MOODY'S INVESTORS SERVICE

CREDIT OPINION
22 January 2020

Update

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RATINGS

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

Domicile	Porto Alegre, Rio Grande do Sul, Brazil
Long Term CRR	Ba2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	Ba3
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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

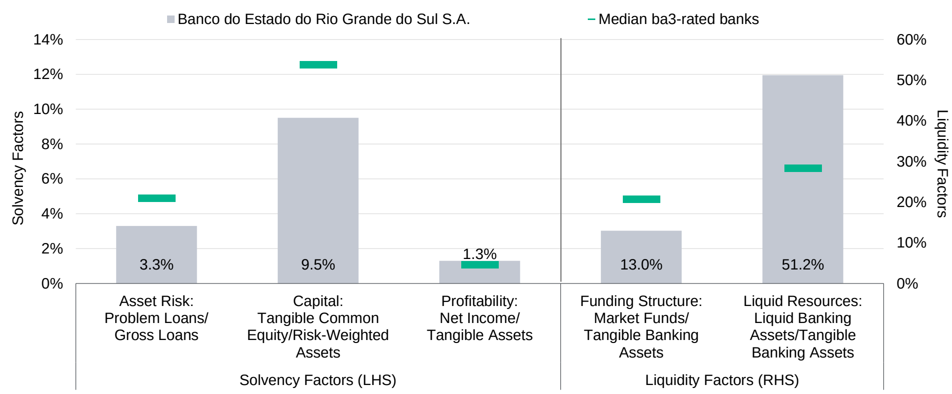
Update following rating affirmation

Summary

Banco do Estado do Rio Grande do Sul S.A. (Banrisul) has a Baseline Credit Assessment (BCA) of ba3, which reflects the bank's challenged asset risk and profitability, adequate capitalization, as well as its funding structure, which is predominantly made up of low-cost deposits. It also incorporates Banrisul's strong regional franchise, whereby a relevant share of its deposits and operations are based within the state of Rio Grande do Sul, which, however, remains under significant fiscal distress. Banrisul is controlled by the state government of Rio Grande do Sul.

On 16 January 2020, we affirmed Banrisul's ratings and assessments. The deposit ratings of Ba3 are based on the bank's BCA of ba3 and do not receive any uplift derived from affiliate or government support. The A1.br Brazilian national scale deposit rating assigned to Banrisul is positioned at the top of the range of the available options for Ba3-rated issuers in Brazil (Ba2 stable). The ratings carry a stable outlook.

Exhibit 1
Rating Scorecard - Key financial ratios



Source: Moody's Investors Service

Credit strengths

» Stable low-cost core deposit funding, which is attributable to its leading regional franchise

» Ample liquid assets, which are largely invested in sovereign bonds

» Improving profitability because of higher payroll lending growth in a low interest rate environment

Credit challenges

» High regional concentration and correlation

» Profitability challenges stemming from stronger competition and the low interest rate environment in Brazil

» The bank's limited flexibility in reducing operating costs to counter margin pressures or to invest in products and technology, which is reflected by its cost-to-income ratio of 59.5% as of September 2019, nearly 900 basis points higher than that of the other Brazilian banks we rate

Outlook

Banrisul's ratings have a stable outlook, reflecting our view that the trajectory of the bank's solvency over the next 12-18 months will be in line with the Ba3 rating.

Factors that could lead to an upgrade

» Banrisul's ratings could be upgraded if its asset quality improves significantly, combined with a sustained rise in its recurring profitability and capitalization.

Factors that could lead to a downgrade

» Greater-than-expected increases in asset risk and profitability, and further declines in adjusted capitalization would all strain the rating.

Key indicators

Exhibit 2

Banco do Estado do Rio Grande do Sul S.A. (Consolidated Financials) [1]

	09-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (BRL Billion)	80.6	77.4	73.3	69.0	66.9	5.1[4]
Total Assets (USD Billion)	19.4	20.0	22.1	21.2	16.9	3.7[4]
Tangible Common Equity (BRL Billion)	6.0	5.3	5.1	4.5	5.9	0.7[4]
Tangible Common Equity (USD Billion)	1.4	1.4	1.5	1.4	1.5	(0.7)[4]
Problem Loans / Gross Loans (%)	2.5	2.2	3.6	5.0	4.3	3.5[5]
Tangible Common Equity / Risk Weighted Assets (%)	9.5	8.8	8.2	7.6	9.8	8.8[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	9.9	9.3	14.2	21.3	17.0	14.3[5]
Net Interest Margin (%)	7.3	8.0	7.8	8.1	7.3	7.7[5]
PPI / Average RWA (%)	5.0	5.0	5.0	4.6	5.1	4.9[6]
Net Income / Tangible Assets (%)	1.6	1.4	1.5	1.0	1.3	1.3[5]
Cost / Income Ratio (%)	59.5	60.7	58.1	62.4	60.2	60.2[5]
Market Funds / Tangible Banking Assets (%)	14.0	13.0	14.9	18.0	22.7	16.5[5]
Liquid Banking Assets / Tangible Banking Assets (%)	51.4	51.2	26.0	51.1	43.5	44.6[5]
Gross Loans / Due to Customers (%)	67.1	67.1	66.8	71.9	84.3	71.5[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel III - fully-loaded or transitional phase-in; LOCAL GAAP. [3] May include rounding differences due to scale of reported amounts. [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel III periods presented.

Sources: Moody's Investors Service and company filings

Profile

Banco do Estado do Rio Grande do Sul S.A. (Banrisul) is a multiple-service bank controlled by the government of the Brazilian state of Rio Grande do Sul, which holds 49.39% of its stock. Although the bank has operations across Brazil, its presence is concentrated in the country's southern region, primarily in the state of Rio Grande do Sul. As of June 2019, Banrisul had market shares of 48.4% in terms of time deposits, 13.1% in terms of savings, 27.9% in terms of demand deposits and 19.2% in terms of loans in Rio Grande do Sul. As of 30 September 2019, the bank reported a consolidated asset base of BRL80.6 billion.

Detailed credit considerations

Weakened asset risk, compounded by regional concentration, to benefit from greater payroll focus

Banrisul's Asset Risk score of b1 reflects the loan book's regional concentration and the historical negative pressure from the corporate portfolio, particularly on the bank's small and medium-sized enterprise and unsecured consumer loan books.

Banrisul's 90-day problem loan ratio in the third quarter of 2019 of 2.8% was almost 70 basis points higher than the level a quarter earlier. The rise was largely because of a spike in Banrisul's corporate loan book, which has historically been the main source of asset risk in the bank's balance sheet. Riskier loans accounted for a sizable 8.9% of total loans in Q3 2019, while the flow of renegotiated loans in the 12 months ended September 2019 was 2.8% of the total loan book. Reserves comfortably cover problem loans, at a rate of 276.4% in September 2019, but the deterioration in the corporate book led to a significant decline in reserves in the quarter. In response to weakening corporate asset quality, Banrisul has increased its focus on secured payroll lending, which now accounts for 45% of its total loan book and should help mitigate further asset-quality deterioration. Nevertheless, we expect Banrisul to continue to face asset-quality challenges as it manages its problem loan exposures and its regional concentration in the state of Rio Grande do Sul.

Good capitalization buffers to absorb unexpected losses

Banrisul's capitalization, which we measure as tangible common equity/risk-weighted assets, was 9.5% as of September 2019, up only modestly from a year earlier. This ratio takes into consideration the standard adjustments related to risk-weighted assets, which include a higher risk factor of 100% on the Brazilian government securities portfolio.

On a regulatory basis, Banrisul's Common Equity Tier 1 capital ratio stood at 14.9% in September 2019 and total capital was at 16.2%, well above the regulatory minimums of 7% and 10.5%, respectively.

The bank's capitalization is yet to return to levels before its 2016 acquisition of the right to provide payroll services for state employees for BRL1.25 billion from the state of Rio Grande do Sul, which reduced its capitalization by over 200 basis points. In Q4 2018, Banrisul also made a one-off cash dividend payout to its shareholders in lieu of an IPO of its card division, Banrisul Cartoes S.A., which reduced its capitalization by 70 basis points.

Portfolio shift to counter legacy profitability pressure from high credit costs, intangible amortizations

We score Banrisul's Profitability at ba3, a score that has improved in recent years, benefitting from the bank's focus on secured payroll lending and its low cost of funding thanks to its high share of low-cost deposits, which accounted for almost 90% of its total funding.

As of September 2019, Banrisul's adjusted net income-to-tangible assets ratio was 1.3%. With competitive pressures rising in Brazil's low interest rate environment, Banrisul will find it hard to maintain its current profitability levels without significant growth, particularly if it continues to face high credit costs. Although the bank's fee-based business from the insurance and credit card payment divisions continues to perform well, the fierce competition expected in 2020 will constrain revenue generation.

In addition, because Banrisul is a state-owned bank, its efficiency lags that of its private peers, with its cost-to-income ratio of 59.5% as of September 2019 being nearly 900 basis points higher than that of the other Brazilian banks we rate, reflecting its limited flexibility in reducing operating costs to counter margin pressures or to invest in products and technology, in line with that of its peers.

Strong funding and liquidity reflect its leading regional franchise

The baa3 score for Combined Liquidity is a key credit strength and reflects Banrisul's low reliance on market funds, stable core deposit funding base and high levels of liquid assets, which together reflect its entrenched retail banking franchise in the regional market. As of September 2019, market funds represented 14% of its tangible banking assets and were backed by liquid assets that accounted for 51.4% of its tangible banking assets.

Deposits continue to represent a major portion of the bank's funding base, with granular customer deposits forming more than 80% of it as of September 2019. This funding base has been historically stable, supported by the bank's extensive footprint in the state, contributing to its low-cost funding structure compared with that of banks of a similar size. Banrisul's issuance of bank notes (letras financeiras) and domestic onlending from both federal and regional development banks (mainly Banco Nac. Desenv. Economico e Social - BNDES [Ba2 stable, ba2]) have helped the bank diversify its funding to some extent, and accounted for around 9% of its funding in September 2019.

As a result of its regional franchise, Banrisul is considered a safe haven for depositors in the state of Rio Grande do Sul, and we expect the bank's deposit funding to remain stable.

Banrisul's rating is supported by Brazil's Moderate- Macro Profile

The Moderate- Macro Profile for Brazil reflects the large scale and diversification of the country's economy, strong international reserves and the improved effectiveness of its monetary policy. However, the economic rebound that started in 2017 after two years of economic contraction has been low, reflecting the political uncertainties surrounding policy continuity beyond 2019. We expect economic growth to remain moderate in 2019, which will support modest lending growth in the next 12 months on the back of low interest rates and inflation, which improve borrowers' repayment capacity. Asset quality is likely to remain stable, with no pressure on funding needs. The slowdown in government-owned banks' lending has reduced market distortions.

Environmental, social and governance considerations

Banrisul's exposure to Environmental risks is low, consistent with our general assessment for the global banking sector. See our environmental risk heat maps for further information.

Overall, we believe banks face moderate social risks. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which are partly mitigated by sizable technology investments and banks’ long track record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct are also a social risk. Social trends are also relevant in a number of areas, such as shifting customer preferences toward digital banking services increasing information technology costs, aging population concerns in several countries hurting the demand for financial services or socially driven policy agendas that may translate into regulations that affect banks’ revenue base. See our social risk heat map for further information.

Governance is highly relevant for Banrisul, as it is to all participants in the banking industry. Corporate governance weaknesses can lead to a deterioration in a bank's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven, and for Banrisul, we do not have any particular governance concerns. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Additional notching guidelines

In the absence of a bail-in resolution regime framework in Brazil, the ratings of subordinated debts, bank hybrids and contingent capital securities follow the "Additional Notching Guidelines," as per the Banks methodology. In these cases, the approach takes into account other features specific to debt classes, resulting in additional notching from the Adjusted BCA of the issuer.

Government support

We believe there is a low likelihood of government support for Banrisul's ratings, which reflects the bank's small share of deposits and assets in Brazil's banking system.

Counterparty Risk (CR) Assessment

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than both the likelihood of default and the expected financial loss suffered in the event of default, and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (for example, swaps), letters of credit, guarantees and liquidity facilities.

Banrisul's CR Assessment is positioned at Ba2(CR)/Not Prime(CR)

The CR Assessment of Ba2(cr) is one notch above the Adjusted BCA of ba3 based on our view that senior obligations represented by the CR Assessment will be more likely preserved than senior unsecured debt to minimize losses, avoid disruption of critical functions and limit contagion. This CR Assessment reflects an issuer's probability of defaulting on certain operating liabilities and other contractual commitments that are less likely to be subject to the application of a resolution tool to ensure the continuity of operations.

Methodology and scorecard

About Moody's Bank Scorecard

Our scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 3

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

Macro Factors							
Weighted Macro Profile	**Moderate -**	**100%**					

Factor	**Historic Ratio**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	3.3%	ba1	←→	b1	Geographical concentration	Long-run loss performance
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel III - transitional phase-in)	9.5%	b1	←→	b3	Capital fungibility	
Profitability						
Net Income / Tangible Assets	1.3%	baa3	←→	ba3	Expected trend	
Combined Solvency Score		ba2		b2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	13.0%	baa3	↓	ba1	Deposit quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	51.2%	baa1	↓	baa2	Stock of liquid assets	Expected trend
Combined Liquidity Score		baa2		baa3		
Financial Profile				ba3		
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				Ba2		
BCA Scorecard-indicated Outcome - Range				ba2 - b1		
Assigned BCA				ba3		
Affiliate Support notching				0		
Adjusted BCA				ba3		

Instrument Class	**Loss Given Failure notching**	**Additional notching**	**Preliminary Rating Assessment**	**Government Support notching**	**Local Currency Rating**	**Foreign Currency Rating**
Counterparty Risk Rating	1	0	ba2	0	Ba2	Ba2
Counterparty Risk Assessment	1	0	ba2 (cr)	0	Ba2(cr)	
Deposits	0	0	ba3	0	Ba3	Ba3
Dated subordinated bank debt	-1	0	b1	0		B1

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
BANCO DO ESTADO DO RIO GRANDE DO SUL S.A.	
Outlook	Stable
Counterparty Risk Rating	Ba2/NP
Bank Deposits	Ba3/NP
NSR Bank Deposits	A1.br/BR-1
Baseline Credit Assessment	ba3
Adjusted Baseline Credit Assessment	ba3
Counterparty Risk Assessment	Ba2(cr)/NP(cr)
Subordinate	B1

Source: Moody's Investors Service

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