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Banco do Estado do Rio Grande do Sul S.A.

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Banco do Estado do Rio Grande do Sul S.A.

SACP	bb-	+	Support	0	+	Additional Factors	0

Anchor	bb+	
Business Position	Moderate	-1
Capital and Earnings	Moderate	0
Risk Position	Moderate	-1
Funding	Above Average	0
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	0
Sovereign Support	0

Issuer Credit Rating
BB-/Stable/--

Major Rating Factors

Strengths:	Weaknesses:
• Strong brand recognition and reputation in southern region of Brazil; • Diversified and stable retail funding structure thanks to the bank's large share of deposits in the state of Rio Grande do Sul (RS); and • The rising share of consumer loans in its portfolio, resulting in better asset quality metrics.	• Client base concentrated in the state of Rio Grande do Sul; • The state's ongoing weak credit conditions; and • High competition in the domestic market.

Outlook: Stable

The national scale rating outlook on Banco do Estado do Rio Grande do Sul S.A. (Banrisul) for the next 12 months is positive, reflecting our view that the bank's efforts to diversify its revenue sources and focus on its retail operations have bolstered its operating performance due to increasing business stability that could mitigate the indirect effects of the state's sluggish economy. The global scale rating outlook remains stable, because the ratings on Banrisul are at the same level as those on Brazil, and we rarely rate a financial institution above the sovereign.

Upside scenario

We could raise the national scale rating on Banrisul if it continues to diversify its stable revenue base. Moreover, the government's goal to raise Banrisul's role as an important financing agent in the state could benefit its business growth and resilience. We don't expect a global scale upgrade because the sovereign ratings limit those on the bank.

Downside scenario

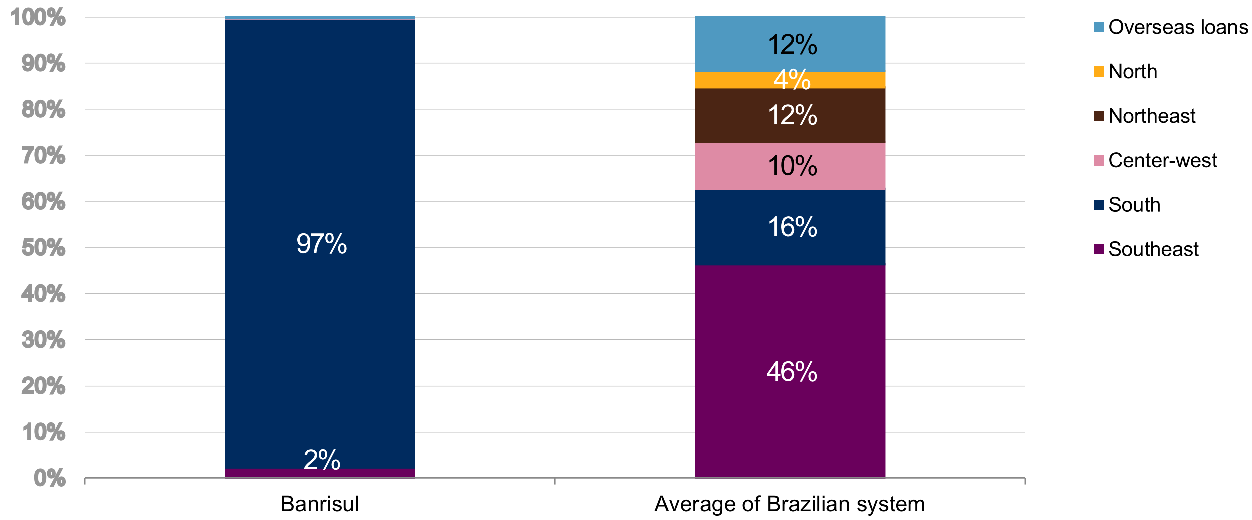
We could revise the national scale rating outlook to stable if we believe the strength of the bank's brand isn't sufficient to mitigate the indirect effects of the state's weaker finances or if the bank substantially increases its risk appetite. We don't expect a global scale downgrade in the next 12 months.

Rationale

The ratings on Banrisul reflects our view that its strong brand reputation and market share in the state of RS have been resilient to the state's weak credit conditions. Still, the risk of operating in the state of RS could eventually weigh on the bank's revenue stability, given the state's prolonged weak finances. Nevertheless, we continue to believe that the state's ability to intervene in the bank's operations is limited because of Brazil's Fiscal Responsibility Law, banking regulations, and Banrisul's strong corporate governance. At the same time, the bank has been strengthening its finances and reporting strong bottom-line results stemming from its stable business model and large share of deposits in the state. Moreover, we view Banrisul's increasing focus on secured consumer lending, particularly payroll deductible loans, as beneficial for its overall business position, because this lending segments is usually less sensitive to economic cycles.

Chart 1

Banrisul's Loan Portfolio Regional Distribution Compared To The Market Average
As of June 2019



Source: Central Bank and S&P Global Ratings.

Table 1

Banco do Estado do Rio Grande do Sul S.A. Key Figures					
	--Year-ended Dec. 31--				
(Mil. R$)	**2019***	**2018**	**2017**	**2016**	**2015**
Adjusted assets	78,421.5	76,304.9	72,054.9	67,723.2	66,883.8
Customer loans (gross)	34,237.2	34,063.7	31,369.1	30,337.4	32,013.3
Adjusted common equity	6,568.2	4,888.6	4,878.6	4,282.3	6,161.0
Operating revenues	4,109.7	8,064.7	7,758.5	7,317.8	6,500.2
Noninterest expenses	2,640.5	5,126.4	4,843.2	4,643.8	4,016.6
Core earnings	655.7	1,049.4	1,053.6	660.3	849.2

*Data as of June 30.

Anchor:'bb+' for banks operating in Brazil

Under our bank criteria, we use our Banking Industry Country Risk Assessment's (BICRA) economic and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a commercial bank operating only in Brazil is 'bb+', based on the country's economic risk score of '7' and an industry risk score of '5'.

In our opinion, Brazil's low-income levels and the government's weak fiscal position constrain the country's economic resilience. We project GDP growth for 2019 of 1%, which implies a similar subpar expansion of the previous two years.

Political volatility, associated with the process of approving pension reform, has held back investment and the recovery in household spending has flattened because labor market dynamics remain weak. We assume a pension reform will be approved later this year, which underpins our forecast for real GDP growth of 2.2% in 2020. We expect credit to grow 6%-8% this year after a 5.0% growth in 2018, only 0.5% in 2017, and the 3.5% contraction in 2016. Corporations have continued to deleverage, while their overcapacity has depressed credit demand. Nonperforming loans (NPLs) have dropped from their peak of 3.5% of total loans in 2017 to 3.0% in March 2019, and we expect them to continue decreasing to 2.5%-2.7% for the rest of the year and in 2020.

Our industry risk assessment for Brazil reflects its well- developed financial regulation that's broadly in line with international standards, and the regulator's good track record that has helped the Brazilian financial system withstand the economic downturn. In addition, the Brazilian banking system has an adequate funding mix with a large and stable core customer deposit base, satisfactory access to domestic and international capital markets, and low reliance on external funding. These strengths are moderated by the large presence of government-owned banks that create distortions. We believe that the new administration, in line with the previous one, is implementing measures to reduce their relative importance over time.

Business position: High regional concentration offset by revenue diversification, and strong brand reputation and market share in the state

In our view, Banrisul has continued to improve its bottom-line results over the past few quarters due to its efforts to diversify its revenue base and increase its focus on its secured retail lending and other operations, where it has a competitive advantage due to its vast branch network and strong market share in the state. In addition to its strong market position in the payroll deductible lending, the bank is aiming to sharply increase its participation in other lending segments in the state of RS, such as agribusiness and commercial credit for both retail consumers and small and mid-size enterprises (SMEs). However, the high concentration of the bank's client base in the state still weighs on its business positon. We believe this could undermine Banrisul's business stability stemming from the state's weak credit quality.

Revenue diversification, strong brand reputation, and market share in the state (almost 20% of the credit market) continue to support the bank's operations. Banrisul continues to work on improving its product mix in order to provide services to a broad spectrum of clients. We also believe the continued increase of fees and commissions from cross-selling opportunities with new business lines (such as payment services and insurance) cushion the effects of the state's struggling economy.

In our view, the bank's strong franchise in the state will continue to support its profitability over the next few years. However, despite its strategy of increasing its client base and operations, which have generated sound profitability in the past few quarters, we believe the stiff competition in Brazil's banking sector may pose challenges to this trend. We believe competition from large banks and new players may pressure Banrisul's margins, slowing the rise in return on equity (ROE) over the next few years.

Table 2

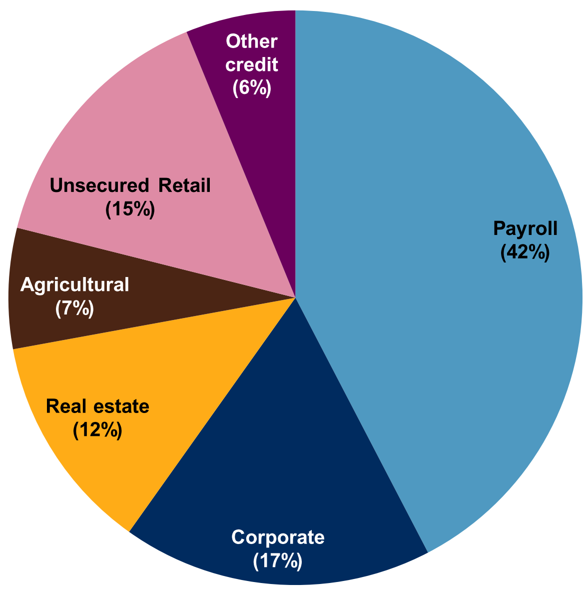
Banco do Estado do Rio Grande do Sul S.A. Business Position

		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Loan market share in country of domicile	N/A	1.0	0.9	0.9	0.9
Deposit market share in country of domicile	N/A	1.9	2.0	2.0	1.9
Return on average common equity	17.7	14.7	15.6	10.4	14.3

*Data as of June 30. N/A--Not applicable.

Chart 2

Banrisul Loan Portfolio Breakdown
As of June 2019



Source: S&P Global Ratings.

Capital and earnings: Forecasted RAC ratio of 5.5%-6.0% for the next 18 months

Our assessment of Banrisul's capital and earnings reflects our forecasted risk-adjusted capital (RAC) ratio of 5.5%-6.0% for the next 18 months and a comfortable regulatory capital level based on the bank's 15.8% Basel III ratio as of June 2019.

Our base-case scenario assumptions include the following factors:

- Brazil's GDP growth of 1.0% in 2019 and 2.2% in 2020.
- Conservative portfolio growth of 5%-7% for the next two years, as the bank continues to increase its consumer and

agribusiness loans while its SME portfolio recovers from the challenging economy.

- Revenue from fees and commissions to rise 8%-10% given the bank's focus on increasing revenues from services by developing its insurance and credit card acquiring network business lines.
- Net interest margins (NIMs) should slightly decrease following the adjustment in the asset and liability mismatch, caused by the sharp decrease in interest rates in Brazil in the last few years.
- Dividend payment rate to remain at 40% of net income, following the historical average.

Table 3

Banco do Estado do Rio Grande do Sul S.A. Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Tier 1 capital ratio	14.5	13.5	14.7	14.2	14.8
S&P Global Ratings' RAC ratio before diversification	5.5	5.1	5.6	5.1	N/A
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0
Net interest income/operating revenues	65.6	70.6	67.2	70.6	67.9
Fee income/operating revenues	24.1	24.8	22.5	23.2	22.2
Noninterest expenses/operating revenues	64.2	63.6	62.4	63.5	61.8
Preprovision operating income/average assets	3.7	3.9	4.1	3.9	3.9
Core earnings/average managed assets	1.7	1.4	1.5	1.0	1.3

*Data as of June 30. N/A--Not applicable.

Risk position: Benefits from increasing focus on secured consumer lending and revised credit policies

Banrisul risk position reflects the bank focus on servicing its core customers with traditional expertise with a modest risk appetite, as seen in tightly managed growth under the past few years. The bank also continue to increase the proportion of secured consumer loans in its portfolio, which reached 55% of total loans from 49% as of June 2017. In our view, the bank's shift towards a less risky portfolio during weak economic conditions benefits its risk position. Banrisul has also reviewed most of its credit policies and developed stronger underwriting standards for its loans. Given the product mix change and stronger underwriting, Banrisul's NPLs have sharply improved to 1.8% in June 2019 from its peak of 5.7% in 2016. The bank's net charge-offs ratio has also improved to 1.9%, which was the lowest reported ratio since 2014. Nevertheless, Banrisul's regional concentration remains high. Southern Brazil accounts for 97% of the bank's portfolio--compared to the market average of 16%--which weighs on Banrisul's risk position given the state's weak economy. The bank, however, doesn't have client concentration because its top 20 exposures represent less than 10% of its lending book.

Table 4

Banco do Estado do Rio Grande do Sul S.A. Risk Position					
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Growth in customer loans	1.0	8.6	3.4	(5.2)	5.0
Total managed assets/adjusted common equity (x)	12.1	15.8	15.0	16.1	10.9
New loan loss provisions/average customer loans	3.4	3.9	4.7	5.3	5.0
Net charge-offs/average customer loans	2.0	2.7	3.2	2.9	2.5

Table 4

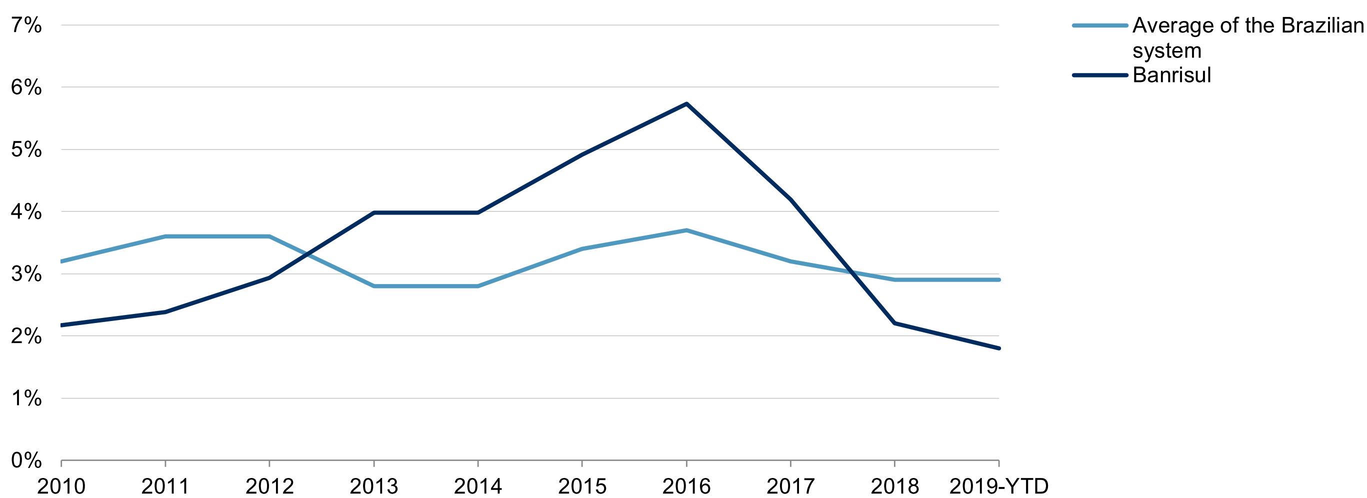
Banco do Estado do Rio Grande do Sul S.A. Risk Position (cont.)

		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Gross nonperforming assets/customer loans + other real estate owned	1.8	2.2	4.2	5.7	4.9
Loan loss reserves/gross nonperforming assets	416.2	355.7	211.0	151.7	143.2

*Data as of June 30. N/A--Not applicable.

Chart 3

Banrisul's Nonperforming Assets Versus The Brazilian System Average



Source: Central Bank and S&P Global Ratings.

Funding and liquidity: Diversified and stable funding structure thanks to a large market share in the state of RS

Compared with other Brazilian banks, Banrisul benefits from a diversified and stable funding structure due to its wide branch network and strong brand recognition in the state. These factors facilitate funding from demand, savings, and time deposits from individuals. The bank's position as the financial agent for state employees provides a stable, diversified, and low-cost deposit base, supported by its robust market share of almost 50% of the time deposits within RS. As of June 2019, time and demand deposits accounted for 70% of Banrisul's funding base, 70% of which are retail clients. The rest consist of savings deposits (16%), domestic issuances (6%), and other funding sources (8%). Given that its funding structure relies on deposits with liquidity clauses, Banrisul has high levels of liquid assets on its balance sheet. In our view, the bank adequately manages its liquidity because its broad liquid assets have historically covered slightly more than 70% of its total deposits. In addition, the bank's stable funding ratio was still above those of its peers, at 165% as of June 2019.

Table 5

Banco do Estado do Rio Grande do Sul S.A. Funding And Liquidity

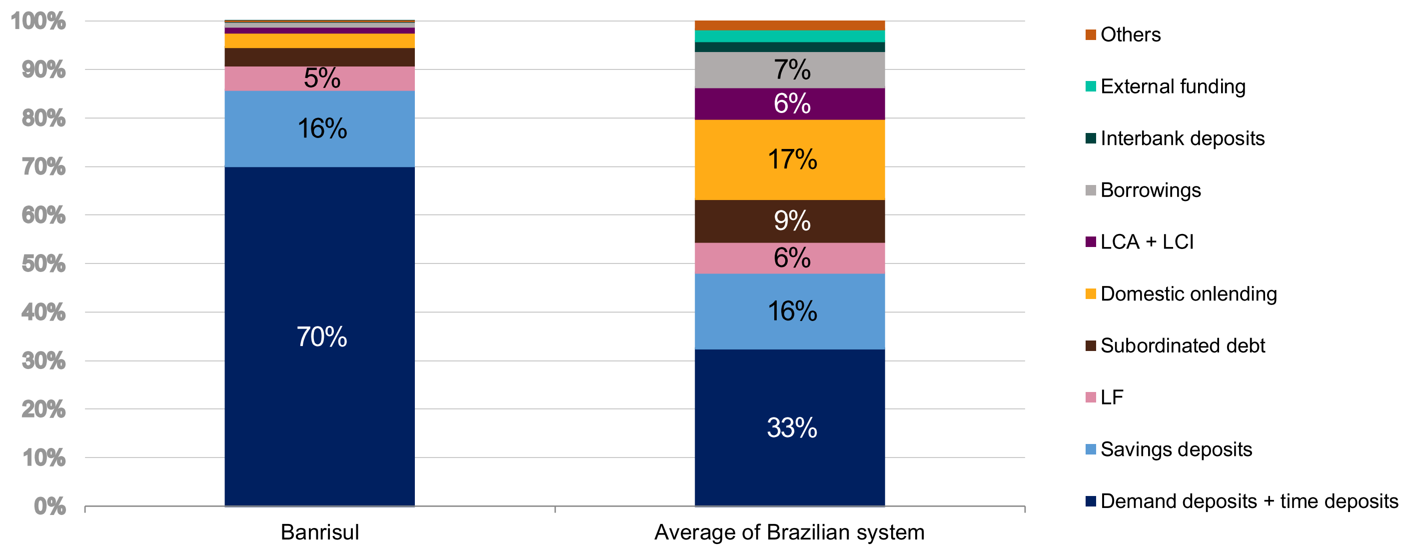
		--Year-ended Dec. 31--			
(%)	**2019***	**2018**	**2017**	**2016**	**2015**
Core deposits/funding base	85.6	85.9	83.4	80.0	73.9
Customer loans (net)/customer deposits	57.5	58.1	57.7	61.7	72.7
Long-term funding ratio	91.6	92.0	90.1	87.8	83.9
Stable funding ratio	165.3	163.7	158.0	152.3	134.3
Short-term wholesale funding/funding base	9.2	8.8	10.9	13.3	17.9
Broad liquid assets/short-term wholesale funding (x)	6.6	6.7	5.4	4.3	2.8
Net broad liquid assets/short-term customer deposits	173.8	176.3	174.4	171.8	113.0
Short-term wholesale funding/total wholesale funding	64.0	62.5	65.4	66.5	68.5

*Data as of June 30.

Chart 4

Banrisul's Funding Mix Compared To The Market Average

As of June 2019



Source: S&P Global Ratings.

Support: A limited link to the government

We classify Banrisul as a government-related entity (GRE) with a limited link to the government, which stems from our doubts about the government's capacity to support its GREs. Despite the state's weak finances, we believe that Brazil's Fiscal Responsibility Law, banking regulations, and Banrisul's strong corporate governance shield the bank from a possible extraordinary negative intervention from the state.

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- 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: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Anchor Matrix

Industry Risk	**Economic Risk**									
	1	2	3	4	5	6	**7**	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	bbb-	**bb+**	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of September 17, 2019)*

Banco do Estado do Rio Grande do Sul S.A.	
Issuer Credit Rating	BB-/Stable/--
Brazil National Scale	brAA+/Positive/--
Issuer Credit Ratings History	
24-Aug-2018	BB-/Stable/--
16-Aug-2017	BB-/Negative/--
23-May-2017	BB-/Watch Neg/--
11-Jul-2016	BB-/Negative/--
14-Jun-2016	BB/Watch Neg/--

Ratings Detail (As Of September 17, 2019)*(cont.)		
14-Mar-2016		BB/Negative/--
17-Feb-2016		BB/Watch Neg/--
10-Sep-2015		BB+/Negative/--
28-Jul-2015		BBB-/Negative/--
18-Mar-2019	*Brazil National Scale*	brAA+/Positive/--
24-Aug-2018		brAA+/Stable/--
11-Jul-2018		brAA+/Negative/--
16-Aug-2017		brA+/Negative/--
23-May-2017		brA-/Watch Neg/--
11-Jul-2016		brA-/Negative/--
14-Jun-2016		brA+/Watch Neg/--
14-Mar-2016		brA+/Negative/--
17-Feb-2016		brAA-/Watch Neg/--
10-Sep-2015		brAA/Negative/--
28-Jul-2015		brAAA/Negative/--
Sovereign Rating		
Brazil		BB-/Stable/B
Brazil National Scale		brAAA/Stable/--

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.