services to over 66 million clients, around 30% of Brazil's total population, underscoring its exceptional market penetration. The bank also owns large investment banking, custody, and payment system subsidiaries that complement its diversification. Moreover, BdB has kept stable fee revenues (27% of total revenues) and its ability to increase its NIM. We believe the latter is a consequence of BdB's strong pricing power, which has let the bank withstand adverse industry conditions while other banks didn't. Going forward, we expect BdB to maintain its ability to generate businesses and pricing power, which we consider one of its main strengths. This strength comes from the bank's strong share in most segments in which it operates, wide range of loans and services, nationwide operations, and solid franchise. This is illustrated by BdB's leading market presence within the agribusiness and payroll segments, where it has 62% and 22% market share, respectively.

While the bank has a nationwide footprint, we believe its management and overall strategy are somewhat subject to political influence, given that the government appoints most of BdB's board members and senior executives. However, in our opinion, the fact that the bank is a listed entity enhances its governance standards, and somewhat mitigates the likelihood of negative government intervention. Moreover, we believe the current government views BdB less as a countercyclical tool for fostering credit in Brazil than the previous administration did.

We're improving our assessment of BdB's capital and earnings based on the bank's ability to establish stronger earnings than we anticipated in our previous forecast while deleveraging its portfolio and reducing its dividends payments compared to historical figures. As a result, our forecasted average risk-adjusted capital (RAC) ratio is now 6.5% for the next two years. Additionally, BdB has improved its regulatory capital metrics, as seen in its Basel ratio of 19.6% in December 2017. Our RAC forecast considers our base-case scenario assumptions, which include:

- Brazil's real GDP growth of 2.4% in 2018 and 2.6% in 2019;
- Overall loan portfolio to resume single digit growth in 2018 and 2019 (from 2% to 6%) because of an improving economy;
- Stable NIM. We believe BdB's strong pricing power and low funding costs will compensate for declining policy rates and the central bank's attempt to limit spreads of retail products;
- Noninterest expenses to grow in line with inflation--although efficiency metrics have recently improved, we believe further gains will be marginal;
- In our base case, we expect credit losses to keep decreasing. We forecast non-performing loans (NPLs) and charge-offs to remain between 2.5% and 3.5%, while renegotiated loans start to gradually decrease;
- Profitability to further improve because of lower credit losses and stable revenue flows (return on assets [ROA] 1.0% /return on equity [ROE] 13%);
- We expect the bank to keep relying on Tier I hybrid instruments, which represent around 30% of our total adjusted capital. However, we recognize that as the bank improves its earnings, the relevance of these instruments could decrease; and
- BdB to maintain a 30% dividend payment ratio in line with the past two years.

We believe BdB has kept its ability to manage risks and that its asset quality metrics continue to compare well with other large banks in Brazil mostly due to its portfolio mix, which is composed of a sizeable amount of secured lending like payroll deductible loans and mortgages (34% and 22% of its retail portfolio, respectively). During the second quarter of 2017, BdB's asset quality metrics began to improve--NPLs reached 3.6%, net charge-offs 3.0%, and renegotiated overdue loans 4.1% of total loans. The average metrics for the largest five banks in Brazil are 3.8%, 6.4%, and 4.6%, respectively. However, although we expect Brazilian economy to continue recovering during the next two years, supporting the bank's efforts to improve--or limit the deterioration of--its asset quality metrics, we highlight that we believe there's still a significant risk that a portion of Bdb's high levels of renegotiated loans will become delinquent and potentially increase its credit losses. Mitigating these risks is BdB's good geographic diversification, supported by one of the largest distribution networks in Brazil, and its well-diversified lending portfolio. Its largest 20 exposures represent about 15.8% of total exposures; better than the industry average.

BdB also enjoys one of the best funding profiles in Latin America, due to both its widespread branch network and its large retail client base. The bank's stable funding ratio remained at 93%, while its loans to deposit metric was 1.1x as of December 2017, in line with peers. However, BdB has the advantage of also relying on funding support from the government through several channels, such as receiving legal deposits and controlling payroll loans of public employees. Therefore, we believe BdB's funding base is above the industry average. The bank's extensive retail network results in a stable deposit base, and its widely known brand and resilience make it a safe harbor in times of stress, as observed in the flight to quality banks in the 2008 crisis. Its well-diversified funding base is divided into three segments: commercial funding (71%), which includes deposits and agribusiness letters of credit; institutional funding (25%), which includes borrowings, on-lending and domestic issuances; and foreign currency funding (4%). Moreover, the bank's broad liquid assets to short-term funding remained stable at 1.2x as of December 2017, which is similar to its regional peers. We expect Bdb's liquidity to remain abundant going forward, especially in light of the low credit growth expected for 2018.

We consider BdB a government-related entity (GRE) because Brazil (foreign currency: BB-/Stable/B) is the bank's majority owner and we believe there's a very high likelihood that the government would provide timely and sufficient extraordinary support to BdB if needed, as it has done before. We base our assessment on our view of BdB's:

- Very important role for the government, because we believe BdB plays a key role in providing competitive and long-term financing to the agricultural sector. BdB also has a large share in terms of deposits and assets in Brazil's banking system, and has a presence throughout the country, including in remote areas with scant other banks. We believe that in the event of a default or distress scenario, the bank's weakened creditworthiness could harm Brazil's economy.
- Very strong link with the government. Deterioration in BdB's creditworthiness would sharply weaken the government's reputation because the latter is publicly associated with the bank through a high degree of control. As a major shareholder, the government has a strong influence on the bank's strategic and business plans.

Outlook

The stable outlook on Banco do Brasil reflects the outlook on our sovereign ratings on Brazil, which currently limits the ratings on the bank due to its high exposure to the domestic market. As a result, we expect the ratings on the bank to move in tandem with those on the sovereign in the next 12 months.

Downside scenario

We could lower the ratings on Banco do Brasil following a similar action on the sovereign ratings of Brazil. We believe this could happen over the coming year should unforeseen weakness in Brazil's payments balance arise, impairing market access or causing external debt to rise sharply. Alternatively, a significant dip in recently improved monetary policy credibility under the current administration, marked by a persistent rise in inflation or weakened commitment to a floating exchange rate regime, would also weigh on the rating.

Upside scenario

We could raise the ratings on Brazil, and in turn on Banco do Brasil, under multiple scenarios over the next several years. The first would be if the next administration, following the 2018 elections, articulates and implements a solid and sustainable fiscal correction policy backed by congressional support. Alternatively, broad policy correction--and the fruits of recent microeconomic reforms--could support a higher GDP growth rate, such that Brazil's growth trajectory is no longer weaker than that of its peers with similar levels of economic development. Or, if the currently very high fiscal deficits decline because the government runs a primary (non-interest) fiscal surplus, indicating that net general government debt to GDP has peaked and is set to fall thanks to policy measures or better GDP growth prospects, we could raise the ratings.

Ratings Score Snapshot

Issuer credit rating	BB-/Stable/B
SACP	bbb
Anchor	bb+
Business position	Very strong (+2)
Capital and earnings	Moderate (0)
Risk position	Adequate (0)
Funding and liquidity	Above average and Adequate (0)
Support	0
GRE support	0
Group support	0
Sovereign support	0
Additional factors	-4

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015

- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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Ratings Affirmed

Banco do Brasil S.A
 Long-Term Counterparty Credit Rating
  Foreign Currency                       BB-/Stable/B
  Local Currency                         BB-/Stable
 Senior Unsecured                        BB-
 Subordinated                            B-
 Junior Subordinated                     CCC+

Ativos S.A. Securitizadora de Creditos Financeiros
 Counterparty Credit Rating
  Brazil National Scale                  brAA-/Stable/--


New Rating
Banco do Brasil S.A
 Short-Term Counterparty Credit Rating
  Local Currency                         B
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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.